Calculating a composite score

The first step in calculating a school’s composite score is to determine the school’s primary reserve, equity, and net income ratios by using information from the school’s audited financial statement. These ratios take into account the total financial resources of the school. The Primary Reserve Ratio represents a measure of a school’s viability and liquidity. The Equity Ratio represents a measure of a school’s capital resources and its ability to borrow. The Net Income Ratio represents a measure of a school’s profitability.

Upon review, some items from a school’s audited financial statement may be excluded from the calculation of the ratios. For example, the Department may exclude the effects of questionable accounting treatments, such as excessive capitalization of marketing costs, from the ratio calculations. (See box below for regulatory list of exclusions.)

All long-term debt obtained for the school’s purposes may be included for purposes of the Primary Reserve Ratio calculation. However, it is important to note that the overall level of debt obtained for long-term purposes that can be included in the numerator of the Primary Reserve Ratio is limited under the regulations. It cannot exceed the amount of the school’s net property, plant, and equipment.

A strength factor score is then calculated for each ratio using equations established by the Department. A strength factor score reflects a school’s relative strength or weakness in a fundamental element of financial health, as measured by the ratios. Specifically, the strength factor scores reflect the extent to which a school has the financial resources to: 1) replace existing technology with newer technology; 2) replace physical capital that wears out over time; 3) recruit, retain, and retrain faculty and staff (human capital); and 4) develop new programs.

A weighting percentage is applied to each strength factor score to obtain a weighted score for each ratio. The weighting percentages reflect the relative importance that each fundamental element has for a school in a particular sector (proprietary or private nonprofit).

The sum of the weighted scores equals the school’s composite score. Because the weighted scores reflect the strengths and weaknesses represented by the ratios and take into account the importance of those strengths and weaknesses, a strength in the weighted score of one ratio may compensate for a weakness in the weighted score of another ratio.

Once a composite score is calculated, it is measured along a common scale from negative 1.0 to positive 3.0 as indicated in the diagram on the next page. This scale reflects the probability a school will be able to continue operations and meet its obligations to students and the Department.

Exclusions

Excluded items. In calculating an institution’s ratios, the Secretary—

(1) Generally excludes extraordinary gains or losses, income or losses from discontinued operations, prior period adjustments, the cumulative effect of changes in accounting principles, and the effect of changes in accounting estimates;

(2) May include or exclude the effects of questionable accounting treatments, such as excessive capitalization of marketing costs;

(3) Excludes all unsecured or uncollateralized related-party receivables;

(4) Excludes all intangible assets defined as intangible in accordance with generally accepted accounting principles; and

(5) Excludes from the ratio calculations Federal funds provided to an institution by the Secretary under program authorized by the HEA only if—

(i) In the notes to the institution’s audited financial statement, or as a separate attestation, the auditor discloses by name and CFDA number, the amount of HEA program funds reported as expenses in the Statement of Activities for the fiscal year covered by that audit or attestation; and

(ii) The institution’s composite score, as determined by the Secretary, is less than 1.5 before the reported expenses arising from those HEA funds are excluded from the ratio calculations.

34 CFR 172(c)
Example: Calculation of a composite score for a proprietary institution*

**Calculation of Ratios**

- **Primary Reserve Ratio**
  \[
  \text{Primary Reserve} = \frac{\text{Adjusted equity}}{\text{Total expenses}} = \frac{760,000}{9,500,000} = 0.080
  \]

- **Equity Ratio**
  \[
  \text{Equity} = \frac{\text{Modified equity}}{\text{Modified expenses}} = \frac{810,000}{2,440,000} = 0.332
  \]

- **Net Income Ratio**
  \[
  \text{Net Income} = \frac{\text{Income before taxes}}{\text{Total revenues}} = \frac{510,000}{10,010,000} = 0.051
  \]

**Calculation of Strength Factor Score**

- **Primary Reserve Strength Factor Score**
  \[
  \text{Primary Reserve Strength Factor Score} = 20 \times \text{Primary Reserve Ratio} = 20 \times 0.080 = 1.600
  \]

- **Equity Strength Factor Score**
  \[
  \text{Equity Strength Factor Score} = 6 \times \text{Equity Ratio} = 6 \times 0.332 = 1.992
  \]

- **Net Income Strength Factor Score**
  \[
  \text{Net Income Strength Factor Score} = 1 + (33.3 \times \text{Net Income Ratio}) = 1 + (33.3 \times 0.051) = 2.698
  \]

**Calculation of Weighted Score**

- **Primary Reserve Weighted Score**
  \[
  \text{Primary Reserve Weighted Score} = 30\% \times \text{Primary Reserve Strength Factor Score} = 0.30 \times 1.600 = 0.480
  \]

- **Equity Weighted Score**
  \[
  \text{Equity Weighted Score} = 40\% \times \text{Equity Strength Factor Score} = 0.40 \times 1.992 = 0.797
  \]

- **Net Income Weighted Score**
  \[
  \text{Net Income Weighted Score} = 30\% \times \text{Net Income Strength Factor Score} = 0.30 \times 2.698 = 0.809
  \]

**Composite Score**

\[
\text{Composite Score} = 0.480 + 0.797 + 0.809 = 2.086 \quad \text{rounded to 2.1}
\]

*The definition of terms used in the ratios and the applicable strength factor algorithms and weighting percentages are found in the Student Assistance General Provisions (regulations) (34 CFR 668) Subpart L, Appendix A for proprietary schools and Appendix B, for private nonprofit schools.*