Circular **03/10**

For Action: Responses to Annex A are requested by 31 July 2003

Planning

Financial Planning and Associated Information

Summary

This circular sets out guidance on providers' financial planning and associated risk management information that the Learning and Skills Council (LSC) wishes to receive by 31 July 2003.

The LSC established its requirements in 2002 for financial planning returns from colleges in respect of three-year financial plans and risk management plans. The requirement was distinct from strategic planning information.

Colleges should approve a financial control budget before 1 August 2003. This should be the first year of colleges' three-year financial plans. To assure this is done and to provide the fundamental basis for monitoring colleges' financial health, an updated circular is now issued.

Supplements: This circular is associated with Supplement A and Supplement B, available on the LSC's website (www.lsc.gov.uk).

Subject: This circular sets out guidance on providers' financial planning information that the LSC wishes to receive by 31 July 2003.

Intended recipients: Although this circular will be of interest to all providers, only further education (FE) colleges are required to provide three-year financial plans and associated information to the LSC.

Status: For response by 31 July 2003.

Supersedes: Circular 02/11.

May 2003

Learning+Skills Council

Contents

Further information

For further information, please contact the appropriate local Learning and Skills Council office, or write to:

Learning and Skills Council
Cheylesmore House
Quinton Road
Coventry CV1 2WT.

www.lsc.gov.uk

Responses to this document

Responses are requested by 31 July 2003.

Enquiries

Telephone helpline: 024 7649 3758
Fax: 024 7682 3590
e-mail: pfs.helpdesk@lsc.gov.uk

Executive Summary

Date: May 2003

Subject: The purpose of the circular is to set out guidance on providers' financial planning and associated risk management information that the LSC wishes to receive by 31 July 2003.

The LSC set out its requirements in 2002 for financial planning returns from colleges in respect of three-year financial plans and risk management plans. For the first time, the requirement was distinct from strategic planning information.

The LSC requires colleges to have approved a financial control budget before 1 August. This should be the first year of colleges' three-year financial plans. To assure the LSC that this has been done, and to provide the fundamental basis for monitoring colleges' financial health, it is now necessary to issue an updated circular.

Intended recipients: Although this circular will be of interest to all providers, only further education (FE) colleges are required to provide three-year financial plans and associated information to the LSC.

Status: For response by 31 July 2003.

Financial Planning and Associated Information

Introduction

1 The purpose of this circular is to provide guidance to further education (FE) colleges on the financial planning and associated information that the Learning and Skills Council (LSC) wishes to receive by 31 July 2003.

Background

2 Circular 03/01: *Success for All – Implementation of the Framework for Quality and Success* sets out how the LSC plans to develop a framework for quality and success by establishing a new planning, funding and accountability system, based on greater partnership and trust, including three-year funding agreements.

3 Consultation on the proposals is being conducted in accordance with the following timetable:

- publication of consultation circular – 31 January 2003;
- responses to consultation required by 25 April 2003; and
- publication of report on consultation and guidance to local LSCs, colleges and other providers – 31 May 2003.

In view of this timetable, it is not possible to confirm final arrangements for these matters in this publication. Further guidance on this is included in Annex B.

4 Circular 03/01 sets out the LSC's strategy for a planning-led approach to funding. A key element of this will be the agreement of three-year development plans with providers. These development plans will:

- set out the improvement goals;
- identify headline targets; and
- be supported by three-year funding agreements.

5 It is intended that initial three-year development plans will be agreed by 31 July 2003. Colleges will be expected to demonstrate how their financial plans support, and are supported by, their development plans.

Information Requested in July 2003

6 One copy of all the information should be returned to the executive director at the appropriate local LSC office no later than 31 July 2003. Colleges that require further clarification, or for whatever reason cannot provide the information by 31 July 2003, should contact their local LSC office at the earliest opportunity. All FE colleges should complete and return a signed copy of the financial planning cover sheet provided at Annex A.

7 A template for all financial planning components is available for download at the LSC's website (www.lsc.gov.uk).

Table 1 Summary of information requested in July 2003

	FE colleges	Submission date	Other providers
Provider Financial Plans			
Financial planning cover sheet	✓	31 July 2003	Not applicable
Three-year financial plan – paper copy	✓	31 July 2003	Not applicable
Three-year financial plan – on disk	✓	31 July 2003	Not applicable
Principal's certificate	✓	31 July 2003	Not applicable
Commentary	✓	31 July 2003	Not applicable
Associated information			
Risk management plan	✓	31 July 2003	Not applicable
Disaster management plan	✓	31 July 2003	Not applicable

Financial Plans

8 Colleges are reminded that the governing body should approve financial plans and that budgets for 2003/04 should be approved before 1 August 2003 (paragraph 10 of Annex B to Further Education Funding Council (FEFC) Circular 99/48 *Financial Memorandum*).

9 Financial planning information will form part of the LSC's performance reviews of providers.

10 The LSC expects financial plans to be prepared on a realistic basis, taking account of the financial planning assumptions suggested in Annex B although, no doubt, colleges will also wish to consider their financial plans on a worst-case scenario basis. The worst-case scenario should be considered in the sensitivity analysis, an example of which was set out in Circular 01/01 *Strategic Plans, Including Financial Forecasts and Accommodation Data*. The sensitivity analysis should also address more favourable outcomes than those included in the financial plan, where appropriate. The college's sensitivity analysis is expected to form an integral part of the college's risk management plan.

Three-year financial plan

11 The three-year financial plan should be an integral part of each college's own strategic and development plans, as it expresses in financial terms the cost of implementing those plans and shows the income and expenditure associated with projected levels of activity. The financial plan is intended to help each college's governing body, and the LSC, to assess the financial effect of a college's strategic and development plans. It is important to include in the financial plan the costs of implementing the college's property strategy for the plan period.

12 The commentary to the financial plan should demonstrate clearly how the financial plan is consistent with the college's own strategic and development plans and with the local LSC's strategic plan.

Five-year financial plan

13 The increasing scale of some college property strategies has required the development of five-year financial plans in order to facilitate review of the college's financial health following completion of the project.

14 The LSC has made the evaluation proforma available to all colleges that wish to produce a five-year financial plan. However, colleges should only submit a three-year version to the LSC at this time.

Disk

15 The proformas will be made available at the LSC's website (www.lsc.gov.uk) as Excel workbooks (Excel 97/Excel 2000 on Windows 95). Disks will not be sent out to colleges unless specifically requested. Colleges unable to use this software should contact the LSC's telephone helpline on the number at the beginning of this document.

Principal's certificate

16 The college's financial plan should form part of a logical sequence linking work on curriculum provision, accommodation strategy and development planning to support the college's strategic plan.

17 Form 5 of the financial plan proforma should be signed by the college's accounting officer in order to confirm that the financial plan and associated information have been approved by the college's corporation and that they do, in fact, support the strategic plan.

Commentary

18 A framework for the textual commentary to support the financial plans is set out in Annex C.

19 In addition, colleges should include separate risk management and disaster management plans.

Guidance

20 Guidance on the completion of the proformas is given in Supplement A to this circular. The proformas themselves are included in Supplement B.

21 For further advice on how to complete the financial plan returns disk, or any other matters associated with this circular, colleges should contact their local LSC or the LSC national office helpline on the number given at the beginning of this circular.

Risk Management and Disaster Management Plans

Risk management plans

22 Colleges are requested to include a sensitivity analysis and costed contingency plans within the commentary to their financial plan. In addition to this, previous planning circulars have requested that colleges share risk management and disaster management plans with the LSC. In 2002, the LSC's officers considered that approximately 75% of colleges prepared adequate risk management plans.

23 Circular 03/08 *FE Colleges: Accounting Policies and Return of Audited Financial Statements* sets out the requirements for risk management planning to allow colleges to comply with the Combined Code of Corporate Governance (Turnbull Report). In order to assure the LSC that colleges are able to meet these requirements, colleges are requested to provide risk management and disaster management plans with their three-year financial plans. In the light of the Turnbull Report, the LSC has increased its level of review of these plans and it is essential that colleges continue to improve their robustness.

24 It is suggested that colleges' plans should cover the following types of risks:

- strategic;
- compliance;
- operational;
- financial; and
- reputational.

25 In practice, these risk 'types' will overlap and it is probable that even non-financial risks will result in a financial impact on the college.

26 The LSC's review of risk management plans in 2002 showed that colleges considered the risks associated with student recruitment, retention and achievement, and staff recruitment and retention, were of almost equal concern. Other significant risks identified

were those in respect of poor inspection results and financial solvency and health.

Disaster management plans

27 Colleges may wish to integrate disaster management planning with the above risk management plan. However, it may be considered appropriate to have a separate section which deals with more extreme risks. Responses to disasters are likely to require more far-reaching actions which, in turn, have an impact on other aspects of the college. Of necessity, this 'domino effect' will involve more resources. Conversely, major disasters are far less likely to occur.

28 A structured approach to these eventualities should consider the following:

- the 'cost' of accepting the risk;
- actions required to avoid the risk;
- potential to reduce the risk;
- actions to contain the risk; and
- ability to transfer the risk (for example, insurance).

29 Colleges are expected to have in place contingency plans that would be required in the event of a major disaster affecting day-to-day operations.

30 In addition to the usual risks of fire, flood or other Acts of God, colleges should consider the effects of events such as failure of information technology services, corruption of essential data (either maliciously or accidentally), loss of key staff or default of major suppliers.

31 Identification of the potential severity of the event should be of major concern. Consider the following.

- Does it have an impact on the college's survival?
- Does it have an impact on the college's finances?
- Does it have an impact on the college's image?
- Is it time-critical?
- Does it have an immediate impact?
- Can the college cope without (and for how long)?
- What alternatives are possible?

32 Colleges are recommended to establish a formal process to define and allocate responsibilities for action to be taken in the event of any major disaster occurrence. At minimum, this process should identify a key manager who will take on the role of business continuity management. This position would take control of the implementation plan and identify such support as necessary. The main initial aspects of this role would be to:

- implement immediate emergency reaction;
- notify and mobilise support services;
- control central co-ordination;
- assess actual and potential damage;
- communicate clear instructions and guidance; and
- restore essential functions.

33 Colleges should be clear in establishing contingency plans and of the need for regular review and assessment of the plans' functionality. Regular testing, monitoring and feedback should ensure that the need for updating is considered. Accountabilities within the plans should be reviewed and authority for the implementation of changes should be clear.

Compliance with the Turnbull Report

34 Risk management and disaster management plans should clearly demonstrate how they meet the requirements of Circular 03/08. Colleges should indicate whether they will be fully compliant with the Turnbull Report by 1 August 2003, and, if not, when they expect to be compliant. The plans should be approved by the college's corporation.

Information Requested Beyond July 2003

Financial mid-year update (February 2004)

35 Where the LSC wishes to receive a mid-year update, it will be requested by the appropriate local LSC office. This will generally apply to those colleges falling into financial health group C (as assessed by the LSC). In any event, those colleges from which a return is required will be notified by 16 January 2004 for submission before the end of February 2004. The software application for returning this information will be included on the LSC's website. Guidance on the completion of the mid-year update can be found in Supplement A to this circular.

Finance record

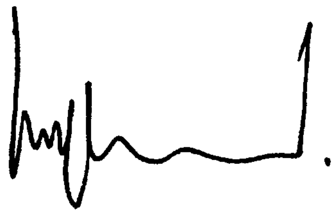
36 The requirement to submit a finance record, previously included in the LSC's strategic planning circular, is now contained within Circular 03/08.

Benchmarking data

37 The LSC provides basic benchmarking data to colleges based on submissions of financial plans. An exercise to improve this service is currently taking place in conjunction with the college finance director network. Some additional financial information may be sought from colleges at a later date.

Requirement to notify the Learning and Skills Council

38 The college should notify the LSC in writing if at any time there is a significant deterioration in its financial position (FEFC Circular 99/48 *Financial Memorandum* at Annex B, paragraph 33).



John Harwood, Chief Executive

Annex A: Cover Sheet for Return of Financial Plans and Associated Information: July 2003

Area Finance Director
Cheylesmore House
Quinton Road
Coventry
CV1 2WT
T 024 7682 3758
F 024 7682 3590

www.lsc.gov.uk

(Reference Circular 03/10)

This cover sheet must be completed in respect of all returns. Please photocopy (or download from the Learning and Skills Council (LSC) website: www.lsc.gov.uk), complete and return it to the executive director at the local LSC office by **31 July 2003**.

Learning+Skills Council

Name of college *(please print)*
Code
Contact for queries *(please print)*
Telephone number
Fax number
e-mail

Returns enclosed (please tick)

Financial plan		**Submission date**
three-year financial plan	☐	31 July 2003
principal's certificate	☐	31 July 2003
disk	☐	31 July 2003
commentary	☐	31 July 2003
Risk management plan	☐	31 July 2003
Disaster management plan	☐	31 July 2003

Declaration

Signature ______________________________

Principal/Head of college ______________________________

Name (please print) ______________________________

Date ______________________________

Annex B: Financial Planning Assumptions 2003/04 to 2005/06

Introduction

1 The Learning and Skills Council (LSC) publishes national guidance on many aspects of further education (FE) funding. Furthermore, it is increasingly important for local priorities to be met. It is the LSC's intention for greater emphasis to be placed on local, rather than national, planning. Accordingly, therefore, colleges are requested to agree planning assumptions with the local LSC office.

2 The following guidance on financial planning assumptions should be taken as general advice rather than specific instructions.

3 As outcomes of the consultation on the LSC's proposals in response to *Success for All* will not be complete until 31 May 2003, it is again important this year that planning assumptions are clearly set out in the commentary to the financial plan and that colleges' sensitivity analyses and risk management plans identify contingency actions where it is felt that the assumptions adopted may not be secure.

Further Education Participation Allocations

4 Guidance on FE participation allocations is given in the LSC's publication, *Funding Guidance for Further Education in 2003/04*. The key points to consider are set out in section 1 of that publication. From 2003/04, the LSC seeks to establish more realistic allocations, in order to ensure that institutions deliver their funding agreements and that resources are made available to fund deliverable growth in priority areas.

5 The above publication should be read in conjunction with other LSC documents, including Circular 03/01 *Success for All – Implementation of the Framework for Quality and Success,* which discusses proposals for three-year funding agreements, headline targets and development plans, and the LSC publication *Funding: Indicative Rates for Further Education, Work-based Learning and School Sixth Forms in 2003/04*.

6 These documents are available on the LSC's website (www.lsc.gov.uk).

Base level of funding

7 In general, the national FE base rates have been increased by 10% for the academic year 2003/04. This increase is shown in Table 1 overleaf.

Table 1 National FE base rates, 2003/04

Inflation	2.5%	
Success for All	2%	A real terms increase linked to agreeing a development plan with targets
Teachers' Pay Initiative (TPI) and staff development element of the standards fund	3.5%	Consolidation of existing funding
Teachers' pensions	2%	New funding to cover the cost of increased employer contribution to the teachers' pension scheme
Total	10%	

8 The only exceptions to this policy are where colleges are on individual convergence tracks through a special agreement with the LSC, in order to offer them support in dealing with financial difficulties.

Subsequent funding increases

9 Except where these special arrangements exist in future years, for financial planning purposes, all colleges should assume that average funding increases for inflation continue at 2.5% a year.

10 Circular 03/01 develops the objective in *Success for All* that colleges which stay on track to deliver their development plan and achieve their targets will continue to have increases in FE funding averaging 2.5% above the rate of inflation in 2004/05 and 2005/06. However, colleges should identify and develop plans to offset the opportunity or risk that funding may be higher or lower than this in future years.

11 Where colleges have special funding arrangements agreed with the LSC, they should ensure that the impact of subsequent allocations is clear in developing their financial plans. Further guidance on this may be obtained from the local LSC office.

Full-time equivalent learner definition

12 For the purposes of monitoring learner numbers, and in the context of three-year funding agreements (see Circular 03/01), the definition for full-time equivalent (FTE) learners will be learner profile FTEs.

13 A learner studying a programme of 450 or more planned guided learning hours (glh) in a funding year will count as one FTE. A learner studying a programme of less than 450 glh in a funding year will be converted to a fraction of one FTE by dividing the planned glh of the learner's programme by 450.

Learner funding rate

14 Circular 02/11 introduced the concept of a learner funding rate (LFR) for financial planning purposes.

15 The LFR will be calculated from the total FE recurrent grant allocation for the year, divided by the total planned further education FTEs for that year. Colleges should ensure that year-on-year movements in the LFR are explained in the commentary to the financial plan.

European Funding

16 The LSC has developed its approach to the European Social Fund (ESF) as a co-financing organisation, and has issued separate guidance on both this new approach (*Funding Guidance 2003/04; ESF Requirements of Co-financing within the LSC*) and on the traditional use of ESF. Where local agreements are in place, colleges should include this level of funding in their plan.

17 Colleges planning a higher level of funding than currently received should address the effect of not achieving that funding in their sensitivity analysis and risk management plan. Colleges should also consider the risk of incorrect application of ESF eligibility rules.

Work-based Learning

18 Circular 02/13 *Funding Arrangements for Work-based Learning for Young People 2002/03* set out changes which became operational in 2002/03. Colleges should assume, for financial planning purposes, that national formula-funded rates increase subsequently (on a like-for-like basis) for inflation at 2.5% a year. Colleges should identify in their sensitivity analysis the effect of potential future movements in these rates as a result of further reviews by the National Rates Advisory Group (NRAG).

19 Further guidance is available in the LSC publication *Requirements for Funding Work-based Learning 2003/04*.

Recovery of Funds

20 Arrangements for recovery of funds for underachievement in 2002/03 will be published by the LSC. Arrangements for future years are currently subject to review associated with the establishment of pilot or pathfinder colleges and the development of three-year funding agreements.

Pilot colleges

21 For 2002/03 the rules for recoveries will be the same as those applying to all other colleges. Because the pilot is being launched part-way through 2002/03, the LSC will still seek to recover funds where targets have not been achieved. However, the assessment of recoveries resulting from underperformance will be taken entirely on trust – there will be no planned audit of the amount.

22 From 2003/04 onwards the LSC will not be seeking the recovery of funds for underperformance. This will reflect a more precise allocation around which the LSC and the colleges agree more realistic targets.

Pathfinder colleges

23 The pilot will be followed by a pathfinder phase. The LSC is committed to extending this arrangement to up to another 100 colleges from 2003/04 onwards.

24 The outcomes of the 2002/03 funding audit will be considered (when it becomes available in February 2004) in relation to the maintenance of the trust relationship and continued involvement as a pathfinder.

25 The LSC will not seek to recover funds where planned volumes and patterns of provision have not been delivered, provided that the trust relationship has been maintained.

Other Funding and Grants Guidance

26 The LSC has published guidance in respect of other funding and grant programmes as follows:

- Circular 03/05 *Capital Project Grant Support: New and Updated Arrangements from 2003/04 Onwards*;
- Circular 03/03 *Development of a Common Funding Approach for Additional Learning Support*;
- Circular 02/20 *Capital Project Grant Support: Updated Arrangements for 2002/03*; and
- Circular 02/15 *Centres of Vocational Excellence: Update for Further Education Colleges*.

These documents, and any subsequent updates, are available on the LSC's website.

Inflation

27 The Treasury has estimated that the gross domestic product (GDP) deflator – a measure of inflation – over the years 2003 to 2006 will be 2.5% each year. Colleges should use this estimate in calculating movements in the cost of non-pay items, unless they have better information about the specific price changes that will affect them.

Pay Costs

28 Colleges should continue to make their own decisions on pay awards based on the institution's individual circumstances.

29 As confirmed in the chancellor's Budget presentation on 9 April 2003, national insurance contributions (NICs) paid by employers, employees and the self-employed on all earnings above the NICs threshold of £89 a week were increased by 1% from April 2003. Colleges should review their contribution rates to ensure that they reflect this change.

Pension Costs

30 Circular 02/07 *FE Colleges: Accounting Policies and Return of Audited Financial Statements* confirms the treatment to be applied by FE colleges in respect of the requirements of FRS 17 *Retirement Benefits* for the disclosure of pension scheme liabilities. Circular 02/07 also includes tables for the calculation of provisions in respect of enhanced early retirement pensions.

31 Where any college recognises a need for additional payments to be made into its pension funds, it should clearly highlight this in its commentary to the financial plan and set out the basis upon which the calculation has been made.

32 As already advised to colleges, the report on the teachers' pension scheme from the government actuary has confirmed an increase in the employer's contribution from 8.35% to 13.5% with effect from 1 April 2003.

General

33 The assumptions set out in this annex are provided for colleges as general guidance. As clarification is available in respect of three-year funding agreements, development plans and recoveries of funds for underachievement, the LSC will publish further guidance on its website.

Annex C: Commentary to the Plan

Introduction

1 The Learning and Skills Council (LSC) asks colleges to provide a commentary to support the financial plan, clarifying the following points:

- how the financial plan is consistent with the college's own strategic and development plans, and how it is consistent with the local LSC's strategic plan;
- a statement of the key assumptions used in the financial plan;
- major movements between plan periods for income and expenditure account and balance sheet headings;
- major variances between the latest out-turn estimate for the current year and the original budget;
- the contribution made by different areas of activity;
- the college's self-assessment of its financial health and an explanation of any variance from the computed financial health group; and
- a statement of the degree to which the college's risk management and disaster management plans comply with the guidance in the Turnbull Report on Corporate Governance (Turnbull Report).

2 A checklist is provided on issues to consider when completing the financial plans and monitoring. The checklist is for colleges' own use and does not need to be returned to the LSC.

Financial Objectives

3 In order to assist the college in achieving its strategic and development plans, the governing body should set financial objectives or targets. The purpose of setting such objectives is to establish limits within which the college should operate. Governors may wish to set targets for aspects such as solvency, reserves and dependency on certain types of income. Examples of financial objectives are included below. When the LSC reviews colleges' financial plans it considers whether the targets set by those colleges are appropriate, particularly for solvency.

Assumptions

4 Guidance on financial planning assumptions can be found in Annex B. However, in view of the increasing importance of local provider planning, colleges are requested to set out clearly the assumptions used in their financial plans.

Sensitivity Analysis

5 The information in the financial plan should reflect the financial effect of the planned levels of activity described in a college's strategic and development plans. However, these plans are based on assumptions containing some degree of uncertainty. The sensitivity analysis is intended to show the financial implications if more unfavourable conditions apply. Therefore, we ask colleges to examine critically the underlying key assumptions and to assess realistically the effect of failure to meet their plans. The college's sensitivity analysis should be an integral element of its risk management plan.

6 Some planning assumptions have critical implications for a college's strategic plan and the consequences of alternative outcomes can be complex. For example, a major project that would not proceed without LSC support could affect a college's growth or the number of staff employed, leading to a very different outcome from the original financial plan. *Where a financial plan contains critical assumptions of this nature, we advise colleges to complete a second plan based on the alternative scenario and to share it with the LSC*. Where a college considers that different outcomes have an impact on its financial viability, we consider it essential to produce an alternative financial plan that reflects the impact of those changes.

7 Colleges should identify contingency actions to mitigate the consequences of the identified sensitivities. Colleges should notify the local LSC office where these actions mean a rationalisation of provision in any programme area or locality.

8 An example of a sensitivity analysis was set out in Circular 01/01 *Strategic Plans, Including Financial Forecasts and Accommodation Data*.

9 To appreciate the implications of sensitivities it is important that they are costed.

10 When reviewing colleges' financial plans, the LSC will consider the adequacy of sensitivity analysis and contingency planning carried out by colleges.

Financial Health Self-assessment

11 Colleges are asked to provide a self-assessment of their financial health. The guidance on financial health self-assessment is based upon the following principles:

- the prime responsibility for a college's financial health rests with the college;
- self-assessment provides the impetus to improve a college's financial health and is most effective when it is structured, rigorous and continual; and
- both the college's self-assessment and the LSC's assessment of the college's financial health should focus on the same guidelines, at the forefront of which lies the robustness of the college's finances: in particular its solvency, the likely risks in the college's environment and the adequacy of the college's contingency plans.

12 When the LSC assesses which financial health group is appropriate for a college, it considers the guidelines for each group, as set out below, the college's self-assessment and a computed health group. Further information in respect of the computed health group is set out below.

13 An indicative health group assessment, derived from the computed health group, is shown on Form 5 of the financial plan. Where colleges do not feel that this gives a true representation of their financial health, they need to explain the underlying reasons in the commentary.

14 Each college should insert their own assessment of their health group on Form 5, stating which of the following groups most closely identifies with their financial position and supporting the statement with key analysis and reasons that justify the assessment. Such assessments concentrate on the overall strength of the balance sheet, cash flow plan and the likelihood of achieving the college's income and expenditure projection. The board of governors should confirm the assessment. Please note the definitions of these groups are guidelines and not criteria.

Group A

15 Group A comprises colleges that appear to have sufficiently robust finances in order to implement their strategic and development plans and to deal with the circumstances most likely to occur during the planning period.

These colleges will normally have:

- a positive cash flow from operations each year;
- more than 25 cash days in hand;
- a current ratio above 1.5:1;
- a positive balance on their general reserve (income and expenditure account);
- an operating surplus year-on-year; and
- total borrowing less than 50% of their general reserve (income and expenditure account).

16 Also, these colleges will have carried out a rigorous sensitivity analysis and will have modelled the issues which are most critical to their success. In addition, they will have identified contingency plans in order to deal with the most adverse variances.

Group B

17 Group B comprises colleges demonstrating signs of financial weakness that might limit their ability to implement their strategic and development plans, should they encounter adverse circumstances during the planning period. Colleges in this group are likely to have weaker solvency than those in Group A, but should still have:

- a positive cash flow from operations each year;
- more than 15 cash days in hand;
- a current ratio between 1.0:1 and 1.5:1;
- a positive balance on their general reserve (income and expenditure account);
- an operating position at break-even; and
- total borrowing no greater than their general reserve (income and expenditure account).

18 In addition, this group also covers those colleges that may appear to have features similar to those for Group A, but whose assumptions appear either over-ambitious or over-optimistic. For example, some colleges in Group B are planning significant efficiency savings without robust plans in place to achieve those savings. Some colleges may have included income generation without a supporting business plan. In addition, this group also includes colleges that are improving from a Group C position.

Group C

19 Group C comprises financially weak colleges that are (or may become) dependent on the goodwill of others. This might involve, for example, a loan from their bank for solvency purposes. Group C colleges are at significant risk of failing to deliver their strategic and development plans. Colleges in this position are likely to have:

- a cash outflow from operations in one or more years;
- less than 15 cash days in hand;
- net current liabilities (current ratio less than 1.0:1) in one or more years;
- an accumulated deficit on their general reserve account;
- an operating deficit; and
- total borrowing in excess of their general reserve (income and expenditure account).

20 Although this circular sets out financial plan submission requirements for FE colleges only, the above descriptors and indicators (with the exception of borrowing levels) are applicable to all providers.

Computed Health Group and Indicative Health Group Assessment

21 To assist colleges in assessing their appropriate financial health group, the LSC has developed a computed health group model.

However, this model does not take account of 'soft' factors such as management style, data management performance, risk management and contingency planning and other intangible factors which may have an impact on a college's financial health. Consequently, colleges are reminded that the LSC's assessment of their financial health is not based solely on the automatic computed health group.

22 An indicative health group assessment, derived from the computed health group model, is shown on Form 5 and colleges will be expected to comment on reasons for either agreeing or disagreeing with the assessment.

23 The indicative health group assessment is based on the following financial ratios:

- cash generation;
- cash days;
- current ratio;
- general reserves;
- operating surplus; and
- total borrowing.

24 These ratios are taken from the plans supplied by the colleges and then allocated a score. The sum total of each year of these scores is then weighted in favour of the first two years, and the health group is assessed depending on the final score achieved. A higher weighting is given to earlier years as they can be planned with a greater degree of accuracy than later years. Table 1 sets out the limits for the scoring and shows how these are weighted.

Table 1 Scoring limits and weighting

	College return	Weighting
Cash generation	>0.02	6
	=>0.00	3
	<0.00	0
Cash days	>25	6
	>15	3
	>0	0
	=<0	-3
Current ratio	>1.5	6
	<1.5	3
	<1.1	0
	<1.0	-50
	<0.5	-100
General reserves	>5%	6
	=>0%	3
	<0%	0
	<-5%	-3
Operating surplus	>3%	6
	=>0%	3
	<0%	0
Total borrowing as a percentage of reserves	<50%	6
	=<100%	3
	>100%	0

25 The weightings are totalled for each year. Then the yearly totals themselves are weighted on the following basis:

- first year's totals (x3);
- second year's totals (x2); and
- third and fourth years' totals (no additional weighting).

When a five-year plan is produced, only the first four years' data are used in establishing the indicative health group assessment.

26 When the final score is known, then the indicative health group is assessed:

- >168 A
- >84 B
- All others C

Confirmation of Financial Health Assessment

27 During autumn 2003, the LSC will write to college principals indicating whether it agrees with a college's financial health self-assessment. The LSC will explain the reasons for any differences in assessment. Principals should share this letter with the board of governors.

Checklist for Commentary

28 The checklist below is for colleges' own use and does not need to be returned to the LSC.

Financial objectives

29 Has the college set detailed financial objectives? Are they set out in the commentary?

30 Has an assessment been included in the commentary of the extent to which they have been achieved?

Strategic and/or development plan

31 Is there a clear link between the projected learner numbers included in the college's strategic and development plans and the growth in funding and full-time equivalent (FTE) learner numbers recorded on Schedule 1A of the financial plan? If not, please explain any changes in the commentary.

32 Do the payroll costs included in Form 2B of the plan reflect future staffing plans?

33 Does the financial plan reflect the financial implications of the college's property strategy?

34 Does the financial plan demonstrate that the college's financial objectives are being achieved? If they are not, is this addressed in the commentary?

Statement of key assumptions

35 Does the commentary include assumptions about:

- growth in funding and learner funding rate (LFR);
- income from the LSC other than a participation element;
- income from non-LSC sources, in particular: education contracts, tuition fees, European funds, commercial activities and New Deal;
- implementation of property strategy, in terms of capital investment, long-term maintenance and routine maintenance;
- increases in the pay bill arising from the effects of pay awards made;
- changes in national insurance contributions (NICs);
- changes in pension fund contributions;
- incremental drift: where incremental scales exist, estimate the gain resulting from staff losses at the high end of the scale being offset by new staff at the

lower end; and

- any changes anticipated for the local government superannuation scheme?

36 Does the commentary include the general level of pay awards assumed in the plan?

37 Does the commentary state any variation in the general inflation rate for specific items of income or expenditure?

38 Does the commentary state the interest rates assumed?

39 Does the commentary state the assumptions underlying income from all sources and all expenditure cuts?

Approval

40 Has the whole governing body approved the plan?

Self-assessment of financial health

41 Has the governing body made regular assessments of the college's financial health?

42 Has a review of the strategic plan and financial plan taken place in order to assess whether the college is able to support its plan with the resources identified?

43 Have the underlying strengths and weaknesses of the college's financial position been examined in order to assess the extent to which the college is likely to be vulnerable to adverse variances?

44 Does the commentary explain the college's rationale for its financial health self-assessment?

45 Does the commentary give reasons for any variance from the indicative health group assessment, if applicable?

Supplementary information required in the commentary

Form 1

46 Does the commentary give a detailed explanation of all significant transfers to and from reserves?

47 Does the commentary explain significant year-on-year movements?

48 Does the commentary explain any variances between the latest estimate of out-turn for the current year and the original budget?

49 Does the commentary give the sources of grant income?

50 Does the commentary give the nature of any repayment of ESF funding?

51 Does the commentary give the sources of income from franchising provision?

52 Does the commentary give the main income-generating activities?

53 Does the commentary give the names, and nature of business, of all subsidiary companies?

Forms 2A and 2B

54 Does the commentary give details of any provisions included in expenditure?

55 Does the commentary explain large year-on-year movements?

56 Does the commentary give details of any remaining Hunter funds claimed, analysed into priority 1(a) and 1(b)?

Form 3

57 Does the commentary identify significant asset purchases and disposals, including consents and purposes?

58 Does the commentary give the details of any loans, including consents and background?

59 Does the commentary explain significant year-on-year movements in debtors and creditors?

Form 5

60 Has the reconciliation of movements between years been completed?

61 Has the financial health self-assessment been completed?

62 Has the budget statement been completed?

63 Has the risk management plan been completed and approved by the board of governors?

64 Has the principal signed the form?

Planned maintenance

65 Does the commentary give details of the college's planned maintenance programme, if applicable?

Risk management

66 Has the college attached a risk management plan that is approved by the governing body?

67 Does the risk management plan cover disaster planning, risk analysis, sensitivity analysis and contingency planning?

68 Does the risk management plan comply with the Turnbull Report?

Sensitivity analysis

69 Does the sensitivity analysis deal with:

- shortfalls in recruitment;
- tariff changes;
- changes to fee structures;
- larger than expected pay increases;
- higher costs of borrowing;
- lack of LSC support for capital schemes; and
- the effect on all income sources?

70 Is the risk analysis consistent with the sensitivity analysis, in particular in its assessment of projected learner numbers?

71 Does the commentary to support the sensitivity analysis identify expenditure that could be shed, if necessary, within the next three years? Is this linked to the contingency plan?

72 Where a significant reduction in the range of provision is proposed, was this discussed and (if necessary) agreed with the local LSC?

73 Where the assumptions are pessimistic and likely to push the college towards insolvency, does the commentary to support the sensitivity analysis set out the contingency measures necessary to restore the situation? Is this also addressed in the strategic plan?

74 Does the commentary to support the sensitivity analysis include any changes resulting from more pessimistic assumptions than those made above?

75 Does the commentary to support the sensitivity analysis include the results of any changes in capital funding?

76 Does the commentary to support the sensitivity analysis include any remedial action to be taken to moderate the financial effects of more pessimistic assumptions?

77 Does the commentary to support the sensitivity analysis address all items included in the risk analysis within the strategic plan?

Other information

78 Does the commentary give the name and telephone number of the contact person for all enquiries?

Examples of Financial Objectives Adopted by Colleges

79 The following examples are suggested for colleges to consider in setting financial objectives.

80 The college wishes to remain financially sound, so as to:

- protect itself from unforeseen adverse changes in enrolments; and
- generate sufficient income to enable maintenance and improvement of its accommodation and equipment.

81 The college wishes to maintain, or attain, the confidence of funders, suppliers, bankers and auditors.

82 The college wishes to raise the awareness of college staff of the financial environment under which it operates.

83 Specifically these objectives will be achieved by:

a maintaining a sound financial base (solvency and liquidity) based on the following:

  i we will have a general reserve of XX% of income by 31 July XXXX and YY% by 31 July XXXX;

  ii we will maintain cash days of XX or more at all times;

  iii we will achieve break-even by 31 July XXXX and have an operating surplus by 31 July XXXX;

  iv we will generate a cash inflow from operating activities by 31 July XXXX;

  v we will reduce borrowing to XX% of general reserves by 31 July XXXX, and YY% by 31 July XXXX;

  vi we will have a current ratio of more than XX:1 by 31 July XXXX);

b improving financial management by the following:

  i we will produce management accounts on a monthly basis, incorporating an income and expenditure account, balance sheet, 12-month rolling cash flow plan, capital expenditure, financial performance indicators, staffing information and funding information (including plans);

c we will strengthen procedures for testing the desirability and affordability of any proposals which have a financial implication by 31 July XXXX;

d we will introduce post-implementation review procedures in order to assess the success or otherwise of major investments (building, information technology, staffing, marketing, and so on) exceeding £XX,XXX by 31 July XXXX);

e maintaining the confidence of funding bodies, suppliers and professional advisors:

  i providing financial and non-financial returns on time and in the agreed format;

  ii ensuring all returns requiring certification by auditors are unqualified;

  iii adhering to the college's policy to pay all suppliers within XX days of receipt of an invoice;

f raising awareness of financial issues:

  i providing advice, guidance and training to staff, management and governors on funding, funding methodologies, budgeting and the college's financial procedures;

  ii providing adequate information to ensure that staff, management and governors are kept up-to-date with the financial position of the college; and

g improving the stock of college accommodation and equipment:

  i generating sufficient funds to ensure that the college's specified programme of planned maintenance can be undertaken;

  ii generating sufficient funds to ensure that the college can invest in the new technology and equipment required to support learning programmes and college administration;

  iii ensuring adequate procedures are in place to protect assets from loss, theft and neglect.

Notes

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