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Report to Congressional Requesters

August 2017

HIGHER EDUCATION

Education Should Address Oversight and Communication Gaps in Its Monitoring of the Financial Condition of Schools

Accessible Version

GAO-17-555

GAO Highlights

Highlights of GAO-17-555, a report to congressional requesters

Why GAO Did This Study

Education oversees the financial condition of about 6,000 postsecondary schools whose students received $125 billion in federal student aid in fiscal year 2016. With the recent closures of several large schools, GAO was asked to review Education's financial oversight of schools.

This report examines (1) how Education oversees the financial condition of schools; (2) the extent to which Education's oversight has been effective at identifying schools at risk of closure; and (3) the extent to which Education informs schools and the public about its financial oversight. GAO analyzed the most recent Education data on school closures and finances since school year 2010-11 (through 2015-16 for closures, 2014-15 for composite scores, and 2013-14 for letters of credit); examined federal laws, regulations, and guidance; reviewed accounting standards and industry practices; and interviewed Education officials, experts in school finance, and administrators at 10 schools in a nongeneralizable sample selected for variation in financial condition, enrollment, and ownership.

What GAO Recommends

GAO recommends that Education (1) update the financial composite score to better measure schools' financial conditions, (2) improve its guidance to schools on how it calculates the composite score, and (3) provide public data on final composite scores for all schools. Education disagreed with the first recommendation, agreed with the second, and will further evaluate the third. GAO continues to believe these recommendations are valid, as discussed in the report.

View GAO-17-555. For more information, contact Melissa Emrey-Arras at (617) 788-0534 or emreyarrasm@gao.gov.

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Education Should Address Oversight And Communication Gaps In Its Monitoring Of The Financial Condition Of Schools

What GAO Found

The Department of Education (Education) reviews the annual audits of postsecondary schools to assess compliance with financial responsibility standards for schools that participate in federal student aid programs and increases its oversight of schools that do not meet these standards. In school year 2014-15, Education reviews found that about 450 of approximately 6,000 schools that participate in federal student aid programs did not receive a passing financial composite score (a measure of schools' financial health). Education may secure financial assurances from schools that do not meet the standards, in the form of a letter of credit, to help cover federal costs if a school closes and students become eligible to have their federal student loans forgiven. Education has also taken steps to expand its oversight of certain large schools and companies that own multiple schools through more frequent monitoring and additional reporting requirements.

School closures are relatively rare, but limitations of Education's composite score hamper its effectiveness at identifying at-risk schools. About 95 schools closed in school year 2015-16, according to Education data. The vast majority of closures in the past 5 years were small schools (less than 500 students), but recent closures of several large schools affected thousands of students and resulted in over half a billion dollars in federal losses from unrepaid student loans. The composite score has been an imprecise risk measure, predicting only half of closures since school year 2010-11, although schools can close for nonfinancial reasons as well. GAO identified three key limitations of the composite score:

- **Accounting changes**: It does not reflect updates in accounting practices.
- **Outdated financial measures**: It does not incorporate new financial metrics that would provide a broader indication of schools' financial health, such as liquidity, historical trend analysis, or future projections.
- **Vulnerability to manipulation**: It allows some schools to take advantage of a feature of the composite score calculation to inflate their scores by taking out loans, thereby avoiding requirements to post letters of credit.

Despite these limitations, Education has not updated the composite score since it was first established 20 years ago. Identifying and responding to risks is a key component of federal internal control standards, and Education's failure to update its key financial measure makes it harder for Education to identify and manage schools at risk of closure.

Education does not fully explain to schools key aspects of its financial oversight nor does it disclose complete results to the public. Effective communication is a key principle of federal internal control standards. However, Education's guidance to schools does not sufficiently detail how it calculates the composite score; administrators GAO interviewed at 7 of 10 selected schools expressed confusion about their scores' calculations. Schools that are unable to accurately estimate their scores may not be able to effectively plan for the costs of obtaining a letter of credit. Further, the most recent composite scores publicly released by Education left out 17 percent of schools, whose students received over $8 billion in federal student aid. As a result, students do not have access to available information on whether their schools are financially sound so they may confidently invest their time and money.

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Abbreviations

Corinthian	Corinthian Colleges Inc.
Education	Department of Education
ITT	ITT Educational Services Inc.
FASB	Financial Accounting Standards Board
Multi-regional Division	Multi-regional and Foreign Schools Participation Division
SEC	Securities and Exchange Commission

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
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August 21, 2017

The Honorable Rosa DeLauro
Ranking Member
Subcommittee on Labor, Health and Human Services,
Education, and Related Agencies
Committee on Appropriations
House of Representatives

The Honorable Richard Durbin
United States Senate

The Honorable Brian Schatz
United States Senate

Approximately 13 million students and their families in the United States rely on federal student aid programs to help them achieve their higher education goals.[1] The Department of Education (Education) administers these federal student aid programs, which provided $125 billion in assistance to eligible students in fiscal year 2016. However, the recent closures of several large postsecondary schools have interrupted the education of tens of thousands of students, leaving them unsure of how to complete their education and placing the federal government at risk for millions of dollars in unrepaid student loans. To help guard against these events, Education monitors the financial condition of about 6,000 schools that participate in federal student aid programs.[2] Education monitors the financial health of these schools on an annual basis to determine if they are financially responsible and able to fulfill their obligations. When it identifies financial concerns, it can implement additional oversight to protect against potential losses to the federal government that could result if the school were to close, since students affected by a school

[1] For this report, we define federal student aid programs as financial aid programs authorized under Title IV of the Higher Education Act of 1965, as amended (Higher Education Act) (codified at 20 U.S.C. §§ 1070-1099d).

[2] In order to participate in federal student aid programs, schools must meet the Higher Education Act's definition of an institution of higher education and comply with other requirements, including those related to financial responsibility. In this we report we use the term "school" to refer to a domestic institution of higher education that has participated or is currently participating in federal student aid programs.

closure may be eligible to have their federal student loans forgiven. For example, Education reported that the 2015 closure of Corinthian Colleges has already resulted in over $550 million in loan relief, with that amount expected to climb. In light of these issues, you asked us to review Education's financial oversight of schools that participate in federal student aid programs.

This report examines (1) how Education oversees the financial condition of schools; (2) the extent to which Education's oversight has been effective at identifying schools at risk of closure; and (3) the extent to which Education informs schools and the public about its oversight of the financial condition of schools.

To address these questions, we conducted our review of Education's financial oversight of schools using the following approaches:

- To determine how Education oversees the financial condition of schools, we analyzed Education's data on schools' financial responsibility composite scores (a measure of schools' financial health) and Education's additional oversight of schools not meeting federal financial responsibility standards for participating in federal student aid programs from school years 2010-11 through 2014-15, the most recent year of data available.[3] We also analyzed Education data on schools that were required to provide a letter of credit to the department due to financial concerns for school years 2010-11 through 2013-14, the most recent year of data available. We assessed the reliability of these data by reviewing Education's data systems and documentation, tracing 40 randomly drawn records back to the source documents, and interviewing Education officials, and we determined that the data were sufficiently reliable for our reporting purposes. To examine Education's oversight processes, we reviewed relevant federal laws, regulations, and policy guidance on the financial responsibility standards for schools that participate in federal student aid programs. We also interviewed Education officials in a nongeneralizable selection of three regional offices with responsibility for monitoring schools' finances.[4]

[3] In this report we use school year to refer to the "award year" as defined in the Higher Education Act; the 12-month period that begins on July 1 of one year and ends on June 30 of the following year.

[4] We selected these regional offices to reflect a range in office caseloads, the types of schools they oversee, and geographic diversity.

- To assess the effectiveness of Education's oversight, we analyzed 10 years of Education's data on school closures from school year 2006-07 to 2015-16, with more detailed analysis of closures since school year 2010-2011. We assessed the reliability of these data by reviewing Education's data system and checking the data for completeness against news reports of school closures, and we determined that the data were sufficiently reliable for our reporting purposes. To assess the composite score and identify any potential limitations, we reviewed the composite score formula and compared it to Financial Accounting Standards Board standards, industry practices, and practices identified in previous GAO reports on financial risk assessments.[5] Additionally, we assessed Education's composite score against government standards for internal controls for identifying and responding to risks. We also interviewed experts in higher education finance and accounting, officials from the two largest credit rating agencies, and representatives from four higher education associations.[6] While they provided their perspectives, the views from these experts and representatives are not generalizable.
- To determine the extent to which Education communicates with schools and the public about its financial oversight, we examined Education's guidance to schools and its annual public disclosure of schools' financial composite scores for school year 2014-15. We also interviewed officials at 10 schools about their experiences with Education's financial oversight and calculation of the financial composite score. We selected this nongeneralizable sample based on a range of criteria, including school financial responsibility composite score, enrollment size, and ownership type (nonprofit and for-profit).[7] While these interviews cannot be generalized to the larger school population, they reflect the types of experiences schools may have

[5] The Financial Accounting Standards Board is an independent, private nonprofit organization that establishes financial accounting and reporting standards for public and private companies and nonprofit organizations that follow generally accepted accounting principles.

[6] We selected these four higher education associations because of their expertise and knowledge of school finances and the federal financial responsibility standards for schools participating in federal student aid programs. We also included associations representing both nonprofit and for-profit schools.

[7] We also included schools owned by publicly traded companies and private equity firms. We did not interview officials at public schools because Education generally does not calculate a composite score for these schools. Instead, public schools are required to demonstrate that their liabilities are backed by the full faith and credit of a state or other government entity, among other requirements.

with Education’s financial oversight. We also interviewed Education officials about their policies and procedures and asked Education officials we interviewed from the regional offices about the guidance they provide to schools. We assessed Education’s actions against federal internal control standards for communicating with external parties.

We conducted this performance audit from December 2015 to August 2017 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

In order to participate in federal student aid programs (which provide federal loans, grants, and other aid to eligible students) authorized under Title IV of the Higher Education Act, schools must demonstrate that they are financially responsible, based on criteria and processes established in

Loan Discharges for School Closures

Students who attended a school that closed may be eligible to have the full balance of their outstanding federal student loans discharged if they are unable to complete their program of study due to the closure of the school. A loan discharge relieves the borrower from having to repay his or her loan. These students are also eligible to be reimbursed for any amounts previously paid on those loans. To be eligible, students generally must (1) have been enrolled when the school closed or withdrew no more than 120 days before the school's closing date, and (2) not have completed the program of study at another school (e.g., by transferring credits earned at the closed school to another school).

Source: GAO analysis of Department of Education documents. | GAO-17-555

federal law and regulations.[8] Education's Office of Federal Student Aid conducts annual reviews of schools' financial conditions as part of the department's commitment to ensuring institutional accountability and protecting federal interests.[9] Education assesses schools against the financial responsibility standards and requires schools that do not meet the standards to receive additional oversight.[10] In some cases, Education requires schools to provide financial guarantees to protect against federal financial losses if the school closes and its students become eligible to have their student loans forgiven.[11]

Financial Responsibility Standards

The specific financial responsibility standards that apply to each school depend on the school's ownership type, i.e., public, nonprofit, and for-profit (see table 1). The bulk of Education's financial oversight efforts

[8]See 20 U.S.C. § 1099c(c); 34 C.F.R. §§ 668.15, 668.171 – 668.175, and apps. A-B. In November 2016, Education issued a final rule revising its financial responsibility regulations, among other things. These revisions were scheduled to take effect July 1, 2017. See Student Assistance General Provisions, Federal Perkins Loan Program, Federal Family Education Loan Program, William D. Ford Federal Direct Loan Program, and Teacher Education Assistance for College and Higher Education Grant Program, 81 Fed. Reg. 75,926 (Nov. 1, 2016). In May 2017, a law suit was filed challenging the final rule in federal district court. California Ass'n of Private Postsecondary Schools v. DeVos, No. 1:17-cv-00999 (D.D.C. May 24, 2017)). In light of the pending litigation, Education delayed key provisions of the final rule, including those related to the financial responsibility standards for schools participating in federal student aid programs. The agency also stated that it plans to review and revise the final rule through the negotiated rulemaking process. See Student Assistance General Provisions, Federal Perkins Loan Program, Federal Family Education Loan Program, William D. Ford Federal Direct Loan Program, and Teacher Education Assistance for College And Higher Education Grant Program, 82 Fed. Reg. 27,621 (June 16, 2017). Since then, two additional law suits have been filed in federal district court, challenging the Secretary's delay of the final rule. See Bauer v. DeVos, No. 1:17-cv-01330 (D.D.C. June 6, 2017) and Massachusetts v. Dep't of Educ., No. 1:17-cv-01331 (D.D.C. July 6, 2017). Unless otherwise clear from context, any citations to Education's regulations pertain to the regulations in effect at the time we did our work. Participating schools may also be required to comply with other requirements in the Higher Education Act and Education's regulations related to their financial condition, but in this report we focus on the financial responsibility standards.

[9] See Student Assistance General Provisions, 62 Fed. Reg. 62,830 (Nov. 25, 1997).

[10] If Education determines that a school is not financially responsible, it may also fine the school, or limit, suspend, or terminate the school's participation in federal student aid programs.

[11] The Higher Education Act authorizes student loans to be discharged in a number of circumstances, including school closure. See generally 20 U.S.C. § 1087 and 34 C.F.R. § 685.212.

focus on private nonprofit and for-profit schools. Public schools are not required to meet some of the financial responsibility standards that apply to nonprofit and for-profit schools if they demonstrate that their liabilities are backed by the full faith and credit of a state or other government entity. However, public schools must still submit financial statements to Education and meet other standards.

Table 1: Key Financial Responsibility Standards for Schools Participating in Federal Student Aid Programs

Nonprofit and For-Profit Schools	Public Schools
Financial composite score: The school must receive a passing score on Education's composite measure of three financial ratios designed to gauge a school's financial health. **Refund reserve and timeliness:** The school must have sufficient cash reserves to return unearned federal student aid funds to Education as required when a student withdraws from school and make these returns in a timely manner, as applicable. **Meeting all financial obligations:** The school must be meeting all of its financial obligations, including making required refunds to students under its refund policy and repaying any federal student aid debts to Education. **Debt payment status:** The school must be current in paying its debts.	**Full faith and credit:** Public schools are not subject to certain financial responsibility standards if the school demonstrates to Education that its debts and liabilities are backed by the full faith and credit of the state or another government entity.
Past performance and affiliation: A school is not considered financially responsible if the school has violated certain federal student aid program requirements, or if a person who exercises substantial control over the school owes a debt for such a violation. For example, a school is not considered financially responsible if it has been cited during the last 5 years for failing to submit an audit as required. **Auditor opinion of financial statements:** The school is generally not considered financially responsible if the opinion expressed by the auditor in the school's audited financial statements is adverse, qualified, or disclaimed, or the auditor expressed doubt about the continued existence of the school as a going concern (i.e., doubt about a school's ability to continue operating for the next 12 months).	

Source: GAO analysis of selected federal regulations in effect as of June 2017 and the Federal Student Aid Handbook for school year 2016-17. | GAO-17-555

Note: For more information on these financial responsibility standards, see 34 C.F.R. pt. 668, subpart L.

Financial Oversight of Schools by Accreditors

Accreditors also play a role in assessing the financial condition of schools that participate in federal student aid programs. These independent organizations are responsible for applying and enforcing standards that help ensure that the programs offered by schools are of sufficient quality to achieve their stated objectives.[12] Accreditors must have standards

[12] Under the Higher Education Act, in order to be eligible to participate in federal financial aid programs, a school must be accredited by a nationally recognized accrediting agency that has been determined by Education to be a reliable authority as to the quality of the education or training offered. 20 U.S.C. §§ 1001(a)(5), 1099b.

related to a school's financial capability.[13] Financial assessments by an accreditor may include regular reviews of schools' annual financial statements and an accreditor may request additional reporting from schools with problematic financial conditions. When a school does not meet its accreditor's standards, the accreditor may impose sanctions or take other actions. We previously found that accreditors most frequently sanctioned schools for failure to meet standards on financial capability, rather than standards on academic quality or administrative capability.[14]

Education Focuses Oversight on Schools Not Meeting Financial Responsibility Standards and Has Increased Oversight of Certain Types of Schools

Education Reviews Schools' Annual Audits and Places Additional Requirements on the Small Percentage of Schools Not Meeting Financial Responsibility Standards for Schools that Participate in Federal Student Aid Programs

To assess a school's compliance with the financial responsibility standards for participating in federal student aid programs, Education reviews the school's annual financial statements and compliance audits.[15] These audits must be prepared for the school by an independent auditor, and in general, for-profit schools have 6 months and nonprofit and public schools have 9 months after the school's fiscal year ends to submit the audits to Education. Either the auditor or a school official transmits the documents to Education's eZ-Audit website and enters specific financial

[13] See 20 U.S.C. § 1099b(a)(5). Among other things, accreditors' standards are required to assess schools' fiscal capacity as appropriate to the specified scale of operations.

[14] GAO, *Higher Education: Education Should Strengthen Oversight of Schools and Accreditors*, GAO-15-59 (Washington, D.C.: Dec. 22, 2014).

[15] See 34 C.F.R. § 668.23. In general, Education requires audits of for-profit schools to comply with the Education Inspector General's Audit Guide, and audits of nonprofit and public schools to comply with applicable Single Audit Act requirements.

information needed for Education's oversight.[16] Education officials told us that an Education contractor initially screens the financial audits for completeness and flags any audits that indicate a school may not have met the financial responsibility standards required to participate in federal student aid programs. The contractor sends any audits that warrant further review to the appropriate Education division responsible for the school, where Education staff then conduct a full assessment to determine if the school is in compliance with these financial responsibility standards, according to Education officials. For example, an Education analyst assesses whether the school followed requirements to return any federal student aid funds owed to Education in a timely manner.

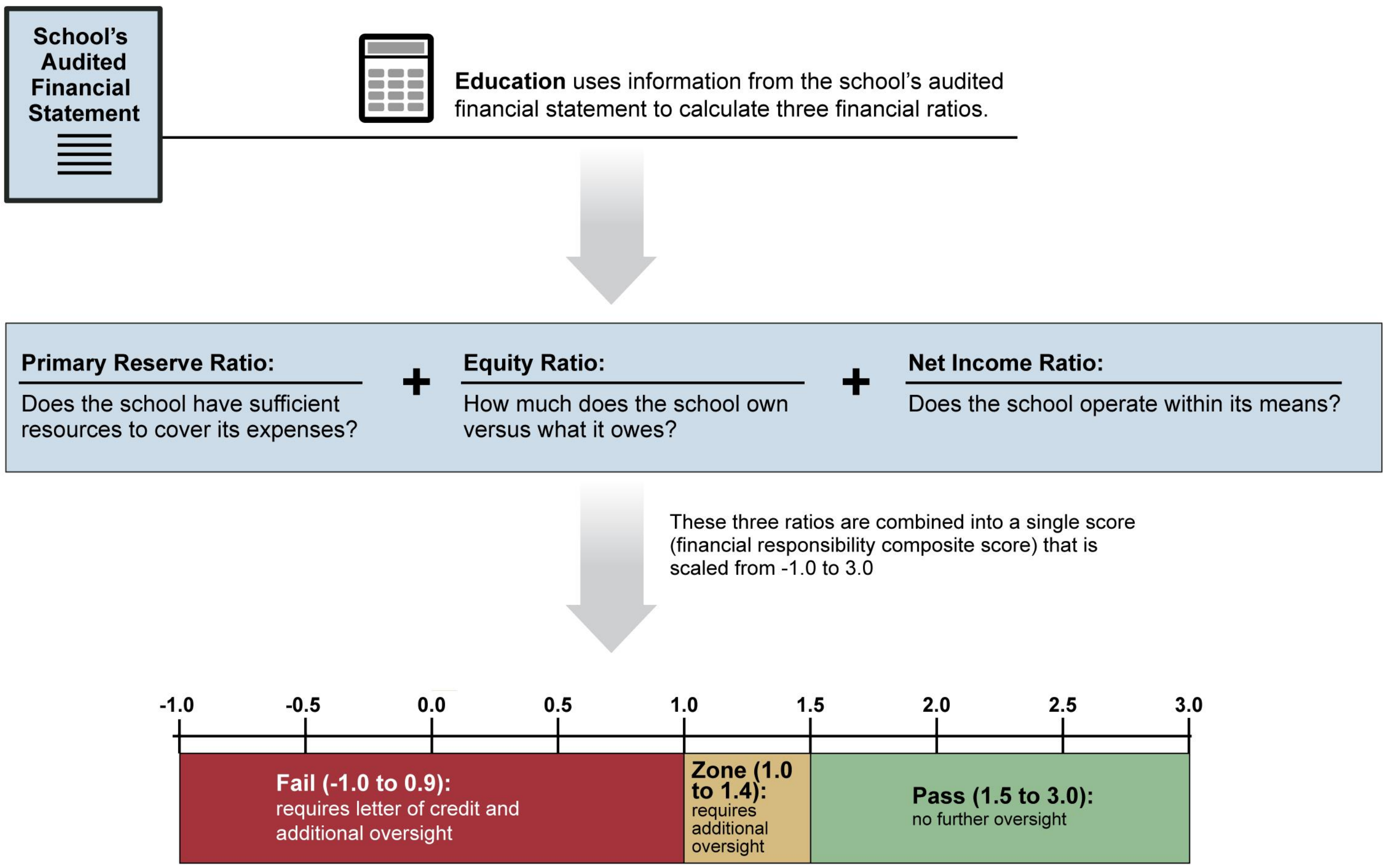
A financial composite score is also calculated for each nonprofit and for-profit school based on items drawn from the school's audited financial statements (see fig. 1).[17] The composite score—a metric for evaluating a school's financial condition—uses a formula based on three financial ratios.[18] A passing score is 1.5 to 3.0; a "zone" score is from 1.0 and 1.4, and a failing score is from -1.0 to 0.9.

[16] When a company is the sole owner of multiple schools, according to Education guidance, the agency reviews one consolidated financial audit for the parent company, and then calculates a single financial composite score for these schools based on the company's overall financial condition.

[17] Education can also use schools' other financial information entered into the eZ-Audit website or request additional information from schools to calculate composite scores.

[18] Education uses slightly different formulas when calculating these ratios for nonprofit and for-profit schools. See 34 C.F.R. § 668.172 and appendices A - B.

Figure 1: Summary of Education's Annual Financial Responsibility Composite Score Calculation for Schools Participating in Federal Student Aid Programs



Source: GAO analysis of Department of Education information. | GAO-17-555

Notes: Education uses slightly different formulas when calculating these ratios for nonprofit and for-profit schools. See 34 C.F.R. § 668.172 and appendices A - B. Education does not typically calculate a composite score for public schools.

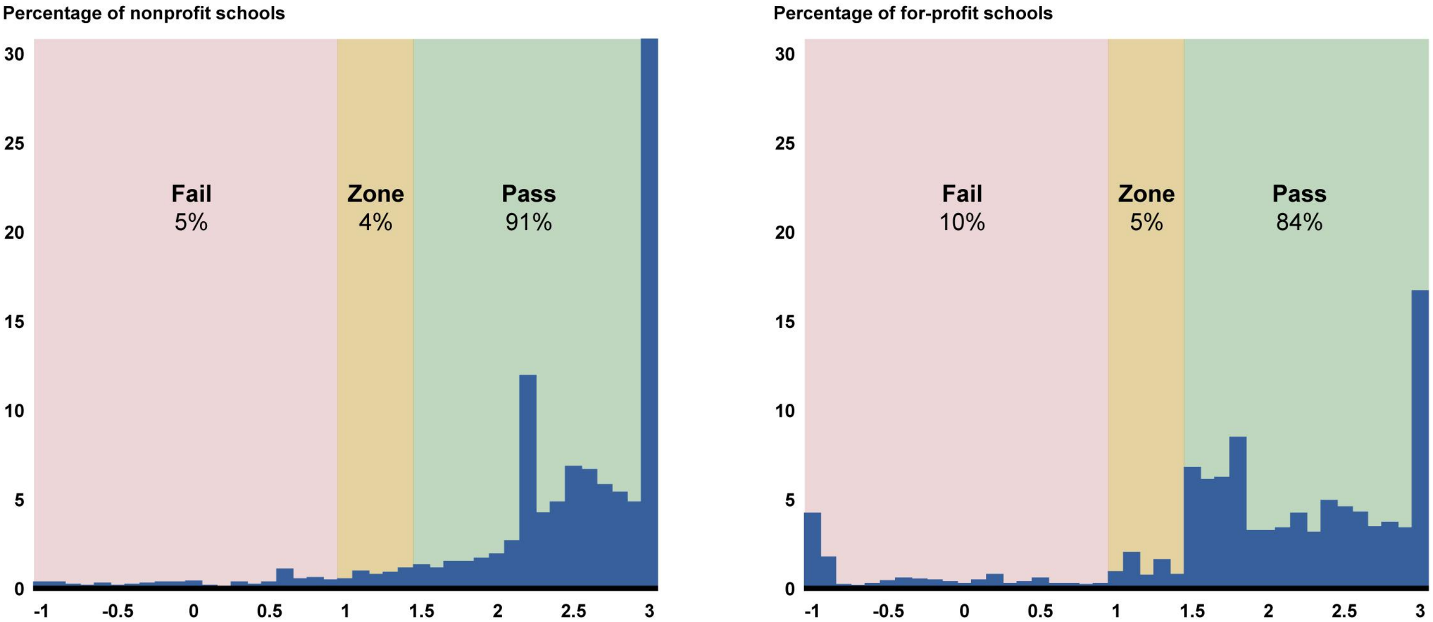
A small percentage of schools fail to meet Education's financial responsibility standards each year, primarily due to low (i.e., zone or failing) composite scores, according to our analysis of Education data. In school year 2014-15, the most recent year for which data are available, 13 percent of schools receiving composite scores had zone or failing composite scores. These 454 schools collectively enrolled over 550,000 students.[19] In prior years, only a few dozen schools at most did not meet one or more of the other financial responsibility standards.[20]

The percentage of schools not receiving passing composite scores has been relatively consistent since school year 2010-11, fluctuating by only a few percentage points over the past 5 school years, according to our analysis of Education's composite score data. A higher percentage of for-profit schools received non-passing scores than nonprofit schools. For example, 10 percent of for-profit schools had failing composite scores compared to 5 percent of nonprofit schools in 2014-15. Additionally, 5 percent of for-profit schools and 4 percent of nonprofit schools had zone composite scores (see fig. 2).

[19] For the purposes of our analyses, we considered a school to be an entity with a unique identification number assigned by Education (known as an OPEID) because Education reports financial responsibility information on an OPEID basis. However, depending on how schools are organized, an OPEID may correspond with one or multiple campuses.

[20] The most recent available data on noncompliance with the other financial responsibility standards were for school year 2013-14. In that year, for example, 52 schools were cited for having insufficient cash reserves for refunds or failing to make timely refunds to Education, and 3 schools had a "going concern" opinion in their financial statements, in which the auditor expressed substantial doubt about the school's ability to continue operating for the next 12 months.

Figure 2: Distribution of Financial Composite Scores by School Type, School Year 2014-15



Source: GAO analysis of Department of Education data. | GAO-17-555

Note: Percentages may not add up to 100 due to rounding.

Schools that receive a zone or failing composite score, or do not meet one or more of the other financial responsibility standards, may continue to participate in federal student aid programs if they agree to additional oversight.[21] Depending on the specific circumstances (as outlined below), Education may apply one or both of the following measures:

- **Heightened cash monitoring:** When a school receives a zone or failing composite score, or fails other financial responsibility

[21] The type of additional oversight varies depending on the circumstances. Schools that receive a zone composite score but meet the other financial responsibility standards can continue to participate if the school agrees to operate under heightened cash monitoring and comply with other oversight requirements. If a school receives a failing composite score, receives a zone score for more than 3 consecutive years, or fails to meet any of the other financial responsibility standards, it is required to provide a letter of credit worth at least 10 percent of the school's federal student aid funds from its most recent fiscal year in addition to agreeing to heightened cash monitoring and other oversight requirements. Alternatively, schools may submit a letter of credit equal to 50 percent or more of the school's federal student aid funds from the most recent fiscal year, which allows the school to participate without being subject to heightened cash monitoring or the other oversight requirements. See 34 C.F.R. § 668.175.

standards, Education may place it on heightened cash monitoring. This increases the reporting requirements for the school and postpones its ability to draw down federal student aid payments from Education until after funds are paid to students.[22] Schools can also be placed on heightened cash monitoring for nonfinancial reasons, such as concerns about a school's administrative capability or accreditation status.

Education placed 456 schools on heightened cash monitoring for not meeting financial responsibility standards at some point during school year 2014-15.[23] This was by far the most common reason schools were placed on heightened cash monitoring, according to our analysis of Education's data. Collectively, these schools enrolled over 1 million students.

- **Letter of credit:** Education requires a school that has a failing composite score or fails other financial responsibility standards to submit a letter of credit to continue to participate in federal student aid programs. Schools obtain the letter of credit from a bank, which charges them a fee for this service—typically a percentage of the value of the letter of credit. The letter of credit protects Education against potential liabilities for student refunds, loan cancellation costs, and other costs associated with a school closure.[24] A letter of credit must be worth at least 10 percent of the school's federal student aid funds from its most recent fiscal year, although the amount may be more, depending on the circumstances. For example, Education may

[22] Education has two levels of heightened cash monitoring (HCM), known as HCM1 and HCM2. Schools placed on HCM1 must disburse funds to students before they draw down federal student aid from Education. HCM2 is a higher level of oversight, for which Education requires schools to disburse funds to students and then submit documentation of their eligibility to Education for review before it releases federal student aid funds to the school. This delays a school's ability to access federal student aid for 30 to 60 days after disbursing these funds to students, according to Education officials we spoke with. Education officials explained that schools are not typically placed on HCM2 solely due to financial responsibility concerns; instead, HCM2 is used for more serious compliance issues, such as fraud. The officials said that these compliance issues are typically found by an Inspector General audit or an Education program review, which evaluates a school's compliance with federal student aid program requirements.

[23] In school year 2014-15, 427 were placed on HCM1 (132 nonprofit and 295 for-profit schools), 25 schools were on HCM2 (6 nonprofit and 19 for-profit schools), and 4 for-profit schools were moved from HCM1 to HCM2 during the year.

[24] In the case of a school closure, Education can cash the letter of credit to cover any outstanding debts owed by the school.

increase the letter of credit if a school fails more than one of the financial responsibility standards, according to agency officials.

Education required 269 schools to post letters of credit specifically due to failing composite scores in school year 2013-14 (the most recent year for which letter of credit data were available), according to our analysis of Education data. Another 74 schools were required to post letters of credit for not meeting other financial responsibility standards, such as having an adverse audit opinion or untimely refunds. Nearly half of the letters were for the minimum of 10 percent of the school's prior year federal student aid funding. These letters of credit ranged from about $5,000 to over $92 million in school year 2013-14.

Education Has Taken Steps to Increase Oversight of Certain Types of Schools, Including Those Owned by Publicly Traded Companies and Private Equity Firms

Education has taken steps to improve its oversight of large schools with campuses in multiple locations, including schools owned by publicly traded companies and private equity firms. Education formed the Multi-regional and Foreign Schools Participation Division (Multi-regional Division) in 2014 to centralize its monitoring of large school groups with campuses in more than one region.[25] This division currently monitors 47 companies that collectively own 330 schools with thousands of campuses including major publicly traded companies that operate schools, private equity firms, and privately held companies. Together these schools enrolled 1.7 million students who received about 26 percent of all federal student aid in school year 2014-15 (over $15 billion), according to our analysis of Education's federal student aid data.

Publicly Traded Companies and Private Equity Firms

A publicly traded company is a company whose stock is available for purchase by the general public and is traded on public markets, such as the New York Stock Exchange. Publicly traded companies are required to regularly disclose certain business and financial information to the public.

Private equity firms manage investments generally available only to institutions and other large investors. Private equity firms acquire ownership stakes in companies and seek to profit by improving operating results or through financial restructuring, and then selling companies to another firm or through a public stock offering.

Source: GAO analysis of Securities and Exchange Commission documents and a Congressional Research Service report. | GAO-17-555

The Multi-regional Division provides centralized and increased oversight of these large school groups. Education had previously divided oversight responsibility among its seven regional offices based on the location of each school, regardless of school size and type of ownership. Since large school groups generally operate schools in multiple regions, Education officials we spoke with said creating the Multi-regional Division provided a more holistic review of a parent company's financial condition, and created one central contact point at the department. An Education

[25] A school group is a group of schools with a common owner.

financial analyst experienced in assessing large schools conducts a full review of each school's financial audits and independently assesses the school's compliance with the financial responsibility standards for schools participating in federal student aid programs, according to Education officials.[26] Additionally, in response to the abrupt closure in 2015 of Corinthian Colleges, a large for-profit school with over 100 campuses across the country at its peak, Education officials said the Multi-regional Division has adopted new tools that provide a more complete picture of the financial condition of these companies, including:

- **Regular monitoring of financial information:** The Multi-regional Division uses additional information beyond the annual financial audits to track the financial condition of schools. For example, this division actively monitors Securities and Exchange Commission (SEC) disclosures from the publicly traded companies that own schools, such as quarterly financial reports and notices of significant financial developments. This division also subscribes to an online service that provides corporate profiles and access to additional financial information and ratios.
- **Additional reporting requirements:** The Multi-regional Division requests additional information from its schools with zone or failing composite scores. For example, these schools are required to submit biweekly cash flow statements, monthly student enrollment numbers, and graduation projections.

The Multi-regional Division has also begun a new effort to expand its monitoring of schools owned by private equity firms, which have become increasingly involved in higher education. In 2015, 10 of the 50 largest for-profit schools, whose students received nearly $1.3 billion in federal student aid that year, were owned by private equity firms.[27] Education officials and other experts we spoke with said these types of schools can pose several oversight challenges, in part because the ownership structure can be complex (e.g., subsidiaries and parent companies) and split among multiple owners. As a result, while a private equity firm may not be the sole owner, it may exercise significant management control

[26] In contrast, an Education financial analyst in the other school participation divisions generally only reviews the financial audits of other schools when compliance issues are identified during the initial audit screening by an Education contractor.

[27] In February 2017, a group of private equity firms purchased the publicly traded company that operated the largest for-profit school (University of Phoenix), whose students received over $2 billion in federal student aid in school year 2014-15.

over a school. Another risk is that private equity firms are not subject to regular SEC reporting requirements, unlike publicly traded companies that own schools, limiting the financial information available to Education. To better understand the oversight challenges posed by these types of schools, Education has recently started to identify schools that are fully or partially owned by the same private equity firms to determine if they should be treated as a single school group rather than as individual schools, according to an Education official. If these schools are treated as a single school group they would be required to submit company-wide financial statements that may reveal additional financial risks that would be missed at the individual school level.

In November 2016, Education issued a final rule revising the financial responsibility regulations, which established additional financial and nonfinancial situations for which Education would be able to require a letter of credit from schools.[28] The final rule was generally scheduled to take effect July 1, 2017; however, Education has delayed the effective date of key provisions, including those related to financial responsibility, and has also announced plans to review and revise the final rule through the negotiated rulemaking process.[29]

While School Closures Are Rare, Limitations in Education's Oversight Hamper Its Ability to Identify At-Risk Schools

Although the Number of School Closures Is Small, Abrupt Closures of Large Schools Can Result in Substantial Costs

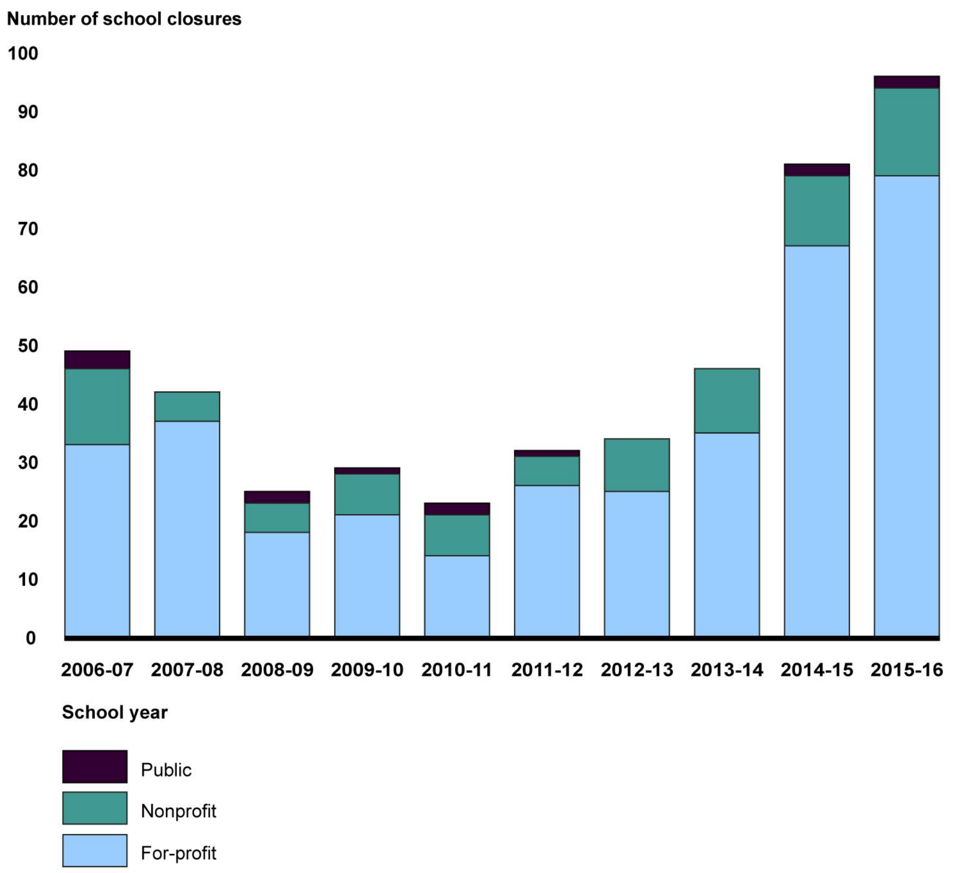
A relatively small number of schools close each year. For example, according to our analysis of Education data, 96 schools closed during school year 2015-16, accounting for less than 2 percent of the

[28] 81 Fed. Reg. 75,926 (Nov. 1, 2016). In addition, the final rule established a new federal standard and a process for determining whether a borrower has a defense to repayment on a loan based on an act or omission of a school.

[29] 82 Fed. Reg. 27,621 (June 16, 2017). As previously mentioned, the rule was delayed pending resolution of a federal lawsuit challenging the rule. Federal lawsuits have also been filed challenging Education's delay of the rule.

approximately 6,000 schools that participated in federal student aid programs.[30] However, the number of school closures remains higher than in previous years, primarily due to a rise in for-profit school closures (see fig. 3).

Figure 3: School Closures by School Type, School Years 2006-07 through 2015-16



Source: GAO analysis of Education's Postsecondary Education Participants System data. | GAO-17-555

Abrupt School Closures: Corinthian Colleges and ITT Educational Services

Before its closure in April 2015, Corinthian Colleges Inc. (Corinthian) was one of the country's largest for-profit providers of higher

[30] Of these closures, 15 were nonprofit schools (accounting for 1 percent of nonprofit schools), 79 were for-profit schools (accounting for 4 percent of for-profit schools), and 2 were public schools (accounting for less than 1 percent of public schools).

education, enrolling more than 72,000 students who received roughly $1.4 billion dollars in federal student aid. Corinthian had been under heightened oversight from Education since June 2014 for failing to respond timely to Education's inquiries about its job placement rates. At the time of its closure, Corinthian had already sold the majority of its campuses, as part of an agreement with Education for an orderly closeout of its schools. Corinthian could not find a buyer for its remaining campuses, which it abruptly closed in April 2015. At the time of its closure, according to Education, Corinthian appeared to be in compliance with the financial responsibility standards for schools participating in federal student aid programs, but was later found by Education to have manipulated its composite score.

The following year, ITT Educational Services Inc. (ITT), another large for-profit provider of higher education, abruptly closed all of its 136 campuses in September 2016, affecting more than 35,000 students. Education had placed ITT under heightened oversight and required the school to post a letter of credit since August 2014 for failing one of the financial responsibility standards for schools participating in federal student aid programs. Specifically, ITT was late in submitting its required financial audit following a Securities and Exchange Commission investigation into allegedly undisclosed losses from the company's private student loan programs. In June and August 2016, Education placed additional restrictions on ITT and prohibited some of its schools from enrolling new students with federal student aid in response to adverse actions by the school's accreditor. By September, ITT ceased all operations.

Source: GAO analysis of Department of Education and company documents. | GAO-17-555

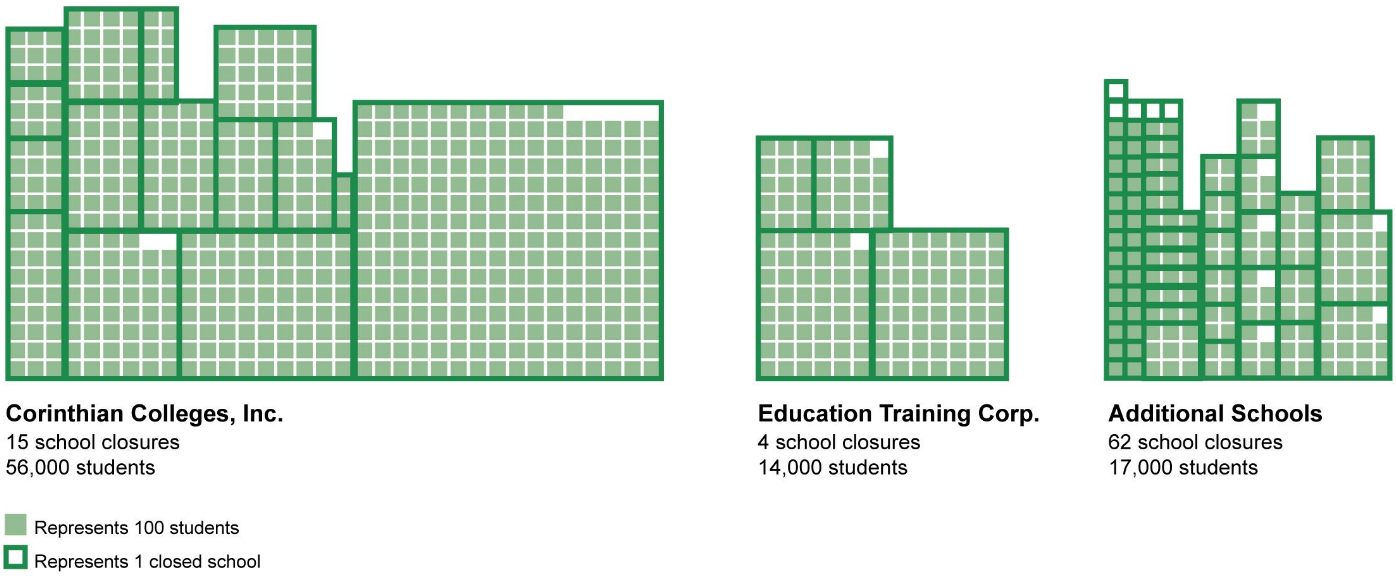
The vast majority of schools that have closed over the past 5 years enrolled fewer than 500 students. Although these closures were disruptive to the students and communities involved, the resulting federal financial losses from such closures were limited, given the size of the school. Federal financial losses can also be limited when the school ceases operations in an orderly process over several months. A well-managed closure can give students time to complete the current school term and make arrangements to transfer and continue their education at another school.

Abrupt closures of large schools, although infrequent, create bigger challenges for students and Education. Large school closures can affect tens of thousands of students and result in hundreds of millions of dollars in financial losses for the federal government and taxpayers. For example, 70,000 students were enrolled at schools owned by two companies that closed in school year 2014-15—almost four times the total number of students enrolled at the other 62 schools that closed that year (see fig. 4). When a large school closes, more students may be eligible for discharge of their federal student loans.[31] For example, of the more than 450 total schools that closed over the past decade, the closure of 6 large schools (or companies that owned schools) accounted for two-thirds of loan discharges during that period. Regardless of school size, the effect from school closures is often worse if the closures occur abruptly with little or no advance warning, because these schools generally do not have time to establish transfer arrangements that allow students to easily continue their education at another school. Students affected by an abrupt closure may therefore be more likely to apply to Education for a discharge of their federal loans. This was the case with Corinthian Colleges, which in 2015 abruptly closed its campuses with only a few hours' notice to students. Due to the abrupt closure as well as other factors, Education has thus far approved more than $550 million in student loan discharges for former Corinthian College students.[32]

[31] See, generally, 20 U.S.C. § 1087 and 34 C.F.R. § 685.212. Borrowers may also assert, as a defense to repayment, certain acts or omissions by the school.

[32] This amount, according to Education reports, includes both closed school discharges and borrower defense discharges, which provide loan forgiveness to students when a school has misled them or engaged in other misconduct.

Figure 4: School Closures by Enrollment Size, School Year 2014-15



Source: GAO analysis of Education's Postsecondary Education Participants System and Integrated Postsecondary Education Data System. | GAO-17-555

Notes: The figure illustrates student enrollment 2 years prior to closure for the few cases in which schools had not reported prior year enrollment data to Education. Enrollment data were unavailable for five of the closed schools. Another large for-profit provider of higher education, ITT Educational Services Inc., closed in the following school year 2015-16.

Education's Key Financial Oversight Measure Has Limitations and Does Not Reflect Advances in Financial Analysis

Limitations of Education's composite score have made it an imprecise predictor of school closures. Half the colleges that closed from school years 2010-11 through 2015-16 received passing financial composite scores on their last assessment before they closed. For example, 58 of the 96 schools that closed in school year 2015-16 had recently received passing scores. Closures can be difficult to predict in part because each school faces its own unique challenges that can eventually push the school into financial trouble. Schools can also close for nonfinancial reasons (e.g., loss of accreditation, legal action), or a combination of both financial and nonfinancial factors.[33] For example, Dowling College faced

[33] Education's historical data on school closures do not include sufficient information on the cause of each closure to determine whether or not a school closed for financial reasons or if the closure occurred abruptly or through a managed process.

accreditation issues, enrollment declines, and financial problems prior to its closure in 2016, according to reports from Education and school officials. Education's composite score is not designed to account for nonfinancial risks; however, the financial responsibility standards for schools participating in federal student aid programs are Education's primary means of securing financial protections through a letter of credit from schools at risk of closure. If the composite score more accurately identified schools at risk of closing, it would enable Education to obtain letters of credit prior to their closing to protect the federal government against possible financial losses.[34] In addition, some schools with failing composite scores may not be at immediate risk of closure. For example, almost 80 percent of the schools that failed the composite score in school year 2010-11 were still operating more than five years later (as of June 2016).

The composite score's inconsistent performance is due in part to limitations of the underlying formula and the fact that it has remained unchanged for 20 years. The composite score is based on common financial ratios that Education selected in 1997 after consulting with an accounting firm, school officials, and other experts.[35] However, it has not been updated since then and several experts and school officials we interviewed identified weaknesses with the composite score formula. These weaknesses include the effect of subsequent accounting changes, advancements in financial analysis, and the formula's vulnerability to manipulation.

Accounting Changes

Education's composite score formula has not kept pace with changes since 1997 in standard accounting practices, resulting in large swings in the composite scores of some schools over time and creating the potential for differing interpretations. Accounting practices and standards

[34] Education relies on other oversight mechanisms, such as compliance and program reviews, to assess nonfinancial risks. For example, Education conducts an annual risk assessment of all schools participating in federal student aid programs and uses both financial and nonfinancial information to select schools for program reviews. However, Education does not request a letter of credit from schools for nonfinancial concerns.

[35] The composite score was originally developed through Education's rulemaking process. For a summary of the rulemaking process used to establish the financial responsibility regulations for schools participating in federal student aid programs, including the development of the financial ratios, see 62 Fed. Reg. 62,830 (Nov. 25, 1997).

are periodically updated, for example, to improve the comparability and usefulness of financial reporting. Changes to state laws can also affect how schools categorize certain financial items in their annual audits and can have significant effects on their composite scores, according to school officials and experts we spoke with. For instance, they said several states have recently passed laws changing how schools manage and report on their endowments. However, when one school applied these reporting changes to its financial audit, the composite score formula no longer captured a third of the school's endowment, reducing the school's composite score from passing to not passing, according to school administrators we interviewed. Administrators at two other schools we spoke with also said that upcoming changes to accounting standards related to leases and revenue recognition will affect school financial statements that will in turn impact the composite score.[36] However, despite the significant effect that accounting changes can have on schools' scores, Education has not reexamined the composite score formula to ensure the score is a reliable measure of financial health.

As accounting practices continue to diverge from the components and definitions in Education's composite score, schools' financial audits may not contain all the necessary information to calculate their score, making it more difficult for Education to apply the formula in a uniform manner. For example, certain components of the composite score are no longer linked directly to items on schools' audited financial statements. For example, one college accountant we spoke with said that certain inputs for the formula, like construction in progress and unsecured related-party receivables (e.g., donation pledges from a member of the school's board of directors), are not always included in a schools' audited financial statements if the auditor determines the dollar amount is not significant. In these cases, Education must rely on additional unaudited information from a school to calculate its composite score. This problem will be compounded by new accounting standards for nonprofit organizations that go into effect in December 2017 that will change the reporting

[36] See Financial Accounting Standards Board (FASB), Leases (Topic 842), Update 2016-02, (Norwalk, CT: February 2016) and FASB, Revenue from Contracts with Customers (Topic 606), Update 2014-09, (Norwalk, CT: May 2014).

categories for net assets on schools' financial statements.[37] As a result, key reporting items in schools' financial audits will no longer align with Education's composite score formula. These differences create ambiguity and make it more difficult to apply the formula in a uniform manner. For example, officials at two of the four higher education associations we interviewed said their member schools have raised concerns that Education staff inconsistently interpret and apply certain components of the formula, increasing the likelihood that Education's measures may not correctly and consistently identify financially troubled schools.

Financial Analysis Improvements

Education's composite score formula does not capture recent advances in financial analysis that could provide a broader indicator of a school's financial health. When the composite score formula was designed in 1997, it was based on the key measures of financial health that were available at the time. Over the last 20 years, the composite score formula has remained unchanged, but the field of financial analysis has continued to evolve with new measures becoming important as economic conditions change. For example, liquidity (i.e., access to cash) has become an important financial measure since the 2007-09 economic downturn, when some schools had trouble meeting payroll and fulfilling contractual obligations. In response, credit rating agencies and industry best practices have incorporated liquidity measures into their methodologies. The Financial Accounting Standards Board has also recognized the importance of liquidity measures and its updated standards call for nonprofit organizations, including schools, to report additional information about liquidity in their financial audits beginning in 2018.[38] However, Education's current composite score focuses on schools' overall wealth rather than on spendable cash and liquid investments. As a result, the score may overstate the assets available to a school to spend on operations.

[37] In 2016, FASB issued an accounting standards update for how nonprofit entities should report assets on their financial statements. This update adopted two new categories for reporting net assets (net assets with donor restrictions and net assets without donor restrictions) rather than the previous three (permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets). This change will be effective for fiscal years beginning after December 15, 2017. However, Education's composite formula is based on the old asset categories that will soon be out of date. FASB, Not-for-Profit Entities (Topic 958): Presentation of Financial Statements of Not-for-Profit Entities, Update 2016-14, (Norwalk, CT: August 2016).

[38] FASB Update 2016-14.

Credit rating agencies have also adopted broader assessments of financial risk that can provide a more accurate indication of a school's financial health than Education's current composite score. For example, while Education's composite score is solely based on annual snapshots of a school's finances, the two credit rating agencies we interviewed use methodologies that include a broader assessment of a school's historical trends and future projections. For example, analysts we interviewed at one credit rating agency said they incorporate 5 to 10 years of historical trends and 2 to 3 years of future projections into their school assessments. This allows these agencies to capture downward trends or emerging risks in a school's finances that Education's composite score could miss. The more sophisticated methodologies used by credit rating agencies have sometimes resulted in assessments of a school's financial condition that are strikingly different from the school's composite score. For example, in 2016, these rating agencies assigned non-investment grade (i.e., junk bond) ratings to 30 schools that received passing composite scores from Education.

Our previous work also provides examples of other federal agencies that use broader assessments of financial risk, and highlights the importance of reevaluating and periodically updating financial measures. For example, federal banking regulators, such as the Federal Deposit Insurance Corporation, use a composite rating system to assess the financial condition of banks in six broad areas: capital, asset quality, management, earnings, liquidity, and sensitivity to market risk. Federal banking regulators have also taken steps to incorporate a more forward-looking approach into their rating system based on lessons learned from bank failures during the 2007-09 financial crisis.[39] In a different industry, the Department of the Interior recently issued revised measures to assess the financial strength of offshore oil and gas operators in response to our recommendation.[40] These would replace the department's previous measures, which relied on a company's net worth, with nine new financial ratios that are intended to provide a broad assessment of a company's financial capacity.

[39] GAO, *Bank Regulation: Lessons Learned and a Framework for Monitoring Emerging Risks and Regulatory Response*, GAO-15-365 (Washington, D.C.: June 25, 2015).

[40] GAO, *Offshore Oil and Gas Resources: Actions Needed to Better Protect Against Billions of Dollars in Federal Exposure to Decommissioning Liabilities*, GAO-16-40 (Washington, D.C.: Dec. 18, 2015).

Vulnerability to Manipulation

A few schools have taken advantage of a feature of the composite score formula to manipulate their scores, which enabled them to avoid having to post a letter of credit. In some ways, the formula incentivizes schools to take on long-term debt (e.g., loans with terms in excess of 12 months) because these debts increase a school's composite score. Long-term debt usually represents a long-term investment in a school's campus and buildings, and the composite score formula treats this type of debt in a positive manner.[41] However, an accountant for multiple schools told us that some schools have taken advantage of this provision and taken on a million dollars in debt in order to obtain a passing composite score. For example, administrators from one school we interviewed said they were planning to borrow at least $6 million in the coming year for facilities expansion and improvements, but also to increase the school's composite score to 1.5, which would allow the school to avoid having to post a letter of credit.

Corinthian Colleges took out short-term loans and reported them as long-term debt to manipulate its composite score, according to Education documents. The company borrowed $43 million on the last day of its fiscal year 2011 to improve its composite score and then immediately repaid it, according to company documents and Education officials. Corinthian again took out loans toward the end of fiscal year 2012 ($58 million) and fiscal year 2013 ($86 million) and quickly repaid them, which Education concluded boosted the school's composite score and helped it avoid having to post a letter of credit. Education officials we spoke with said they were not aware of the full extent of Corinthian's composite score manipulation until it was too late, and the company had closed its schools and declared bankruptcy before Education could request a letter of credit. If Education had addressed this vulnerability earlier, it could have required Corinthian to post a letter of credit that could have covered some of the over $550 million in loan discharges resulting from the school's closure.

[41] Education included long-term debt in the formula for the primary reserve ratio (which measures whether a school has sufficient resources to cover its expenses) to address concerns that schools would be discouraged from making investments in capital improvements if these funds were not counted in the ratio, according to Education guidance. See GEN-01-02.

Education officials we spoke with said they plan to take steps to address this type of composite score manipulation, but these efforts may be too narrowly focused. Education's Office of the Inspector General in a February 2017 report raised concerns about Corinthian Colleges' manipulation of its composite score, and recommended that Education update its procedures to address this vulnerability in the future.[42] Education agreed with the recommendation and plans to instruct its staff to collect and review additional information from schools to determine if they may be manipulating composite scores. However, it is unclear how Education plans to identify these schools. Education officials have told us that they do not think this type of manipulation is prevalent since it is advantageous only to schools on the cusp of receiving a passing score. However, our analysis indicates that a significant number of schools receive composite scores near the threshold, where this type of manipulation could be beneficial. For example, about 30 percent of for-profit schools received composite scores in school year 2014-15 that were close to the passing threshold (i.e., in the 1.5-1.9 range). Given the large number of schools that might have incentives to manipulate their scores, a narrowly targeted approach may not be sufficient.

These three weaknesses with the composite score hamper Education's ability to effectively fulfill its statutory responsibility to determine whether schools participating in federal student aid programs are financially responsible. Several Education officials we spoke with, however, maintain that the composite score is still a good measure of a school's financial condition. Identifying and responding to risks is a key component of federal internal control standards, but Education's financial composite score formula has remained unchanged for 20 years despite significant changes in the financial landscape of higher education.[43] Unless the agency updates the composite score formula to better measure schools' financial conditions and capture financial risks, Education lacks reasonable assurance that the current composite score is a reliable indicator of financial health and is therefore constrained in its ability to protect students and taxpayers against significant financial risks.

[42] Department of Education Office of Inspector General, *Federal Student Aid's Processes for Identifying At-Risk Title IV Schools and Mitigating Potential Harm to Students and Taxpayers*, ED-OIG/A09Q0001 (Washington, D.C.: Feb. 24, 2017).

[43] GAO, *Standards for Internal Control in the Federal Government*, GAO-14-704G (Washington, D.C.: Sep. 10, 2014).

Education Does Not Fully Explain Its Key Financial Measure to Schools or Disclose Complete Results to the Public

Education's Guidance to Schools Does Not Provide Complete Information on Some Components of the Composite Score

In its written guidance to schools about the financial responsibility standards for schools participating in federal student aid programs, Education does not fully explain how it treats certain components of the composite score formula, which has created confusion for some schools. According to a 2012 higher education association report, Education's interpretation of some composite score components is different than schools would expect, which creates confusion and uncertainty for schools.[44] However, Education's Federal Student Aid Handbook (Education's comprehensive annual guide to the statutory, regulatory, and administrative requirements for federal student aid programs) and its step-by-step guide to assist schools with submitting their annual financial and compliance audits do not explain all of Education's interpretations. The Handbook instead refers schools to the regulations, which lay out the composite score formula but do not provide detailed definitions of the various formula components or information on how Education applies this formula in practice.[45] Officials we interviewed at 7 of 10 selected schools expressed confusion about key aspects of the formula and officials at one higher education association told us such confusion has occurred at several other schools. This lack of understanding makes it difficult for schools to correctly estimate their composite scores, contrary to Education's stated intention in the 1997 rule establishing the formula that the composite score methodology would be easily understood by schools and its belief that schools could readily calculate their composite scores from their audited financial statements.[46] In some cases, the lack of

[44] National Association of Independent Colleges and Universities, *Report of the NAICU Financial Responsibility Task Force*, Washington D.C., November 2012.

[45] Education has previously published two Dear Colleague letters to explain how it treats one component of the composite score—long term debt—but has not communicated its approach on other complex issues, such as pension plan liabilities, in a systematic way.

[46] 62 Fed. Reg. 62,830 (Nov. 25, 1997).

understanding can result in schools incorrectly anticipating a passing score and being surprised when they do not pass. For example, officials at three of the seven schools that were confused said their schools unexpectedly received zone or failing scores because they did not understand how Education treated several components of the composite score calculation. Officials at the four other schools also said they did not fully understand how Education calculated their schools' composite scores.[47]

Education officials acknowledged schools' confusion about its composite score calculation, but the agency has not taken steps to clarify or supplement its guidance. Education officials we interviewed identified specific components of the composite score that are most often the source of discrepancies between schools' calculations and Education's final score. They included most of the same issues that school officials raised during our interviews (construction-in-progress, pension plan liabilities, endowments, and long-term debt), and two others—unsecured related party receivables (e.g., donation pledges from members of the school's board of directors) and intangible assets (e.g., trademarks or patents owned by a company). The 2012 higher education association report also identified similar areas of concern.[48] In response to previous concerns about the composite score, Education sent a detailed letter to one higher education association in 2010 explaining its rationale for, and treatment of, certain components, but has not made this potentially useful information broadly available by updating its current guidance to schools. This communication gap does not meet the federal internal control standard of effective communication, which calls for management to communicate with external parties in a way that enables them to help the organization achieve its objectives and address risks.[49] As a result, it is difficult for schools to accurately anticipate and plan for Education's oversight of their finances and for the cost to obtain a letter of credit should it be needed.

[47] One of these four schools received a higher composite score than it had expected, according to officials we interviewed.

[48] National Association of Independent Colleges and Universities, *Report of the NAICU Financial Responsibility Task Force*, Washington D.C., November 2012.

[49] GAO-14-704G.

Education's Public Disclosures about Schools' Financial Scores Are Incomplete

Each year, Education publishes composite scores on its website for most nonprofit and for-profit schools, but does not include the scores for hundreds of these schools.[50] Of all nonprofit and for-profit schools that participated in federal student aid programs in 2014-15, 17 percent are missing composite scores in Education's annual public disclosures, including many large, for-profit schools. Collectively, students at these schools received over $8 billion in federal student aid and these schools include 7 of the 30 largest nonprofit and for-profit recipients of federal student aid.

These omissions happen primarily because Education does not publicly disclose composite scores for all schools that are owned by the same company. Education calculates a single composite score for this group of schools based on the company's consolidated financial statements.[51] Schools with a common owner therefore receive the same composite score. However, Education publicly reports a composite score for only one school in this commonly owned school group, and does not provide the composite score for any of the other schools in the group. For example, Kendall College and Walden University are both owned by the same company. However, Education publishes a composite score for Kendall College, which enrolls about 1,000 students, but not for the substantially larger Walden University, which enrolls over 50,000 students. As a result, students and others seeking the composite scores of certain schools, such as Walden University, are not able to find them.[52]

Incomplete information on the final composite scores for all schools deprives students of information on whether a school is financially sound

[50] See the Department of Education's Federal Student Aid Data Center, School Data website, currently found at: https://studentaid.ed.gov/sa/about/data-center/school.

[51] When a company is the sole owner of multiple schools, according to Education guidance, the agency reviews one consolidated financial audit for the parent company, which Education uses to calculate a single composite score for all of the schools based on the company's overall financial condition.

[52] Education also omits from its public disclosures the small number of schools that are in the process of appealing their composite score because they are not yet final. Schools can appeal their composite score to Education and the agency does not publish any composite scores that are under appeal. From 2007 to 2015, only 10 schools appealed their scores.

enough for them to confidently invest their time and money. Although it has limitations, the composite score is a key indicator of Education's assessment of schools' financial conditions and can provide some useful information to students. Federal internal control standards call for effective communication with external stakeholders, and Education has prioritized the importance of providing students increased transparency about their higher education options in its strategic plan.[53] Even if a school is not at immediate risk of closure, public information on its financial condition is important since research has indicated that a school's financial struggles can have negative effects on its operations. For example, two studies that we reviewed found that financial shortfalls can cause schools to reduce course offerings and increase class sizes.[54] Two other studies have also found that declines in schools' resources per student can result in reduced student supports and lower rates of graduation.[55] Given how a school's financial condition can affect student outcomes, the current gaps in the public information on schools' composite scores make it difficult for prospective students to make informed decisions about their investment in higher education.

Conclusions

When financially struggling schools abruptly shut their doors, it can leave students without education options and force taxpayers to cover the cost of discharged student loans. Effective financial oversight of postsecondary schools is therefore essential to help ensure that schools fulfill their obligations to students and for protecting taxpayer investments

[53] GAO-14-704G and U.S. Department of Education, *Strategic Plan for Fiscal Years 2014 -2018*, (Washington, D.C.: Mar. 10, 2014).

[54] For example, see Phil Oliff, Vincent Palacios, Ingrid Johnson, and Michael Leachman, *Recent Deep State Higher Education Cuts May Harm Students and the Economy for Years to Come* (Washington, D.C.: Center on Budget and Policy Priorities, Mar. 19, 2013); and Sarah Bohn, Belinda Reyes, and Hans Johnson, *The Impact of Budget Cuts on California's Community Colleges* (San Francisco, CA: Public Policy Institute of California, March 2013).

[55] For example, see John Bound, Michael F. Lovenheim, and Sarah Turner, *Why Have College Completion Rates Declined? An Analysis of Changing Student Preparation and Collegiate Resources*, American Economic Journal: Applied Economics, Vol. 2, No. 3 (July 2010); and Douglas A. Webber and Ronald G. Ehrenberg, *Do Expenditures Other Than Instructional Expenditures Affect Graduation and Persistence Rates in American Higher Education*, National Bureau of Economic Research, NBER Working Paper No. 15216 (August 2009).

in federal student aid. Education relies on the composite score as one of its primary tools for assessing the financial condition of schools. However, Education has not addressed multiple limitations of the composite score that have emerged over the last 20 years. Unless Education takes action to update the composite score formula, students and taxpayers will continue to be exposed to significant financial risks.

Although it has limitations, the composite score can still be a source of information for schools and students. However, the lack of clear guidance for schools on the composite score formula and its components creates confusion and uncertainty among school administrators. When schools do not understand how Education calculates composite scores, it is difficult for schools to anticipate whether they will receive a passing score or to plan for additional oversight should they fail. This can result in unwelcome surprises for schools, such as unexpectedly having to obtain a letter of credit. Improving Education's guidance to schools would allow them to more accurately estimate their composite scores and understand how they are being evaluated. In addition, a school's financial condition can have an impact on students' educational prospects, but gaps in the public information on schools' composite scores limit their usefulness as a resource for students. Without complete and transparent data on schools' financial conditions, it may be difficult for students to make informed decisions as to whether a school is a safe investment of their time and money.

Recommendations for Executive Action

To improve oversight of school finances and provide better information to schools and the public about its monitoring efforts, the Chief Operating Officer of the Office of Federal Student Aid should take the following actions:

- Update the composite score formula to better measure schools' financial conditions and capture financial risks.
- Improve guidance to schools about how the financial composite score is calculated, for example, by updating current guidance to include explanations about common areas of confusion and misinterpretation for schools.
- Increase the transparency of public data on schools' financial health by publicly listing the final composite score for each school.

Agency Comments and Our Evaluation

We provided a draft of this report to Education for review and comment. Education provided written comments, which are summarized below and reproduced in appendix I. In its written comments, Education generally disagreed with the first recommendation, agreed with the second, and stated it would further evaluate the third.

In its written comments, Education also said that while our report recognized some of its efforts to improve its oversight of certain schools, the report did not provide a complete picture of the department's efforts. For example, Education noted that it had created a new office to oversee large school groups, required at-risk schools to provide more frequent financial and enrollment information, and enhanced information sharing. However, our report does describe the specific tools and processes Education highlighted in its comments that are relevant to the financial oversight of schools. For example, we described the creation of the Multi-regional Division to oversee large school groups, additional financial and enrollment reporting requirements for at-risk schools, and monitoring additional financial information sources.

With respect to the first recommendation to update the financial composite score formula, Education stated that our report does not show that any changes in accounting standards have made the composite score calculations less reliable. As discussed in our report, the components and definitions in Education's composite score do not reflect changes in accounting practices. As a result, some aspects of Education's formula are no longer directly linked to information in schools' audited financial statements. This makes the composite score difficult to apply in a consistent, uniform manner. This problem will be compounded by new accounting standards that go into effect later this year that change how nonprofit schools will report net assets on their financial statements. Education stated that it will work with the Financial Accounting Standards Board on future changes to the accounting standards that may affect a school's composite score calculation; however, revisions to the underlying composite score formula are necessary to ensure consistency with accounting practices and to realign the formula with the information schools report in their audited financial statements.

Education also stated that the observed differences between the composite scores and credit rating agencies' assessments of 30 schools does not support that the composite score is an unreliable measure of the relative financial strength of those schools. As we stated in the report, the composite score formula has remained unchanged for 20 years, in contrast to the practices of other federal agencies and credit rating agencies that have reevaluated and adjusted their metrics to take advantage of new financial measures and to respond to evolving risks. For example, the two credit rating agencies we interviewed have adopted more sophisticated methodologies that include financial assessments of schools' historical trends and future projections. The discrepancies between Education's composite score and the credit ratings of these agencies for some schools indicates that Education's measure could be missing some indictors of financial risk. Given the increasing number of school closures in recent years and the multiple weaknesses we identified with the composite score, we continue to believe that Education should update its composite score formula to better measure schools' financial conditions and manage financial risks.

Further, Education stated that the composite score's vulnerability to manipulation is a factor to consider and address, but does not in itself undermine its usefulness because any financial measure could be manipulated once the elements of the measure are known. However, the cases discussed in our report illustrate how the formula can incentivize schools to take on additional debt. While intentional manipulation of any formula is always a possibility, changes are needed to address this known weakness with the composite score formula that schools have actively exploited to manipulate their scores and avoid additional oversight.

These three key weaknesses collectively raise significant concerns about the effectiveness of the composite score as a measure of schools' financial conditions. We identified a number of schools with passing composite scores that subsequently closed, affecting thousands of students and resulting in over half a billion dollars in federal losses from unrepaid student loans. We continue to believe that Education should address these weaknesses by updating the composite score formula to better protect students and taxpayers going forward.

With respect to the second recommendation to improve its guidance to schools about how the financial composite score is calculated, Education stated that it agrees that additional general guidance to schools would be helpful. The department also stated that it will update the guidance in its Federal Student Aid Handbook and may provide answers and related guidance to some frequently asked questions on its website.

With respect to the third recommendation to publicly list the final composite score for each school, Education stated that it agrees that transparency in providing financial responsibility outcomes for schools is important. Education also stated that it will further evaluate the recommendation to ensure that any action it takes will provide information to the public that is precise, fair, and accurate. As we noted in the report, Education does not publicly disclose composite scores for all schools that are owned by the same company or schools that are appealing their scores. Our recommendation calls for Education to list the final composite score for all schools, including schools owned by the same company, not scores that are still under review. Since Education already discloses composite scores for the vast majority of schools, it is unclear why information on the financial condition of schools that are owned by the same company should not be available to the public. We continue to believe that Education should take action to address this recommendation to increase the transparency of public data on schools' financial health.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the appropriate congressional committees, the Secretary of the Department of Education, and other interested parties. In addition, the report is will be available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (617) 788-0534 or emreyarrasm@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report are listed in appendix II.

Melissa Emrey-arras

Melissa Emrey-Arras
Director, Education, Workforce, and Income Security Issues

Appendix I: Comments from the Department of Education

July 19, 2017

Ms. Melissa Emrey-Arras
Director, Education, Workforce
and Income Security Issues
United States Government Accountability Office
Washington, D.C. 20548

Dear Ms. Emrey-Arras:

Thank you for providing the Department of Education with a draft copy of the Government Accountability Office's (GAO's) report, "Higher Education: Education Should Address Oversight and Communication Gaps in Its Monitoring of the Financial Condition of Schools" (GAO-17-555; Job Code 100488). We appreciate the hard work that went into the audit and the opportunity to comment on the draft report.

As noted by GAO, Education has taken steps to increase its oversight of certain schools. In December 2014, Federal Student Aid (FSA) created an office that is responsible for monitoring large school groups and currently monitors 47 companies, including major publicly traded companies, private equity firms, and privately held companies, which collectively own 330 schools. FSA has implemented significant new tools and processes to identify at-risk schools and mitigate potential student and taxpayer harm, including more frequent financial and enrollment reporting requirements for at-risk schools, enhanced information sharing, subscriptions to industry analyses for fiscal information about publicly traded schools, and enhancements to the annual risk model used to select schools for program reviews. While the draft GAO report recognized some of this, we do not believe that the draft provides a complete picture of the Department's work in this area; we discuss this further in our response to Recommendation 1.

In the report, GAO recommended the Secretary of Education take the following actions, which are followed by the Department's responses:

Recommendation 1: Update the composite score formula to better measure schools' financial conditions and capture financial risks.

Federal Student Aid
An OFFICE of the U.S. DEPARTMENT of EDUCATION
830 First St. N.E., Washington, DC 20202

Page 2 - Ms. Melissa Emrey-Arras

Response: The Department regulations require that audited financial statements be prepared in accordance with generally accepted accounting principles, and audited in accordance with generally accepted government auditing standards. (34 CFR 668.23(d)) The Financial Accounting Standards Board (FASB) updates the accounting standards to improve the information reported about an entity in an audited financial statement. Changes made to the accounting standards become an integral part of the audited financial statements that are submitted annually to the Department by institutions. The Department monitors changes to the accounting standards to ensure the financial analysis staff is consistently determining the composite scores for institutions. The goal of the composite score, established through direct and open dialogue with the community when the regulations were developed, was to create a relative financial health measure for all institutions using a common standard, while still taking into consideration the key differences that exist between different sectors of postsecondary educational institutions. This blended approach also takes into consideration the total financial circumstances and resources available to an institution in a uniform manner.

In its report, GAO interviewed community members who, in their opinion, identified a number of perceived weaknesses in the composite score formula. The Department has considered similar concerns raised by some community members about the questioned treatment of certain items in the composite score calculation. The Department has also acknowledged that it will work with FASB on future changes to the accounting standards that may impact an institution's composite score calculation.

GAO states that the Department does not have reasonable assurance that the composite score is a reliable indicator of financial health, but has not shown how any changes in the accounting standards have made the Department's composite score calculations less reliable. The fact that GAO identified 30 schools that would have been rated differently by credit rating agencies does not support that the composite score was an unreliable measure of the relative financial strength of those schools. GAO acknowledges that there is a potential for the components used in the composite score to be manipulated. Any financial measure that the Department would use for evaluating financial health could be manipulated once the elements of the financial measure are known. The potential for a component of the financial measure to be manipulated is a factor to consider and address, but does not in itself undermine the benefits of using the composite score analysis.

The Department hopes that the benefits of providing more guidance as discussed in Recommendation 2 mitigate the disagreements with the community that are related to Recommendation 1, and we will continue to work with individual schools to take into consideration additional information that may have an impact on a school's composite score calculation.

Recommendation 2: Improve its guidance to schools about how the agency calculates the financial composite score, for example by updating its current guidance to include explanations about common areas of confusion and misinterpretation for schools.

Response: As indicated by GAO, in the past, the Department has provided a detailed explanation of its rationale, and treatment of certain components of the composite score

Page 3 - Ms. Melissa Emrey-Arras

calculation. The Department agrees that additional general guidance on how it calculates the composite score would be useful to schools. The Department will update its current guidance to schools in the Federal Student Aid Handbook and may post online the answers and related guidance for frequently asked questions.

Recommendation 3: Increase the transparency of its public data on schools' financial health by publicly listing the final composite score for each school.

Response: The Department agrees transparency in providing the financial responsibility outcomes for schools is important. The Department makes available each year a list of institutions and their composite scores, but that list does not include every school within a school group nor institutions where a composite score is still under review. The Department will further evaluate this recommendation to ensure that any action it takes ensures that the information provided to the public is precise, fair, and accurate.

I appreciate your examination of this important issue.

Sincerely,

Matthew D. Sessa
Deputy Chief Operating Officer

Appendix II: GAO Contact and Staff Acknowledgments

GAO Contact

Melissa Emrey-Arras (617) 788-0534 or emreyarrasm@gao.gov

Staff Acknowledgments

In addition to the contact named above, individuals making key contributions to this report were Michelle St. Pierre, Assistant Director; William Colvin, Analyst-in-Charge; Grace Cho, and Jennifer Cook. In addition, key support was provided by Susan Aschoff, Deborah Bland, Sarah Cornetto, Kirsten Lauber, John Mingus, Sheila McCoy, Mimi Nguyen, and Anne Sit-Williams.

Appendix III: Accessible Data

Data Tables

Accessible Data for Figure 1: Summary of Education's Annual Financial Responsibility Composite Score Calculation for Schools Participating in Federal Student Aid Programs

Education uses information from the school's Audited Financial Statement to calculate three financial ratios.		
Primary Reserve Ratio: Does the school have sufficient resources to cover its expenses?	Equity Ratio: How much does the school own versus what it owes?	Net Income Ratio: Does the school operate within its means?
These three ratios are combined into a single score (financial responsibility composite score) that is scaled from -1.0 to 3.0		
Fail (-1.0 to 0.9): requires letter of credit and additional oversight	Zone (1.0 to 1.4): requires additional oversight	Pass (1.5 to 3.0): no further oversight

Source: GAO analysis of Department of Education information. | GAO-17-555

Accessible Data for Figure 2: Distribution of Financial Composite Scores by School Type, School Year 2014-15

Financial Composite Scores	Percentage of nonprofit schools	Fail Percentage	Percentage of for-profit schools	Fail Percentage
-1	0.24%		4.10%	
-0.9	0.24%		1.64%	
-0.8	0.12%		0.10%	
-0.7	0.06%		0.05%	
-0.6	0.18%		0.15%	
-0.5	0.06%		0.31%	
-0.4	0.12%		0.46%	
-0.3	0.18%		0.41%	
-0.2	0.24%		0.36%	
-0.1	0.24%	Fail	0.26%	Fail
0	0.30%	5%	0.15%	10%
0.1	0.06%		0.36%	
0.2	0.00%		0.67%	
0.3	0.24%		0.15%	

0.4	0.12%		0.26%	
0.5	0.24%		0.46%	
0.6	0.97%		0.15%	
0.7	0.42%		0.15%	
0.8	0.49%		0.10%	
0.9	0.36%		0.15%	
1	0.42%	Zone 4%	0.82%	Zone 5%
1.1	0.85%		1.90%	
1.2	0.67%		0.62%	
1.3	0.79%		1.49%	
1.4	1.03%		0.67%	
1.5	1.21%		6.67%	
1.6	1.03%	Pass 91%	6.00%	Pass 84%
1.7	1.39%		6.11%	
1.8	1.39%		8.36%	
1.9	1.58%		3.13%	
2	1.82%		3.13%	
2.1	2.55%		3.28%	
2.2	11.83%		4.10%	
2.3	4.12%		3.03%	
2.4	4.73%		4.82%	
2.5	6.73%		4.46%	
2.6	6.55%		4.16%	
2.7	5.70%		3.34%	
2.8	5.28%		3.59%	
2.9	4.73%		3.28%	
3	30.69%		16.57%	

Source: GAO analysis of Department of Education data. | GAO-17-555

Accessible Data for Figure 3: School Closures by School Type, School Years 2006-07 through 2015-16

School Year	For-profit	Nonprofit	Public
2006-07	33	13	3
2007-08	37	5	
2008-09	18	5	2
2009-10	21	7	1
2010-11	14	7	2
2011-12	26	5	1
2012-13	25	9	

School Year	For-profit	Nonprofit	Public
2013-14	35	11	
2014-15	67	12	2
2015-16	79	15	2

Source: GAO analysis of Education's Postsecondary Education Participants System data. | GAO-17-555

Accessible Data for Figure 4: School Closures by Enrollment Size, School Year 2014-15

Corinthian Colleges, Inc.	Education Training Corp.	Additional Schools
15 school closures 56,000 students	4 school closures 14,000 students	62 school closures 17,000 students

Source: GAO analysis of Education's Postsecondary Education Participants System and Integrated Postsecondary Education Data System. | GAO-17-555

Agency Comment Letter

Accessible Text for Appendix I: Comments from the Department of Education

Page 1

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Federal Student Aid

An OFFICE of the U S DEPARTMENT of EDUCATION

830 First St. N.E.

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Deputy Chief Operating Officer

(100488)

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