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Higher Education Changes Affecting Borrower Defense Rules and Financial Responsibility Standards

By Christopher DuKate, Principal

In September 2019, the United States Department of Education (ED) finalized updates to the borrower defense rules aimed at protecting student borrowers. These rules also updated the financial responsibility standards, due in large part to new accounting guidance that was recently adopted or is pending adoption.

These updated regulations will require an additional supplemental schedule in higher education institutions' audited financial statements. They also change how the financial responsibility scores are calculated. Here's what your institution needs to know.

Updates to Borrower Defense Rules

Under the new borrower defense rules, there are four types of triggers an institution must evaluate. However, only two are applicable to nonprofit institutions that receive Title IV funding:

1. Liabilities arising from settlement, final judgment from a court, or a final determination arising from an administrative action or proceeding initiated by a federal or state entity.
2. For the current fiscal year, when two or more of the following "discretionary" triggers occur, those events automatically become mandatory triggering events:
    - Actions taken against an institution by an accrediting agency, including unsatisfied show-cause orders that could lead to the withdrawal, revocation, or suspension of institutional accreditation.
    - Violation of security or loan agreements with creditors.
    - Citations by state licensing or authorizing agencies for violations of state or agency agreements that may prompt the withdrawal or termination of licensure or authorization.
    - High annual dropout rates as calculated by the ED.
    - The institution's two most recent official cohort default rates are 30 percent or greater, unless:
        - The institution files a challenge, request for adjustment, or appeal under that subpart with respect to its rates for one or both of those fiscal years; and
        - That challenge, request, or appeal remains pending, results in reducing below 30% of the official cohort default rate for either or both of those years, or precludes the rates from either or both years resulting in a loss of eligibility or provisional certification.

When an event occurs that causes a trigger, the institution is required to notify the ED (generally within 10 days of the event occurring) and the financial score will be recalculated. For more in-depth information, refer to NACUBO Advisory 19-04, *Financial Responsibility Standards*.

Key takeaway: The final 2019 triggering event went into effect on July 1, 2020. Institutions that submit Uniform Guidance (UG) reporting to the ED will need to apply the revised Financial Responsibility Standards to that reporting. All Title IV receiving institutions should implement a plan to ensure they are actively monitoring and reporting events that may result in a trigger. In situations where triggers are likely to occur, it's critical for leadership to perform further analysis of the event's impact on the financial responsibility score.

Financial Responsibility Scores

The ED has historically considered three primary ratios to determine the "financial health" of a higher education institution. These three ratios — primary reserve, equity, and net income — were combined into one overall calculation, the composite score, which is calculated annually to assess the financial responsibility of the institution.

The ED has updated the terminology used in the ratio calculations to reflect the impact of two new accounting standards updates, Accounting Standards Update (ASU) 2016-14, *Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities* and ASU 2016-02, *Leases.* The ED also updated other terminology and definitions in the calculation to provide clarity in practice.

The major changes to the financial responsibility scores include:

- An update of the applicable terminology for the new accounting standards and a resulting update to the calculation for the ratios.
- Additional clarification that allows the concept of "grandfathering" existing leases issued before ASU 2016-02 to be included in the calculation of expendable net assets when the financial responsibility score is calculated.
- A requirement to include a supplemental schedule in the audited financial statements. This schedule will need to disclose each of the financial statement amounts to be included in the calculation and a cross-reference to where that amount is disclosed in the financial statements.
- Clarification on how to define the term "debt obtained for long-term purposes."

Key takeaways: All institutions must be aware of the updates to the financial score calculations. It is critical for your institution to evaluate the potential impact of the above on the final score and whether or not you should take advantage of the grandfathering provision options available.

Additionally, the regulations allow for "pre-implementation" debt to be used in the calculation of expendable net assets in the primary reserve ratio calculation, up to the amount of net property, plant, and equipment. Subsequently, all long-term debt used in the calculation must be used for acquisition of capital investments. Debt for operating purposes will not be included as debt-obtained for long-term purposes for inclusion in the calculation of expendable net assets.

Audit Impact

We recommend that institutions reach out to their auditors now to evaluate and assess the potential effect of these changes on their financial responsibility ratio scores, financial statements, and the audit. The new accounting standards are reshaping many disclosures and reporting requirements for the financial statements of higher education institutions, and consequently have impacted the regulations that the ED uses to evaluate and interpret financial stability. The time to discuss these changes is now, as many institutions are currently working through the draft reporting phase of the audit.

These changes will result in additional time needed to prepare and audit fiscal year 2020 financial statements. Auditors are likely performing additional procedures to gain comfort on expressing an opinion on the required supplemental information as well as the potential of additional disclosures. Items that have not previously been considered a material item for disclosure may now require additional scrutiny by your audit firm, which will require an additional investment on the part of your institution in complying with preparing and providing requests.

You can watch a recorded webcast on this topic on our website.

If you have any questions about these changes or other higher education issues, please contact us. Our team of higher education audit, advisory, and tax professionals can help provide the insight and support you need.

This article has been updated.

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About the Author

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Chris has more than 14 years of experience providing auditing, accounting, and consulting services for nonprofit and higher education clients. He has worked extensively with a variety of nonprofit clients, including social service organizations, foundations, museums, sport and membership associations, and colleges and universities. Chris has significant experience performing audits in accordance with Uniform Guidance and has led many consulting projects in both the nonprofit and governmental industries.

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