CIPFA The Chartered Institute of Public Finance & Accountancy

FINANCIAL PLANNING:

A GUIDE FOR BOARD MEMBERS, COUNCILLORS AND TENANT REPRESENTATIVES

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1 DEFINITIONS AND COMMON TERMS

For ease of reference, throughout this document the following terms can be defined as:

Housing organisations – include registered providers, housing associations, ALMOs, local authorities

Boards – include board members, councillors, tenant representatives and those who have oversight of the financial affairs of the organisation, either individually or as a committee or group

Regulators – Homes and Communities Agency for registered providers, ALMOS and local authorities, although HCA cover the latter two for consumer standards only.

Industrial and Provident Societies (IPSs) are registered with the Financial Services Authority (FSA). Currently, those that are charities are 'exempt' charities. They cannot register with the Charity Commission, but are otherwise subject to charity law. The Charities Act 2006 requires all exempt charities either to have a principal regulator to oversee their compliance with charity law, or (where there is no suitable body to act as principal regulator) to lose their exempt status and be regulated by the Commission. ALMOs fit under this umbrella, they are usually set up as a company limited by guarantee, with the local authority as the sole member or guarantor.

It is expected that from 1 August 2014 all newly registered Industrial and Provident Societies will either be co-operative societies or community benefit societies.

Under self-financing, **Local Authorities** have to account for the management of the Housing Revenue Account to tenants and residents and those charged with governance. The Voluntary Code for Self-financing applies to Local Authorities with an HRA. This Code covers those Authorities who have voluntarily agreed to meet the Principles and Provisions that it sets out.

2 INTRODUCTION

2.1 All Boards should carry out an annual review to confirm the overall strategy and objectives of their organisation. Very often, the starting point is a review of the strengths, weaknesses, opportunities and threats (SWOT) to the business; this can extend to the broader context of political, economic, social and technological factors (PEST). Most housing organisations then publish a formal Business Plan setting out the key aims and objectives, generally for the next 5 years.

2.2 A key part of the Business Plan is the financial plan demonstrating how the aspirations will be met from a financial perspective and translates aims and objectives into financial forecasts. As well as the Board, the whole of the executive management team should have ownership and understanding of the Business Plan. Financial planning is important for the various levels of governance that authorise, endorse, monitor and manage an organisation.

2.3 Regulators in particular look for a joined-up approach to the vision, objectives and plans of organisations and for the "golden thread". This means that you should be able to follow a link from the vision through the objectives, team plans and budgets, down to the individual objectives and performance indicators. A business plan is not a statutory requirement but it helps organisations demonstrate good governance and viability.

2.4 For ALMOs, housing associations or groups with industrial and provident societies or limited companies, the Companies Act 2006 places a statutory duty on company Boards to demonstrate that when making decisions, they have considered the long term effect of those decisions on their company, their staff, their suppliers and the environment. The long-term financial plan is one of the ways a board can demonstrate this.

2.5 This document focuses on the financial plan explaining why it is essential for housing organisations and the key areas to be included. It gives advice to Boards on how to challenge and analyse financial plans as well as how to set targets for the future. Finally it includes a useful checklist to enable greater understanding and constructive challenge in Appendix A.

3 WHAT DO WE MEAN BY A FINANCIAL PLAN?

3.1 Housing organisations, in line with all other businesses, will approve an annual budget each year setting out the estimated expenditure for the next 12 months and where the funds to meet that expenditure will come from. A financial plan looks further ahead and is of necessity closely linked to the strategy and objectives of the business.

3.2 Effective financial plans should be made up of two key areas. Firstly, Boards need to see the anticipated income related to the business's present housing stock. This will identify whether the current portfolio is able to support the expenditure requirements for the future, including stock condition requirements, using reasonable assumptions for future inflation, interest rates etc. Secondly, estimates of any new business or plans need to be included. It is worth noting that there are registered providers who have substantial income/costs relating to other activities (for example in care & support) which *may* be linked to housing stock – but not necessarily.

3.3 Given the number of assumptions included, financial plans are not therefore as detailed as annual budgets. Often, they are presented at a much higher level e.g. in tens or hundreds of thousands rather than in pounds, reflecting the fact that they are high level strategic documents. The main consideration is the forecast trends of the business rather than the detailed figures themselves.

4 WHY PRODUCE PLANS?

Initially, they are produced to cover the identification of re-financing needs and demonstrating the ability to repay the loans. Once in place, there are many reasons why housing organisations need to regularly produce and review medium to long term financial plans and the key reasons are identified below:

4.1. To confirm ongoing financial viability

Confirmation that future income streams will be sufficient to meet expenditure requirements is critical. If this cannot be demonstrated with sound assumptions, action will need to be taken to correct any shortfalls and Boards will be unable to sign off the organisation's annual accounts as a 'going concern'. In the Annual Report, the financial plan will assist with the reporting: previously the operating financial review (OFR), now a 'strategic report' under the revised SORP. Note that external auditors also consider such plans before signing off accounts each year.

4.2. To confirm a positive balance on the Operating Account

For local authorities under self financing, one of the key outputs of the Housing Revenue Account business plan is to demonstrate how a positive balance will be maintained on the operating account. Legally LAs must not budget for a deficit.

4.3. To demonstrate they can finance their key objectives

Organisations should have discussed and agreed their priorities for the future and a financial forecast is required to demonstrate that they will have sufficient income to meet their objectives. These will include regulatory requirements, e.g. achievement of Decent Homes and rent guidance, any transfer promises made to residents and repayment of loans borrowed.

4.4. To evidence ability and capacity to grow and develop

Financial plans enable consideration of various options to be modelled. This should assist in demonstrating that the business has sufficient capacity to develop or resources available for further growth in services.

4.5. To demonstrate value for money (VFM)

Including target efficiencies in the plan ensures that VFM objectives are embedded in the plan and can be monitored in the future

4.6. To identify potential threats and risks to achieving objectives

Using the plan to model various assumptions and different scenarios can assist in identifying critical risks enabling action to be taken to mitigate. The top 5 key risks should be tested in the model. A PEST analysis can assist identifying those risks.

4.7. To confirm that all loan covenants will be met

Where housing organisations have borrowed substantial loan funding or want to increase their funding, there are generally key financial covenants to achieve. It is important for Boards to be sure that future plans do not result in possible breaches to covenants and potential withdrawal of loan facilities.

4.8. To meet funder and rating agency requirements

Many banks and building societies have built into loan documents that financial plans should be updated annually and submitted to them by a specific date. Boards should be aware of these requirements and ensure that business and financial planning work is completed in sufficient time to submit an approved plan.

For Local Authorities

To ensure that their expenditure plans do not cause the HRA debt cap to be breached.

4.9. To meet regulatory requirements

Registered providers have to comply with the Regulatory Framework for Social Housing in England (April 2012) from the Homes and Communities Agency. Within this framework, the Economic Standards apply to all registered providers except for local authorities; the standards convey specific expectations around governance and financial viability that are relevant to good practice in business planning. The standards include strategic planning and control framework, monitoring, timely internal/external reports and returns, fraud reporting, meeting regulatory standards, security of assets, proper use of public funds, risk management, liquidity, financial forecasting and compliance with covenants.

The HCA's current reporting arrangements are based around the viability review that they issue annually.

FFR – the Financial Forecasting Return is produced annually and is based on the approved business plan

FVA – the Financial Viability Assessment is based on the audited annual accounts

Quarterly Return – primarily based on funding facility

5 WHAT TIME PERIOD SHOULD BE USED?

5.1 Financial plans should be prepared for at least the next 5 years to evidence ongoing viability and to demonstrate how the business plan's objectives will be met. This should cover all ongoing day to day income and expenditure as well as planned developments and capital projects over the period.

5.2 Because housing is a long-term business with lengthy cost cycles, most organisations also produce 30 year plans. In fact the regulator requires all registered providers with over 1,000 units to produce and submit such plans every year. For stock transfer associations (LSVTs), the length of the financial model is often dictated by funders who wish associations to demonstrate that they have sufficient net income to enable repayment of loans within agreed timescales.

5.3 It is important to note that whilst the first five years of a financial plan should reflect the organisation's current business plan, 30 year plans are clearly broad brush estimates as they comprise a significant number of assumptions. However they are valuable to demonstrate trends and in particular to identify any potential refinancing or reinvestment needs for the future.

6 WHAT SHOULD BE INCLUDED?

6.1 Where possible plans should start from actual brought forward balances extracted from the organisation's accounts. A projected balance sheet from quarter 3 may also be helpful, as being more up to date. The first year of the plan should therefore be the current year and should be reconciled to at least the approved budget for year 1, with no significant differences between the two. Note that it is important for this first year to be as realistic as possible as generally future years' income and expenditure will use this as the base. It is therefore helpful to review previous plans and assumptions – how well did these compare with actuals and did the organisation deliver what it aimed to, as is done for example through quarterly budget control.

6.2 To this base, reasonable assumptions should be applied e.g. CPI, RPI, LIBOR, increases in staff costs, maintenance, house prices, new build costs etc. Minor changes can have a material impact in future years so should be carefully selected. Boards should be involved in the approval of these key assumptions, with an annual review. A checklist of the types of assumptions required is included in Appendix A for guidance

6.3 The impact of any proposed development should then be added and care taken to ensure that all relevant costs are included. Smaller organisations will probably include specific known schemes but larger developing housing organisations may use

average numbers and costs. If assumptions are going to be made about future unknown developments, average costs, grants and sales income should be used.

6.4 Some organisations may have approved sales programmes and these should be included. Boards will also need to consider whether there is a need to include any additional capital expenditure – for example replacement IT systems or office refurbishments. Finally the impact of any reduced grants or any proposed increases in services should be costed and included.

6.5 A key check on the plan is to question whether any material items have been excluded. Where a group structure exists, it is particularly important to have a financial plan for all subsidiaries to ensure a complete overall picture. More complex groups will have a financial plan for each company with a summary financial plan for the group.

6.6 Smaller organisations should liaise with other organisations on financial planning. They could benchmark assumptions, share resources and good practice.

7 WHAT SHOULD BE PRODUCED?

7.1 Whether directly built on spreadsheets or a dedicated software, financial plans are still heavily spreadsheet reliant, either for inputs, outputs or both. In a spreadsheet based model, it will enable finance staff to complete the complex calculations and model various options and sensitivities. With a dedicated financial plan software, the details will be summarised in spreadsheets prior to input, such as rent plans, development, budgets, treasury, depending on the level of complexity of the operations.

7.2 Many models are individual to the organisation concerned and, in the case of transfer housing associations, some still use the original model, amended over time to include changes since transfer. However, it should be noted that these models are generally valuation models rather than ongoing financial models and may therefore not be the most appropriate tool to use. One would expect a thorough housekeeping review of the financial plan every 5 years, depending on where the organisation is in its strategy lifecycles, rather than a roll forward from one year to the next.

7.3 In many cases, calculations are carried out outside the model and figures then simply entered into the relevant cells. It is important that Boards have confidence that the model itself is accurate. This could be achieved through an audit of the plan and its outputs – this would be more cost effective if done in house although it is possible to obtain an external validation, or a lower level external review of the plan, if required.

7.4 Some organisations use standard financial planning models as they are not so easily changed or amended. This can give an element of comfort particularly in complex modelling – remember however that the output from any plans is only as good as the raw data and assumptions entered. If external help is used to build a financial plan, the organisation needs to ensure staff understand how it works, how it can be amended and how changes can affect outcomes. In terms of risk, the complexities of a business cannot be devolved to a junior member of staff just because a tool is easy to use: checks should be built in to ensure outcomes and trends relate to the inputs and expectations from the business plan. (See 7.2 above, also noting that specific checks must include a senior management review of the plan.)

7.5 As a bare minimum, the financial plan should include an income and expenditure account and an estimated cashflow; a balance sheet would complete the picture. Although some Boards with financial expertise may welcome the opportunity to review the figures, it is not essential for Boards to see the detailed figures to approve the plan. The Finance Director should however, prepare a report on the plan identifying the following key areas:

- The key assumptions used in the construction of the plan

- Annual surpluses or deficits - this can be shown in a graphical format to ease understanding
- A cashflow forecast highlighting annual loan drawdown requirements
- Balance sheet trends for assets, loans and reserves
- Whether loan covenants are met for each year of the plan (and if not what action can be taken to correct this)
- Whether the organisation's current loan finance will be sufficient to meet objectives (and if not, when new monies are required)
- An analysis of the stock profile at the end of each year
- If the lenders stopped any new loans, whether the current loans could be repaid within the terms by stopping growth/new development and how much leeway (capacity) there is within the plan
- Any other performance indicators Boards have stated they wish to see (e.g. surplus targets, asset ratios, debt repayment etc.)

7.6 Organisations may find it useful to agree various parameters to demonstrate viability more easily. It would be best practice to do so. The table below gives an example of the types of indicators available – however it is important to stress that the actual indicators and parameters must be agreed by each organisation dependent on its own loans/costs etc. Boards are encouraged to identify no more than 3 or 4 targets to be tracked in all future budgets and financial plans. Careful thought needs to be given to these targets: these could be determined from covenant requirements, by comparison with other similar organisations (using benchmarking data) or accounting ratios.

7.7 These are possible options and Boards need to consider which measures work for them within their relevant regulatory environment and the strategies they have adopted. This is about managing expectations and highlighting "surprises". Ratios and parameters should probably be reviewed annually to reflect where the business is, for example regarding stock condition survey requirements, component replacements cycle, development programme, modernisation and diversification.

RATIOS	**INDICATIVE PARAMETERS**		
Gearing –			
grants + reserves to loans or	>90%		<65%
debt to asset values	>80%		<60%
Beware - new transfers will be	*higher geared than other organisations*		
Interest cover	<1.05:1		>1.2:1
Average interest rate	>7%		<5.5%
Maintenance/investment costs per unit per annum	>£1,500		<£1,200
Management costs to turnover	>25%		<20%

Measure	Red	Amber	Green
General reserves to turnover	<5%		>20%
Operating surplus to turnover	<10%		>20%

7.8 Where the plan fails to achieve the 'green' targets and is highlighting some amber areas, Boards would wish to question how to strengthen the overall financial position. If the plan is showing 'red' areas, Boards may decide not to approve the plan but carry out further analysis or review before proceeding further.

8 SENSITIVITY ANALYSIS

8.1 As the financial plan is made up of a large number of assumptions over a lengthy period, it is important for the impact of these assumptions to be understood. Sensitivity analysis demonstrates the impact of different assumptions on the plan (and in particular on the annual surplus/deficit and loans borrowed). It should test both income and expenditure.

8.2 Each organisation must determine the areas it needs to see analysed depending on the nature of its own business. It is particularly useful to use the 5 key risks identified as areas for modelling. For example an organisation involved in shared ownership may need to see the impact of delays to sales or reduced valuations; a company with a significant proportion of variable rate debt will need to assess the impact of increases in LIBOR or Bank Base rate; an organisation should evaluate the dependency of its rent income on housing benefits and the impact universal credit changes may have; an organisation with significant amounts of supported housing may want to model reduced grant income.

8.3 Other areas to model could include increases in staff or maintenance costs, changes in CPI, reduced grant or increased maintenance requirements. In addition, the impact of no further development (beyond that already committed) is often asked for by funders and the regulator.

8.4 Some models enable multiple variables to be altered at the same time to give more of a real-world scenario, enabling inter-related items to be varied, e.g. a fall in property values would reduce sales income but could also delay sales. Whilst altering a single variable gives the best indication of risk for that variable, altering inter-related issues perhaps gives the best and most likely outcomes.

8.5 As organisations evolve and increase their mix of tenure, it is important to test the assumptions used: growth may differ between markets, as will the life cycle and maintenance of a product. Scenarios can be built to include exit strategies from shorter term markets or to reflect longer term strategy.

8.6 It is useful to know which assumption has the smallest change with the greatest impact and which change in assumption can "break" a plan (i.e. make a plan break its covenants). Funders often ask for sensitivity tests with higher assumptions than the ordinary to check the solidity of a plan. Through such inputs, you can also identify if a plan is behaving as expected and test for potential errors in setting up the plan or inputs.

9 HOW CAN BOARDS DEBATE AND CHALLENGE FINANCIAL PLANS?

9.1 There are a number of areas where Boards can question staff to ensure that they fully understand the plan before it is approved. If these have not been included in the Finance Director's report, Boards should ask the following (noting that reconciliation to the medium term financial plan should address the first five bullet points):

- Does the plan reflect the overall direction in which the organisation wishes to move, i.e. is it a financial interpretation of the objectives and vision?
- How has the plan been constructed; have finance staff worked closely with business staff and does the proposed plan have the approval of all directors?
- Have the outputs been checked i.e. has the model been audited or checked?
- Do costs and income reflect the current position and if not why not?
- Have all income and expenditure streams been included?
- Are assumptions reasonable without being too optimistic? What external benchmarks have been used? What changes in assumption will "break" the plan (make the plan unviable) and what is the likelihood of that?
- Where improvements are assumed in current costs, what evidence is there to back this up? Similarly, where reduced voids and bad debts are forecast, how will this be achieved?
- Are all income streams contributing to the bottom line? If not what action is being taken to address this?
- What tolerance or headroom is built into the plans to enable the organisation to deal with new requirements or adverse changes?
- Does the model reflect accounting practice e.g. have auditors agreed any proposed capitalised repairs and is the impact of any changes in accounting practice included?
- Is there a need to consider any impairment to assets given the economic climate?
- What are the key sensitivities that could throw the organisation off course? How likely are they to occur?
- What is the impact of the key risks and opportunities of the SWOT and PEST analyses on the financial plan and what is their probability?
- How easily does the plan meet the required loan covenants and if it is close, what headroom is there in place? This is particularly important for 100% debt funded organisations.
- Is there sufficient loan finance in place to meet the needs of the plan and if not when will new funds be needed and is there sufficient spare security to attract loans?
- Is there anything included in the plan that cannot be funded from the housing organisation's current borrowing? (e.g. certain types of expenditure may be excluded from some loan facilities)
- Are there any tax implications to the plan needing to be included/considered?

10 REVIEWING THE PLAN

10.1 As medium to long-term plans with high level assumptions, the plan should generally not be amended for a year once approved. However, there are some instances when Boards may wish for a further report back on the plans on a more regular basis:

- Where a major change is proposed in the plan e.g. a proposal for a new development that will have a material impact on the plan
- In times of economic and financial volatility e.g. where there are significant changes in interest rates or CPI, particularly where these were not anticipated in the original assumptions
- Where achievement of loan covenants is known to be tight (or the organisation is working to amber targets)

- Where actual performance for the year is showing material adverse variance against budget that is likely to be ongoing
- Where there are material external changes which could affect the plan e.g. taxation changes or reduced grant rates

10.2 Not amending the plan during the year does not mean not using or reviewing it: as a dynamic document, it should reflect the business in the changing environment and be used as a monitoring tool. As business decisions are proposed, these should be tested against the financial plan assumptions and forecasts to check how expected outcomes will be affected (beneficially or not). It is usual for development programmes to fit within an overall envelope; changes in scheme timing can be as significant as changes in tenure mix or schemes and these will be tested in the financial plan either at set times (eg quarterly) or at trigger points (variances of specific outcomes over X%). Changes in treasury forecasts should also be tested in the financial plan and reported to Boards (at least quarterly).

10.3 The financial plan should be the subject of a thorough review at least every 5 years to ensure it is an efficient tool for the business, reflecting its business plan. External benchmarking will assist with the scrutiny of the assumptions. Comparing actuals to forecasts should ensure better forecasts going forward. Outputs should be reconciled to financial statements for the past year. If in any doubt, an external validation of the financial plan should be carried out to reassure Boards the financial model is reliable for their purposes.

11 CONCLUSIONS

11.1 Boards can make a real contribution to the financial plan by being critical friends. In particular, they should understand the importance of the financial plan and be clear on the links between the Business Plan objectives and the financial forecasts. This will provide assurance that the business is viable now and in the foreseeable future and enable them to confirm that the organisation is a ‘going concern’ to auditors and funders as required.

11.2 The financial plan should be “owned” by the Board as it is ultimately their responsibility. To achieve this, organisations should ensure Boards have the ability to challenge and understand how their business plan is translated into the financial plan.

Appendix A

KEY FEATURES OF FINANCIAL PLANS – CHECKLIST

This gives a brief overview of the types of information to be discussed and agreed by Boards before being included in the financial plan. Note that the figures included in the plan should be those material to the bottom line as the plan's aim is to demonstrate trends and high level viability and results are generally shown in £'000s (£K) or £'000,000s (£m). Each board therefore needs to agree and identify the assumptions most material to its own business.

Beware that inflation and price increases may differ in the medium term (first 5 years) compared to the long term assumptions. This may be because of known contracts, agreements, regulations or strategies such as pay or rent freeze. It is also easier to predict how changes will happen on average over a long period than in the short term: the wish for a 2.5% RPI over the forthcoming 30 years will not be smooth but include highs and lows (eg the 2 years 2008 2009 average is 3.55%, made up of 8.2% and -1.1%).

Consumer Price Index - Generally organisations use 2% as a long term rate although this could vary in the early years dependent on the latest economic indicators. From 2015/16, a key factor for rent income (September 2014+ figure).

Retail Price Index - Generally organisations use 2.5% as a long term rate although this could vary in the early years dependent on the latest economic indicators. Until 2014/15, a key factor for rent income (September 2013 figure).

Properties - The model should include all current properties, with increases for new homes into management and decreases for properties sold under Right To Buy / Right To Acquire, demolition or staircasing of shared ownership.

Rents - This may need to include different tenure types and agreements. Rents are subject to rent regulation depending on tenure type. Account should also be taken of any movements/trends towards target rents, any transfer promises, affordable rents (inclusive of service charges).

Service and Support charges - This should be in line with regulatory guidance and aim for full costs recovery unless subsidised.

Voids and Bad debts - Assumptions here depend very much on the stock and location. Care should be taken not to assume significant improvements on current figures unless there are clear action plans in place to achieve this and should take into account the impact of welfare reform. Rent policy should be reflected where voids are relet at "target" or "limit" rent. Difference in demand depending on property size (impact of single room subsidy, under occupancy).

Property sales - Net Sale proceeds from RTB or staircasing together with any planned disposals. It is also now necessary to include the potential first tranche sales of shared ownership properties. Where there is a programme of proposed sales, this should also be included with a reasonable estimate of the potential timing of receipts. Care should be taken when assuming real increases in property values in the current economic climate. (It is worth noting that the capital receipt from a property sale could make the business plan appear to be in better shape than it is. If the sales do not materialise the plan could be in trouble, especially the debt position. This could be modelled through stress testing, but some organisations omit these altogether on the grounds of prudence).

Other Income - Generally increased by RPI/CPI only unless this is material with known growth.

Management costs - This covers a large number of areas and is generally increased by RPI/CPI plus a small element of growth. Some organisations calculate a management cost per home, apply it to total stock numbers and increase this by inflation. Staff costs are often shown separate and subject to a lower inflation for a number of years. This is often an area under review for efficiencies and value for money.

Maintenance and investment (including capitalised repairs) - Check this against building trade inflation websites and you may use a different assumption for properties depending on their age and geographical location. Be prudent in your capitalisation as high levels of capitalised repairs are rarely agreed by external auditors although componentisation and life cycle of items have reduced the arguments.

Depreciation and Impairment - This should reflect the organisation's depreciation policy for each group of assets.

Interest and loan repayment - Shorter term assumptions should be based on advice from treasury advisers and you must remember to include your actual loan margin costs and any non-utilisation fees. In the long term, security and headroom is built into plans by having as high a rate of 'real interest rate' (i.e. the difference between interest rates and RPI) as you can accommodate. Often funders look for at least 3% differential so if you are using RPI of 2.5% you should use at least 5.5% interest rates for all new borrowings.

Other costs – Generally increased by RPI/CPI only unless this is material with known growth. May be a zero-based short term increase to drive out inefficiencies.

Efficiencies - Many organisations include target efficiency savings or attempt to increase costs by less than RPI/CPI. Care should be taken that any such assumptions are not overly optimistic and are backed up with planned actions.

Development of new properties - If you have separate development assumptions as part of your scheme appraisals, it is important to use these in your financial plan too. Ensure you review these against actuals every year ahead of the financial plan assumptions being set. Be realistic around development periods and in particular on potential sales proceeds.

Other capital expenditure - Don't forget to include assumptions about the replacement of assets e.g. offices, IT, vehicles etc., at the end of their useful lives.

Grants - Be clear on grant recycling and accounting treatment

Disclaimer: this guidance is meant as an aid to financial planning and does not supersede any legislation or legal definitions.

Details about the Housing Panel and its activities can be found on the Panel website Housing Technical Panel

The Panel thanks Arthur Merchant for preparing the original outline for this bulletin, and Pascale Mézac, John Hawes, Michael Heekin, Ken Lee and Philip Winter for their assistance in its update.

Comments

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