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SUMMARY: This letter explains the Department of Education's calculations of certain ratios that are used to determine whether institutions demonstrate financial responsibility under the regulations in Subpart L of 34 CFR 668.

Dear Colleague:

The Department annually calculates financial ratios for each institution participating in the student financial aid programs authorized by the Higher Education Act of 1965, as amended. Institutions provide the information that is used to perform these calculations in their required annual financial statement audits. The Department, in turn, uses these ratios to determine whether an institution demonstrates financial responsibility under the regulations.

As described in §668.172(b) and Appendices F and G to §668, the Department calculates three financial ratios: primary reserve, equity, and net income. These three ratios are combined to produce a composite score. The minimum composite score for an institution to demonstrate financial responsibility is 1.5. If an institution's composite score is less than 1.5, the Department informs the institution of its calculated score and asks the institution to comply with the alternative financial responsibility requirements that are described in §668.175.

Some institutions have questioned the Department's calculation of the primary reserve ratio that allows the inclusion of "debt obtained for long-term purposes." Specifically, a limited amount of debt obtained for long-term purposes can be included in the numerator of the primary reserve ratio. Of particular interest to some institutions is whether debt obtained for long-term purposes may include any or all long-term debt reported on an institution's audited financial statement.

In order to be included in the primary reserve ratio calculation, an institution must be able to show that the long-term debt was related to its "long-term purposes" as demonstrated by investment in the institution's Plant, Property, and Equipment (PP&E). A more complete explanation follows.

The primary reserve ratio measures an institution's expendable resources as one indicator of its overall financial health. It is both a reasonable measure of financial viability and a broad measure of the liquidity of an institution. Because this ratio measures an institution's expendable resources within the context of its operating size, it is a measure of relative wealth or wealth against commitments of the institution. In other words, it is a measure of an institution's margin against adversity.

Typically, primary reserve ratios exclude PP&E and provide no credit for the debt related to their acquisition. The rationale for excluding PP&E in this context is that the primary reserve ratio is a measure of expendable resources. The primary reserve ratio, then, is not a measure of equity. PP&E is neither liquid nor expendable. If an institution must liquidate its PP&E to meet its current operating expenses, it is in extremely poor financial health.

However, in the proposed regulations for measuring an institution's financial responsibility using three financial ratios, the Department proposed removing all “plant debt” from the primary reserve ratio calculation. See 61 FR 49554. However, several commenters felt that the proposed regulation, if adopted, would discourage institutions from making long-term investments to their capital structures because such funds would not be counted in the primary reserve ratio. The Department agreed and consequently published a final regulation that includes in the primary reserve ratio calculation that portion of long-term debt that had been assumed by an institution in acquiring PP&E. This is shown in Appendices F and G where the type of long-term debt that could be counted in the primary reserve ratio is described as “debt obtained for long-term purposes.” The Appendices also show the relationship between debt and PP&E because the debt cannot exceed the net amount of PP&E.

Under the regulation, the primary reserve ratio calculation includes any long-term debt that resulted from acquiring assets through a capital lease, and any note payable where the proceeds of the note were used to acquire PP&E. Specifically, the calculations set out in Appendices F and G provide that "the value of plant, property and equipment is net of accumulated depreciation, including capitalized lease assets." In a capital lease transaction, ownership of the asset passes to the lessee upon signing the lease. Capital leases are unlike operational leases in part because in an operational lease ownership does not pass to the lessee, and the asset must be returned to the lessor at the end of the lease period. The debt that should be included in the primary reserve ratio calculation as part of an institution's adjusted equity must be related to PP&E the institution has acquired for long-term purposes. The formula also limits the amount of debt for long-term purposes so that it cannot exceed the net amount of PP&E. Other long-term debts owed by an institution should be excluded from the calculation if they do not meet this requirement.

In conclusion, “debt obtained for long-term purposes” is not the equivalent of any “long-term debt.” Consequently, debt that is included in the primary reserve ratio must be associated with investments in an institution's PP&E. Other long-term debts that do not represent investments in PP&E are not considered to be “debt obtained for long-term purposes" under the regulations, and may not be included in the ratio calculation.

If you have any questions about this letter, please contact Dan Madzelan of my staff at (202) 502-7816.

Sincerely,

Lee Fritschler
Assistant Secretary for
Postsecondary Education