Accounting Tutorial

Department of Education (ED) Financial Responsibility Standards

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DEBT OBTAINED FOR LONG-TERM PURPOSES

SITUATION

The controller and external auditor of a Not-for-Profit (NFP) institution are discussing new financial responsibility requirements that came into effect July 1, 2020 and the Financial Responsibility Supplemental Schedule (FRSS) that must be part of the audited financial statements. They've reviewed NACUBO Advisory 19-04; the Regulation, including Appendix B for NFP institutions; and NACUBO's Excel spreadsheet that replicates Appendix B with formulas. However, both have questions concerning the new definition of "debt obtained for long-term purposes (DOLP)."

They know that under the previous financial responsibility rules, allowable DOLP could not exceed net property, plant, and equipment (PP&E) and could include capital lease obligations. However, the new definition of DOLP has several components. The illustrative FRSS in Appendix B displays pre- and post-implementation DOLP, as well Construction in Progress (CIP) related debt, and pre- and post-implementation lease liabilities. The FRSS also contains asset categories that correspond to those liabilities.

Because the controller and external auditor know that financial responsibility requirements for leases include transition options related to the implementation of Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) 2016-02, *Leases*, they are not exactly sure if DOLP should include related capital lease or Right-of-Use (ROU) asset liabilities. Further, after FASB announced that reporting entities could postpone the implementation of ASU 2016-02 by one year, the NFP institution elected to postpone implementation until FY21.

Both are wondering:

- Should capital lease obligations be included in DOLP?
- Are leased / ROU liabilities subject to the pre- and post-implementation rules for DOLP?
- What are the rules for DOLP and how should related assets be displayed on the FRSS?

PURPOSE OF THE TUTORIAL

This tutorial explains the new criteria, includes sample worksheets that track DOLP and related PP&E (including capital leases and CIP), provides a sample note disclosure, and includes an illustrative section of the FRSS (based on information from Appendix B in the regulation).

A separate tutorial covers the rules for ROU assets after the implementation of ASU 2016-02.

BACKGROUND

On September 23, 2019, the Department of Education (ED) finalized new borrower defense rules that went into effect on July 1, 2020. The new rules center around student borrowers' defense to repayment and amend the financial responsibility requirements by updating definitions of terms used in the calculation of ratios that comprise the composite score.

The financial responsibility standards were revised in order to:

1. Respond to significant new accounting standards (FASB ASU 2016-02, *Leases* and FASB ASU 2016-14, *Presentation of Financial Statement of NFP Entities*)
2. Address ED and Governmental Accountability Office concerns over how DOLP is used in the calculation of the primary reserve ratio
3. Correct known issues with ratio calculations for NFP institutions
4. Reduce ED judgement when verifying amounts reported via eZ-Audit back to an institution's audited financial statements.

See NACUBO Advisory 19-04 for additional information about the new rules and formulas.

DEBT OBTAINED FOR LONG-TERM PURPOSES (DOLP)

Primary Reserve Ratio:
DOLP is used in the calculation of expendable net assets. Expendable net assets is the numerator of the primary reserve ratio, and the formula is as follows:

Expendable net assets:

Start:	Net assets without donor restrictions
Add:	Net assets with donor restrictions
Subtract:	Net assets with donor restrictions in perpetuity
Subtract:	Term endowments
Subtract:	Life income funds with donor restrictions
Subtract:	Intangible assets
Subtract:	Net property, plant, and equipment (PP&E)
Add:	Post-employment and defined benefit pension liabilities
Add:	All debt obtained for long-term purposes [DOLP] (details below)
Subtract:	Unsecured related party receivables
Equals:	**Expendable net assets**

DOLP:
The Regulation indicates that DOLP is debt that exceeds twelve months, including the short-term portion of such debt, and includes lease liabilities for capital lease and ROU assets. DOLP cannot exceed net PP&E, subject to new rules. Additionally, short-term lines of credit or other short- or long-term credit instruments used for CIP, not to exceed total CIP, are allowable.

<u>New Rules for DOLP:</u>
The requirements in the new regulation deconstruct allowable DOLP into the following categories:

I. DOLP related to net PP&E (excluding CIP)
    a. Includes capital lease obligations under Accounting Standards Codification (ASC) 840
    b. Includes ROU asset obligations under ASU 2016-02, **when an institution does not elect the allowable ASU 2016-02 transition provision** (the transition election "grandfathers" the accounting and reporting of operating leases under ASC 840)

II. DOLP for CIP

I. <u>DOLP related to net PP&E</u> (excluding CIP) and including criteria (a) and (b) above. The regulation introduces two main components: **pre-implementation and post-implementation DOLP.**

1. Pre-implementation DOLP – is based on the regulatory definition in effect prior to the July 1, 2020 effective date of the new regulation, or FY19 for most colleges and universities.
   - Pre-implementation DOLP is debt up to the amount of net PP&E under the prior regulation (before 7/1/2020 or FY19 for most), reduced by activity that occurred after the date of the audited financial statements that were used to calculate the financial responsibility composite score under the previous regulation (again, before 7/1/2020 or FY19 for most).
     - Pre-implementation DOLP contains capital lease liabilities included in DOLP in the prior financial responsibility reporting year (FY19 for most).
     - Note, if an institution has received a notice from ED that adjusts the reported DOLP, the ED adjusted amount is the starting point (beginning balance) for pre-implementation DOLP.
   - If institutions do not elect the grandfathering transition option, after implementing ASU 2016-02, pre-implementation DOLP will continue to include obligations for previously reported capital leases that are reclassified to ROU assets under ASU 2016-02.
   - NACUBO recommends that leased / ROU assets be separately tracked on worksheets / schedules that support PP&E reported on the Statement of Financial Position (SOFP) and FRSS. *Institutions can choose to further disaggregate PP&E on the FRSS to display capital leases and related obligations or ROU assets and related obligations.*
   - Refinancings of pre-implementation DOLP are allowable as long as the refinanced amount does not exceed what would have been allowable pre-implementation DOLP.
   - In summary, for FY20, (or the first set of audited financial statements finalized after the 7/1/2020 effective date of regulation), the amount of pre-implementation debt is all DOLP used in the FY19 financial responsibility composite score calculation, including capital lease liabilities, and reduced by principle payments, lease payments, and other. *The result cannot exceed net "pre-implementation" PP&E, which for FY20 is defined as FY19 reported net PP&E (including capital leases), adjusted for depreciation, amortization, and retirements during FY20.*

2. Post-implementation DOLP – is defined as debt entered into for the audited financial statements that apply to the July 1, 2020 effective date (FY20 for most) and used for the acquisition or development of assets capitalized as well as capital leases or ROU assets.
   - The debt instrument (loan agreement, bond issue, line of credit, etc.) must indicate that the purpose of the debt is to fund PP&E.
   - Per the Regulation and reinforced in an ED Question and Answer document, debt collateralized by PP&E does not qualify.
   - Institutions that do not elect the grandfathering transition option, after implementing ASU 2016-02, will include leased / ROU liabilities entered during the first effective year of the new financial responsibility regulations (FY20 for most) with post-implementation DOLP.
     - Post-implementation DOLP is separately displayed on the FRSS and includes leased / ROU liabilities.
     - *Alternatively, institutions can separately display lease liabilities as part of post-implementation DOLP.*

II. DOLP for CIP (Bullet (II) above) – this regulatory criteria begins with CIP in FY20 (the first set of audited financial statements under the new regulation) and includes any debt associated with CIP.

- Because CIP is reported before assets are place in service, ED recognizes that short-term lines of credit, renewable types of bridge financing, commercial paper, and so forth, can be associated debt.
- All of the above credit facilities are allowable as long as the debt is associated with CIP (specified in the debt instrument).

SUPPLEMENTAL SCHEDULE (FRSS), SUGGESTED WORKSHEETS, AND DISCLOSURES

Because DOLP cannot exceed net PP&E, suggested worksheets should first begin with net PP&E and second, associated DOLP to net PP&E categories according to the regulatory rules.

The worksheets should be used to support / provide additional detail required on the FRSS. All reported details on the FRSS must tie to audited numbers in the financial statements—either directly on the face of the financial statements, in the GAAP notes to the financial statements, or in an additional disclosure that fulfills financial responsibility regulatory requirements.

WORKSHEETS: SAMPLE FORMATS-FIRST YEAR OF IMPLEMENTATION

- The worksheets / schedules beginning on the next page (page 5) are illustrative only and show the first year of implementation, i.e. FY2020, assuming a June 30 year-end, and would be updated annually.
- Workpapers can include additional detail for all components of PP&E (land, buildings, furniture/fixtures, equipment, CIP, leased/ROU assets, capitalized software, CIP projects, etc.) and related liabilities.
- The basis for worksheet values are SOFP from Appendix B in the regulation.
  - However, the example in Appendix B assumes that the ASU 2016-02 transition election is chosen.
  - The worksheets in this tutorial assume that the $8,000,000 of post-implementation ROU assets were capital leases at June 30, 2020 with the institution electing to postpone implementing ASU 2016-02 – which is the scenario described on page 1. (NACUBO's anecdotal evidence indicates that most institutions have delayed implementing ASU 2016-02 until FY21.)

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Property, plant and equipment (PP&E)	**Pre-Implementation**	**Post-Implementation**	**Total**
PP&E, net of accumulated depreciation as of June 30, 2019:			
(1) Land, Buildings, Equipment, Furniture and Software	41,000,000	-	41,000,000
(2) Leased capital assets	9,400,000	-	9,400,000
(3) CIP	-	-	-
Total at June 30, 2019	50,400,000	-	50,400,000
FY 20 Activity:			
(1) Land, Buildings, Equipment, Furniture and Software:			
Additions	-	1,000,000	1,000,000
Disposals	(300,000)	-	(300,000)
Depreciation	(1,900,000)	-	(1,900,000)
Sub-total PP&E excl Leases and CIP	***(2,200,000)***	***1,000,000***	***(1,200,000)***
(2) Leases:			
Principle reductions	(1,000,000)	-	(1,000,000)
Amortization	(400,000)	-	(400,000)
Sub-total Leases	***(1,400,000)***	***-***	***(1,400,000)***
(3) CIP:			
Additions	-	200,000	200,000
Sub-total CIP	***-***	***200,000***	***200,000***
PP&E, net at June 30, 2020	**46,800,000**	**1,200,000**	**48,000,000**
Comprised of:			
PP&E	38,800,000	1,000,000	39,800,000
Leases	8,000,000	-	8,000,000
CIP	-	200,000	200,000
	46,800,000	**1,200,000**	**48,000,000**

[The worksheet for DOLP begins on page 6]

	ALLOWABLE DOLP All pre-implementation and post-implementation debt associated with PP&E		NONALLOWABLE DEBT (Debt associated with operations)	
	Pre-Implementation	**Post-Implementation**	**Post-Implementation**	**Total**
Debt at June 30, 2019:				
(1) PP&E	25,600,000	-	-	25,600,000
(2) Capital Leases	9,000,000	-	-	9,000,000
(3) CIP	-	-	-	-
Total at June 30, 2019	34,600,000	-	-	34,600,000
FY 20 Activity:				
(1) PP&E				
Payments	(600,000)	-	-	(600,000)
Additions	-	650,000	-	650,000
Sub-total PP&E excl Leases and CIP	***(600,000)***	***650,000***	-	***50,000***
(2) Leases				
Payments	(1,000,000)	-	-	(1,000,000)
Sub-total Leases	***(1,000,000)***	-	-	***(1,000,000)***
(3) CIP				-
Additions	-	100,000	-	100,000
Sub-total CIP	-	***100,000***	-	***100,000***
(4) Operations				-
Additions	-	-	250,000	250,000
Sub-total Operations	-	-	250,000	250,000
Debt at June 30, 2020	**33,000,000**	**750,000**	**250,000**	**34,000,000**
Allowable Debt comprised of:				
(1) PP&E	25,000,000	650,000	-	25,650,000
(2) Capital Leases	8,000,000	-	-	8,000,000
(3) CIP	-	100,000	-	100,000
Sub-total allowable debt	***33,000,000***	***750,000***	-	***33,750,000***
(4) Non-allowable debt for operations	-	-	250,000	250,000
Total Debt at June 30, 2020	**33,000,000**	**750,000**	**250,000**	**34,000,000**

Analysis:

As a check, pre-and post-implementation debt, as a percentage of pre- and post-implementation PP&E, respectively, should be less than 100% for DOLP to be allowable in the calculation of expendable net assets.

CIP:

It is recommended that CIP debt be separately tracked because CIP related debt and the associated asset must be separately detailed on the supplemental schedule. As a practical matter, CIP can be included in the post-implementation workpaper column – or separated into a separate schedule – depending on materiality and number of construction projects and associated financing arrangements.

Leases:

The assumption for leases in this tutorial and in the worksheets is that:

- An NFP institution has not yet implemented ASU 2016-02 in FY20 (expected to be most NFPs)

Alternatively,

- If an institution has implemented ASU 2016-02, the assumption is that grandfathering transition election has not been chosen.
    - ASC 840 capital leases would be relabeled lease ROU assets
    - However, the illustrative concepts are the same: leased assets and corresponding liabilities, prior to July 1, 2020 are pre-implementation assets and liabilities.

A separate tutorial covers the rules for ROU assets after the implementation of ASU 2016-02.

FRSS:

Institutions can choose to further disaggregate PP&E on the FRSS to display capital leases and related obligations, or ROU assets and related obligations within pre-and post-implementation PPE and DOLP categories, respectively.

REQUIRED FINANCIAL RESPONSIBILITY DISCLOSURES

The following information must be disclosed for post-implementation DOLP included in the calculation of expendable net assets:

- issue date
- term (years to original maturity)
- nature of capitalized amounts
- amount capitalized.

If the above details are not clearly displayed in the GAAP notes to the financial statements, then amounts should be added either within the GAAP notes or in a separate financial responsibility disclosure for post-implementation DOLP.

Per NACUBO Advisory 19-04, the FRSS and any related note disclosures should be included in the Uniform Guidance audit package so that (a) all federal requirements are in one place and (b) general purpose financial statements are not muddled with unique financial responsibility (non-GAAP) requirements.

A separate disclosure is discussed below.

Sample Disclosure – in the UG Audit – part of a unique disclosure labeled "Financial Responsibility Disclosures"

Financial Responsibility Disclosures

Per Regulation CFR 34 Appendix B to Subpart L of Part 668, the following disclosures are required by the Department of Education to assure proper calculation of the institution's financial responsibility ratios and composite score.

(a) ***Debt obtained for long-term purposes*** *is comprised of:*

- *pre-implementation debt – defined as the amounts reported in the last financial statements submitted to the Department of Education prior to July 1, 2020, not to exceed net property, plant, and equipment; and*
- *post-implementation debt – defined as the amount of debt used* ***to obtain property, plant, and equipment*** *after the end of the fiscal year of its most recently submitted financial statements prior to July 1, 2020, less any payments or other reductions. Post-implementation debt can also include debt associated with construction in progress.*

The following tables show the allowable debt obtained for long-term purposes in the institution's financial responsibility calculation and the associated property, plant, and equipment. The allowable debt obtained for long-term purposes at June 30, 2020 is $33,750,000 ($25,000,000+750,000+8,000,000.)

Debt:	**Pre-implementation***	**Post-implementation for capital purposes**	**Post-implementation for operations**	**Total**
Debt at June 30, 2019	$ 25,600,000	$ -		$ 25,600,000
Fiscal year 2020 additions	-	650,000	$ 250,000	900,000
Fiscal year 2020 payments	(600,000)	-	-	(600,000)
Construction in Progress	-	100,000	-	100,000
Long-term debt at June 30, 2020	$ 25,000,000	$ 750,000	$ 250,000	$ 26,000,000
Capital Lease Obligations at June 30, 2020	$ 8,000,000			$ 8,000,000

Property, plant and equipment:	Pre-implementation	Post-implementation	Total
Property, Plant and Equipment, net of accumulated depreciation, June 30, 2019	$ 50,400,000	$ -	$ 50,400,000
Fiscal year 2020 additions, including CIP of $200,000	-	1,200,000	1,200,000
Fiscal year 2020, depreciation, amortization, and disposals	(3,600,000)	-	(3,600,000)
Property, plant and equipment, net at June 30, 2020	$ 46,800,000	$ 1,200,000	$ 48,000,000

Information about the [institution's] debt is found in Note XX of the audited financial statements. Notes YY, and ZZ of the audited financial statements contain information on property, plant, and equipment (including capital leases) and construction in progress, respectively.

[Supplemental Schedule Illustrations on Pages 10 and 11]

Supplemental Schedule: Version 1 (Capital leases included in PP&E and DOLP)

	SOURCE: Audited Financial Statements			
SOFP and FS Note YY	Statement of Financial Position - Property, plant and equipment, net	Property, plant and equipment, net (includes Construction in progress)	48,000,000	
FR Footnote (a)	Notes to the Financial Statements - Property, Plant and Equipment - pre-implementation*	Property, plant and equipment pre-implementation (includes capital leases)		46,800,000
Financial Responsibility (FR) Note (a)	Notes to the Financial Statements - Property, Plant and Equipment - post-implementation with outstanding debt for original purchase*	Property, plant and equipment post-implementation with outstanding debt for original purchase		750,000
Financial Responsibility (FR) Note (a)	Notes to the Financial Statements - Property, Plant and Equipment - post-implementation without outstanding debt for original purchase*	Property, plant and equipment post-implementation without outstanding debt for original purchase		250,000
FR Note (a) and Financial Statement (FS) Note ZZ	Notes to the Financial Statements - Property, Plant and Equipment -Construction in progress	Construction in progress		200,000
FR Note (a) and FS Note XX	Statement of Financial Position - Note Payable and Line of Credit for long-term purposes (both current and long term) and Line of Credit for Construction in progress	Long-term debt - for long term purposes	34,000,000	
FR Note (a) and FS Note XX	Statement of Financial Position - Note Payable and Line of Credit for long-term purposes (both current and long term) and Line of Credit for Construction in progress	Long-term debt - for long term purposes pre-implementation		33,000,000
FR Note (a) and FS Note XX	Statement of Financial Position - Note Payable and Line of Credit for long-term purposes (both current and long term) and Line of Credit for Construction in progress	Long-term debt - for long term purposes post-implementation		650,000
FR Note (a) and FS Note XX	Statement of Financial Position - Note Payable and Line of Credit for long-term purposes (both current and long term) and Line of Credit for Construction in progress	Line of Credit for Construction in progress		100,000

[Supplemental Schedule: Version 2 (PP&E and DOLP display capital leases) – Page 11]

Supplemental Schedule: Version 2 – Breaks out capital lease assets and liabilities (pre-implementation DOLP)

	SOURCE: Audited Financial Statements			
SOFP and FS Note YY	Statement of Financial Position - Property, plant and equipment, net	Property, plant and equipment, net (includes Construction in progress)	48,000,000	
FR Footnote (a)	Notes to the Financial Statements - Property, Plant and Equipment - pre-implementation*	Property, plant and equipment pre-implementation		38,800,000
Financial Responsibility (FR) Note (a)	Notes to the Financial Statements - Property, Plant and Equipment - post-implementation with outstanding debt for original purchase*	Property, plant and equipment post-implementation with outstanding debt for original purchase		750,000
Financial Responsibility (FR) Note (a)	Notes to the Financial Statements - Property, Plant and Equipment - post-implementation without outstanding debt for original purchase*	Property, plant and equipment post-implementation without outstanding debt for original purchase		250,000
FR Note (a) and Financial Statement (FS) Note ZZ	Notes to the Financial Statements - Property, Plant and Equipment -Construction in progress	Construction in progress		200,000
FS Note CC	Statement of Financial Position - Capital leases	Capital leases, net		8,000,000
FR Note (a) and FS Note XX	Statement of Financial Position - Note Payable and Line of Credit for long-term purposes (both current and long term) and Line of Credit for Construction in progress	Long-term debt - for long term purposes	34,000,000	
FR Note (a) and FS Note XX	Statement of Financial Position - Note Payable and Line of Credit for long-term purposes (both current and long term) and Line of Credit for Construction in progress	Long-term debt - for long term purposes pre-implementation		25,000,000
FR Note (a) and FS Note XX	Statement of Financial Position - Capital leases Payable	Long-term debt - for long term purposes pre-implementation - capital leases		8,000,000
FR Note (a) and FS Note XX	Statement of Financial Position - Note Payable and Line of Credit for long-term purposes (both current and long term) and Line of Credit for Construction in progress	Long-term debt - for long term purposes post-implementation		650,000
FR Note (a) and FS Note XX	Statement of Financial Position - Note Payable and Line of Credit for long-term purposes (both current and long term) and Line of Credit for Construction in progress	Line of Credit for Construction in progress		100,000

Related FARM Chapters

¶415 Property, Plant, and Equipment
¶423 Bonds, Notes Payable and Capital Leases