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From: [redacted]
Sent: Tuesday, June 23, 2009 3:57 PM
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Subject: Written Testimony on Financial Responsibility Standards from NACUBO
Attachments: NACUBO Testimony on Financial Responsibility.docx

Please see the attached testimony from the National Association of College and University Business Officers.

[redacted]

WRITTEN TESTIMONY

ON BEHALF OF THE

NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS

SUBMITTED TO THE U.S. DEPARTMENT OF EDUCATION

IN CONJUNCTION WITH REGIONAL PUBLIC HEARINGS

JUNE 2009

The National Association of College and University Business Officers (NACUBO) is pleased to be able to submit these comments as part of your effort to collect information from higher education institutions and organizations around the country. NACUBO recommends that the Department of Education (ED) consider revisiting the assumptions and financial drivers used in the Title IV Financial Responsibility Standards under Subpart L of 34 CFR 668. Institutions that participate in the Title IV federal student financial assistance programs must pass a test of financial strength that is assessed based on three ratios: primary reserve, equity, and net income. NACUBO agrees with the principle that institutions must demonstrate financial strength to effectively operate and educate students. However, we are concerned that the current financial responsibility test lacks the flexibility needed to accommodate extraordinary market downturns and other atypical financial events (e.g. gains and losses associated with the issuance, restructuring, and extinguishment of debt; extraordinary losses from unusual or infrequently occurring events; asset impairments; changes in accounting standards).

BACKGROUND

In 1995, ED contracted with KPMG [redacted], well-known for its work on ratio analysis in higher education, to develop a methodology that ED could use to better judge the financial health of institutions participating in the Title IV programs. KPMG analyzed the financials statements of close to 400 institutions. Several business officers recommended by NACUBO served as members of a review panel for the KPMG project. The ratio analysis methodology proposed by ED in September 1996, and modified in final regulations issued in November 1997, is based on the results of the KPMG effort.

The methodology is based on three ratios—primary reserve, equity, and net income—that measure different aspects of financial health. All are designed to be calculated based on information readily available from audited financial statements. The regulations require that each institution's calculated ratio be converted to strength factors and combined into a composite score. The ratios are combined into a composite so that strengths in one area can offset weaknesses in another.

CONCERNS

Although the current financial responsibility hurdle relies on a blended test so that strengths in one area can offset weaknesses in another, we are concerned that at least one of the current ratios lacks the flexibility needed to accommodate extraordinary events.

When the methodology was originally designed, in the mid 1990s, the financial reporting model for independent not-for-profit institutions was in transition. One of the often debated issues by the mid-1990s review team was how a declining stock market might impact an institution's net assets. At the time, there was less than definitive guidance from the Financial Accounting Standards Board (FASB) concerning the impact of endowment and investment losses on the then new unrestricted net asset class. Even more unclear was the financial reporting categorization of non-recurring or atypical items. Such items affect the change in unrestricted net assets, which in turn has an effect on expendable net assets and both the primary reserve and net income ratios. Categorizing such items as non-operating and basing these ratios on an institution's operating results can strengthen both of these ratios.

In the fall of 2008, an economic downturn, unlike any experienced for decades, caused severe declines in the stock market and turmoil in the credit markets. For independent nonprofit institutions, endowment investment holdings and credit arrangements dramatically changed. Investment portfolio values have declined dramatically, the cost of borrowing has increased, and debt recalls have resulted in new debt issuance costs. Such extraordinary items will dramatically impact unrestricted net assets and consequently expendable net assets. Expendable net assets are a key component of the net income and primary reserve ratios.

In August 2008, FASB issued FASB Staff Position (FSP) FAS 117-1, "Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), and Enhanced Disclosures for All Endowment Funds." The FSP applies to not-for-profit independent institutions with donor-restricted endowment funds. The FSP is effective for fiscal 2009 and will result in significant net asset category reclassifications for independent institutions in UPMIFA states. Currently 35 states and the District of Columbia have passed a version of UPMIFA. Consequently, we expect to see sizable reclassifications of endowment assets from unrestricted net assets to temporarily restricted net assets. Such reclassifications will affect the net income and primary reserve ratios.

NACUBO is concerned that as the economic downturn and accounting changes impact college and university financial statements, many more institutions will be identified as financially unsound when they really have the wherewithal to weather the storm and are fully capable of continuing to carry out their mission. Further, due to the constriction in credit markets, the letter of credit remedy is difficult to procure and much more expensive than in the past.

Recommendations

NACUBO would like to work with ED, national and regional accounting firms, and institutional representatives over the next two months to develop recommendations for modifications to the Financial Responsibility Standards. We believe that the proposed negotiated rulemaking committee on program integrity would be an appropriate venue to consider such changes.

Thank you for the opportunity to address this issue. Please contact us at [redacted] or by telephone at [redacted] if you have any questions.

Respectfully submitted,

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