

## Planning

### Further Education Colleges: Financial Plans and Risk Management 2004-07

#### Summary

This circular sets out guidance on financial planning and risk management information that the Learning and Skills Council (LSC) wishes to receive by 31 July 2004. Colleges should approve an annual budget before the start of each financial year (1 August). This should be the first year of colleges' three-year financial plans. To assure that 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, Supplement B and Supplement C, available on the LSC's website ([www.lsc.gov.uk](http://www.lsc.gov.uk)).

#### Intended recipients

Principals and chief executives of further education colleges, finance directors at further education colleges and regional/executive directors of local Learning and Skills Councils.

#### Status

For response by 31 July 2004.

#### Supercedes

Circular 03/10: Financial Planning and Associated Information.



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# Executive Summary

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**Date:** April 2004

**Subject:** Financial Plans and Risk Management 2004-07

**Intended recipients:** Principals and chief executives of further education colleges, finance directors at further education colleges and regional/executive directors of local Learning and Skills Councils.

**Status:** For information and response.

This circular updates the guidance issued in Circular 03/10: *Financial Planning and Associated Information*.

**Content:** The circular consists of:

A main circular – this sets out the submission requirements and the frameworks of associated commentaries

B two supplements:

Supplement A: Financial plan returns 2004/05: Guidance on completing the plan

Supplement B: Financial plan returns: Template

## Main changes:

- References to latest guidance on 'Success for All', 'Plan-led Funding', Recoveries of Funds and *Funding Guidance for Further Education in 2004/05*
- Inclusion of reference to ten-year financial plan template.
- Clarification of need for financial and risk management plans to be consistent.

- Updated references to results of 2003 risk management reviews and Turnbull compliance.
- Deletion of reference to the Finance Record – now covered in Circular 04/04: *Accounts Direction for Further Education Colleges 2003/04*.
- All assumptions updated to 2004.
- Clarification that content of commentary is at colleges' discretion and is not mandatory.
- The computed health group model is now shown as a separate worksheet in the electronic version template.

**Date of response:** Returns should be submitted to the local LSC no later than 31 July 2004.

## **Further information**

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

Learning and Skills Council  
Cheylesmore House  
Quinton Road  
Coventry CV1 2WT.  
[www.lsc.gov.uk](http://www.lsc.gov.uk)

## **Responses to this document**

Responses are requested by 31 July 2004.

## **Enquiries**

Telephone helpline: 024 7682 3758  
Fax: 024 7682 3590  
e-mail: [pfs.helpdesk@lsc.gov.uk](mailto:pfs.helpdesk@lsc.gov.uk)

# Financial Plans and Risk Management 2004-07

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## Introduction

1 The purpose of this circular is to provide guidance to further education (FE) colleges on the financial planning and risk management information that the Learning and Skills Council (LSC) wishes to receive by 31 July 2004.

## Background

2 Circular 03/01: *Success for All – Implementation of the Framework for Quality and Success* set 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 Following consultation on the proposals, Circular 03/09: *Success for All – Implementation of the Framework for Quality and Success* and Circular 03/16 *Recognising and Rewarding Excellence* have confirmed arrangements for agreeing three-year development plans and funding agreements, and for premium rate funding.

4 Initial three-year development plans have now been agreed with most colleges. Colleges will be expected to demonstrate how their financial plans support, and are supported by, their three-year development plans.

5 The LSC is introducing a new Business Cycle (the cycle), which brings together strategic review, planning and funding. The principles on which the cycle is based reflect

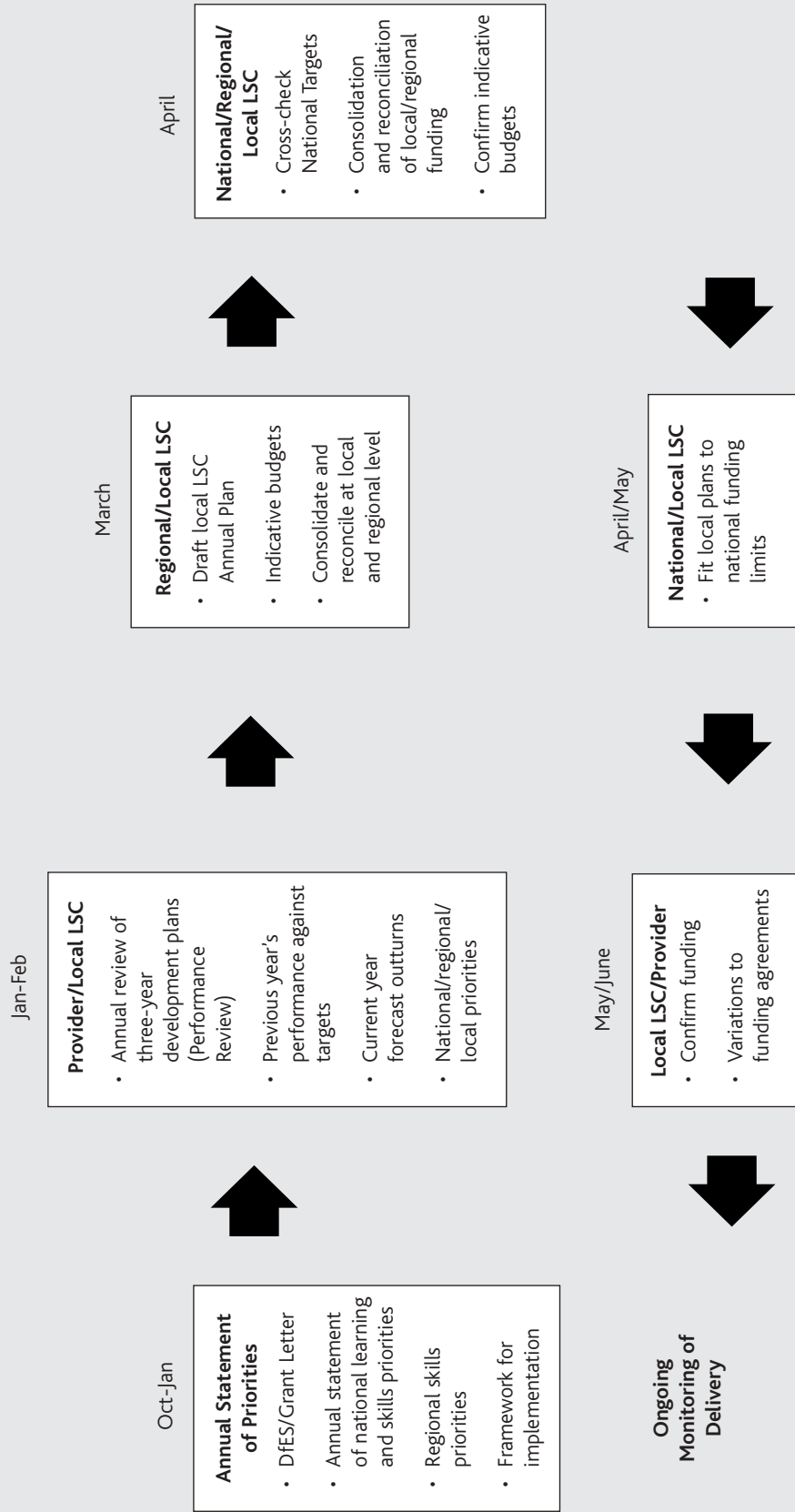
the LSC's commitment to simplicity, minimal bureaucracy, openness, transparency and trust. The cycle also complements and is reinforced by Strategic Area Reviews (StARs). Together, these two processes will provide much greater clarity in terms of priorities and make the LSC's relationships with colleges and other providers clearer and more responsive. Further guidance on the new Business Cycle is contained in Circular 04/02: *Plan-led Funding for Further Education*.

6 The chart overleaf summarises the key elements of the cycle.

7 The LSC will be producing further briefings on the development of the cycle in the coming months. The full cycle will be implemented in 2005/06. This means 2004/05 will be a transitional year. The introduction of plan-led funding is one of the early steps.

8 The LSC has a responsibility under its Financial Memorandum with the Department for Employment and Skills to "...monitor the financial health of providers and, as part of this duty, keep their level of balances under review". The requirements set out in this financial planning circular, together with Circular 04/04: *Accounts Direction for Further Education Colleges 2003/04*, form the fundamental basis upon which this obligation is met.

## Core Business Cycle – Key Processes





## Information Requested in July 2004

9 One copy of all the information should be returned to the executive director at the appropriate local LSC office no later than 31 July 2004. Colleges that require further clarification, or for whatever reason cannot provide the information by 31 July 2004,

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.

10 A template for all financial planning components is available for download at the LSC's website ([www.lsc.gov.uk](http://www.lsc.gov.uk)).

**Table 1 Summary of information requested in July 2004**

	FE colleges	Submission date	Other providers
<b>Provider Financial Plans</b>			
Financial planning cover sheet	✓	31 July 2004	Not applicable
Three-year financial plan – paper copy	✓	31 July 2004	Not applicable
Three-year financial plan – electronic version	✓	31 July 2004	Not applicable
Principal's certificate	✓	31 July 2004	Not applicable
Commentary	✓	31 July 2004	Not applicable
<b>Associated information</b>			
Risk management plan	✓	31 July 2004	Not applicable
Disaster management plan	✓	31 July 2004	Not applicable

## Financial Plans

11 Colleges are reminded that the governing body should approve financial plans, and that budgets for 2004/05 should be approved before 1 August 2004 (paragraph 10 of Annex B to Further Education Funding Council (FEFC) Circular 99/48 *Financial Memorandum*).

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

13 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 a sensitivity analysis. 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**

14 The three-year financial plan should be an integral part of each college's own strategic and three-year 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 three-year development plans. It is important to include in the financial plan the costs of implementing the college's property strategy for the plan period.

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

### **Five-year and ten-year financial plans**

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

17 The LSC has made the evaluation templates available to all colleges that wish to produce a five-year or ten-year financial plan. However, colleges should only submit a three-year version to the LSC in response to this circular.

### **Electronic version**

18 The templates are available on the LSC's website ([www.lsc.gov.uk](http://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 circular.

### **Principal's certificate**

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

20 Form 5 of the financial plan template should be signed by the college's accounting officer in order to confirm that the financial and risk management plans have been approved by the college's corporation and that they do, in fact, support the college's strategic plan.

### **Commentary**

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

22 The increasing emphasis on a plan-led relationship between colleges and the LSC requires that colleges discuss the risks inherent in their plans and appropriate contingency planning with their local LSCs. To provide evidence of the robustness of the financial and risk management plans, the commentary should identify what actions have been agreed in this respect and the financial implications thereof.

### **Guidance**

23 Guidance on the completion of the template is given in Supplement A to this circular. The template itself is included in Supplement B.

24 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

25 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 2003, the LSC's officers considered that approximately 85% of colleges prepared adequate risk management plans.

26 *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 Turnbull Report on the Combined Code of Corporate Governance. 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.

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

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

28 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.

29 Yet again in 2003, the LSC's review of risk management plans 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 weak financial solvency/health, inadequate accommodation, poor operation of MIS and poor inspection results.

### Disaster management plans

30 Colleges may wish to integrate disaster management planning with their risk management plan. However, it may be considered appropriate to have a separate section that deals with more extreme risks. Responses to disasters are likely to require more far-reaching actions that, 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.

31 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).

32 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.

33 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), sudden loss of key staff or default of major suppliers.

34 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?

35 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. As a 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.

36 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**

37 Risk management and disaster management plans should clearly demonstrate how they comply with the requirements of

the Turnbull Report, or, if not, what action is being taken. The plans should be approved by the college's corporation. College financial statements auditors considered that approximately 70% of colleges were fully compliant with Turnbull in 2002/03.

## **Information Requested Beyond July 2004**

### **Financial mid-year update (February 2005)**

38 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 14 January 2005 for submission before the end of February 2005.

39 The software application for returning this information is included on the LSC's website. Guidance on the completion of the mid-year update can be found in Supplement A to this circular.

## **Benchmarking data**

40 The LSC provides basic benchmarking data to colleges based on submissions of financial plans. This information is made available when adequate data has been received by the LSC.

## **Requirement to notify the Learning and Skills Council**

41 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).



*Mark Haysom, Chief Executive*

# Annex A: Cover Sheet for Return of Financial and Risk Management Plans: July 2004

Cheylesmore House    www.lsc.gov.uk  
Quinton Road  
Coventry  
CV1 2WT  
T 024 7682 3758  
F 024 7682 3590

Reference: Circular 04/05

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](http://www.lsc.gov.uk)), complete and return it to the executive director at the local LSC office by **31 July 2004**.



**Learning+Skills Council**

Name of college <i>(please print)</i>	
Code	
Contact for queries <i>(please print)</i>	
Telephone no.	Fax no.
E-mail	

## Returns enclosed (please tick)

Financial plan		Submission date
Three-year financial plan	<input type="checkbox"/>	31 July 2004
Principal's certificate	<input type="checkbox"/>	31 July 2004
Electronic version	<input type="checkbox"/>	31 July 2004
Commentary	<input type="checkbox"/>	31 July 2004
Risk management plan	<input type="checkbox"/>	31 July 2004
Disaster management plan	<input type="checkbox"/>	31 July 2004

Signature
Principal/Head of college
Name <i>(please print)</i>
Date

# Annex B: Financial Planning Assumptions 2004/05 to 2006/07

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## 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 With the continuing development of the arrangements in respect of *Success for All*, 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 2004/05*. The key points to consider are set out in section 1 of that publication. The LSC seeks to establish 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 the following LSC documents, particularly those referring to *Success for All*:

- Circular 04/02 *Plan-led Funding for Further Education*;
- Circular 03/16 *Success for All – Recognising and rewarding excellence if colleges and other providers of further education – Arrangements for premium rate funding*;
- Circular 03/09 *Success for All – Implementation of the framework for quality and success*;
- *Funding: Indicative Rates for Further Education, Work-based Learning and School Sixth Forms in 2004/05*.

6 These documents are available on the LSC's website ([www.lsc.gov.uk](http://www.lsc.gov.uk)).

## Base level of funding

7 In general, the national FE base rates have been increased by 5% for the academic year 2004/05. This increase is shown in Table 1 on the next page.

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

**Table 1 Increase in National FE base rates, 2004/05**

Inflation	2.5%	
<i>Success for All</i>	2.5%	A real terms increase linked to achievement of three-year development plan targets
Total	5%	

**Subsequent funding increases**

9 For financial planning purposes, except where special funding arrangements have been agreed for future years, all colleges should assume that average funding increases for inflation continue at 2.5% a year beyond 2005/06.

10 Circular 03/16 develops the objective in *Success for All* that colleges which stay on

track to deliver their three-year development-plan and achieve their targets will continue to have an increase in FE funding averaging 2.5% above the rate of inflation in 2005/06. This circular also provides for colleges whose performance is assessed as excellent to receive a further 1% premium funding. A summary of the effective real terms increases for the years 2003/04 to 2005/06 is included in the circular and is reproduced below as Table 2

**Table 2 Real terms increase in funding, 2003/04 to 2005/06**

	2003/04	2004/05	2005/06
Premium rate funding for Excellence	2%	3.5%	3.5%
Standard Additional Funding	2%	2.5%	2.5%
Poor performers who agree Development Plans	2%	0%	0%
Those who decline to agree Development Plans (inflation only)	0%	0%	0%



11 Colleges should note that year-on-year increases are cumulative but that assessment of a college as excellent in respect of 2004/05 funding arrangements does not necessarily mean an excellent assessment for 2005/06.

12 Colleges should continue to identify, in their risk management plans, the opportunity or risk that funding may be higher or lower than their plan assumptions.

13 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**

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

15 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**

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

17 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**

18 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.

19 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**

20 Circular 02/13 *Funding Arrangements for Work-based Learning for Young People 2002/03* set out changes that 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 and risk management plans the effect of potential future movements in these rates as a result of further reviews by the National Rates Advisory Group (NRAG).

21 Further guidance is available in the LSC publication *Funding Guidance for Work-based Learning*.

## **Recovery of Funds**

22 Arrangements for the submission of ILR Funding Claims and recovery of funds for underachievement in 2003/04 are set out in Circular 04/03 *FE ILR Funding Claims 2003/04*. These are similar to those agreed for 2002/03. There will be no clawback of funds or reduction in allocation for colleges achieving 97% or more of their planned activity.



## Pilot colleges

23 For 2002/03 the rules for recoveries were the same as those applying to all other colleges. Because the pilot was being launched part-way through 2002/03, the LSC sought to recover funds where targets had not been achieved. However, the assessment of recoveries resulting from underperformance was taken entirely on trust – there was no audit of the amount.

24 From 2003/04 onwards the LSC is not seeking the retrospective recovery of funds for underperformance. This reflects a more precise allocation around which the LSC and the colleges agree more realistic targets.

## Pathfinder colleges

25 The pilot has been followed by a pathfinder phase of a further c100 colleges. The outcomes of the 2002/03 funding audit will be considered in relation to the maintenance of the trust relationship and continued involvement as a pathfinder.

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

## Plan-led funding

27 The introduction of plan-led funding from August 2004 will eliminate retrospective recovery of funds for the majority of colleges.

## Other Funding and Grants Guidance

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

- Circular 03/13 *Capital Handbook: Feedback from Consultation and New Arrangements from 2003/04 Onwards*;

- Circular 03/03 *Development of a Common Funding Approach for Additional Learning Support*;

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

## Inflation

29 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

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

31 The Office of National Statistics has published data showing that average earnings in the public sector have risen by 4 – 5% in each of the past three years. With further increases for employers' national insurance and pensions contributions, colleges should consider if pay cost increases merely in line with inflation are adequate.

## Pension Costs

32 Circular 03/08 *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. That circular also includes tables for the calculation of provisions in respect of enhanced early retirement pensions.

33 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.

## **General**

34 The assumptions set out in this annex are provided for colleges as general guidance.

# Annex C: Commentary to the Plan

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## Introduction

1 The Learning and Skills Council (LSC) asks colleges to provide a commentary to support the financial plan. It is suggested that the commentary needs to clarify the following points:

- how the financial plan is consistent with the college's own strategic and three-year 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 and the effects of variations to these assumptions (a sensitivity analysis);
- 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 suggested 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 three-year 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 three-year 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 and three-year development plans 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.

7 Where a financial plan contains critical assumptions of this nature, colleges are advised 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, it is considered essential that an alternative financial plan is produced that reflects the impact of those changes.

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

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

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

## 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 (see paragraphs 15 to 20), the college's self-assessment, the computed health group (see paragraphs 21 to 26) and the range of 'soft' factors referred to in paragraph 21.

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 three-year 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 that 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 three-year 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 three-year 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 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 college's plan 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.

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

**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

## Confirmation of Financial Health Assessment

27 During autumn 2004 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.

## Suggested Checklist for Commentary

28 The suggested 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 three-year development plan

31 Is there a clear link between the projected learner numbers included in the college's strategic and three-year 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

### 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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