

Supplier management

Supplier financial appraisal guidance

level playing field

encouraging innovation

financial standing

commercial focus

key indicators

resource capacity



Office of Government Commerce

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Supplier financial appraisal guidance

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1: Introduction

1.1 Purpose of guidance

This guidance provides advice on how to conduct the financial appraisal of suppliers bidding for significant¹ public sector contracts. Although it is particularly appropriate for the procurement of strategic services, the principles apply to all government purchasing. The scope and effort of financial appraisal should be proportionate to the size and risk of the contract. The guidance endorses a broad business approach so that risk is assessed relative to the particular factors of the requirement and the supplier.

Although this guidance is primarily intended for staff responsible for public sector procurements, it should also be helpful to potential suppliers by giving them an understanding of the scope and rigour of departments' appraisal processes. Its use is not mandatory but it is strongly recommended by OGC and represents good current commercial practice.

Annexes to this guidance are published as linked modules on the OGC website. These include:

Annex A	<i>Audit & Filing Dates and Exemptions</i>
Annex B	<i>Key Ratios for Analysis</i>
Annex C	<i>Financial Glossary</i>

This guidance updates the financial assessment element of the 1997 HM Treasury publication, CUP Guidance No. 60, *Supplier Appraisal*². The non-financial appraisal elements of CUP 60 are still current guidance.

1.2 Practitioners

Only suitably experienced staff should conduct supplier financial appraisals, calling on specialist expertise such as the OGC Supply Intelligence Service as necessary (see section 6). In terms of formal training, the Government Procurement Service Certificate of Competence in Purchasing & Supply, and the ACCA Certified Diploma in Accounting and Finance (which will become the Diploma in Financial Management in 2002), are desirable supplementary qualifications.

1.3 EC Rules

References to the EC rules are to the EEC Treaty, the EC procurement directives as implemented in UK legislation, rulings of the European Court of Justice and other relevant EC law. The directives and regulations allow for, but do not require financial appraisal to be carried out under the Open, Restricted or Negotiated Procedures.

1.4 Acknowledgement

Prepared by OGC, this guidance has been developed from extensive research into current thinking and practice in both the public and private sectors, drawing on feedback from many contributors. These contributions are acknowledged with thanks.

1. in terms of value, duration, strategic importance or complexity

2. <http://www.ogc.gov.uk/ogc/procurement.nsf/pages/CUPGuidance.html>



2: Overview

2.1 Key messages

The assessment of risk should be based on sound business judgement rather than just the mechanistic application of financial formulae (see section 2.2).

All candidates, whatever their size, should be treated fairly and with equal diligence during the financial appraisal process. Small and Medium-sized Enterprises (SMEs) should not be inadvertently disadvantaged (see 3.2.2).

Candidates are requested to provide accounts for the past two years of trading rather than for the previous three years (which has been a traditional requirement but not required by the EC rules). In the absence of audited statements, other information should be requested that is considered sufficient for assessment purposes (see 3.2.2).

Financial standing should only be considered as part of the risk management exercise. It may not, on its own, reflect candidates' ability to deliver (see 3.2.2).

As a questionnaire pro-forma, suggested information requirements from candidates regarding their economic and financial standing are listed (at 3.2.4).

Although a contract limit based on turnover can be a useful indicator of financial capacity and dependency, candidates should only be eliminated on the strength of contract limit alone if they clearly have insufficient capacity to deliver the requirement (see 3.3.2).

The Profit & Loss account and balance sheet alone do not provide sufficient information for a thorough financial assessment of a supplier. Cash is the immediate requirement for working capital needs; a candidate's cash generating ability should be assessed where possible (see 3.3.2).

Although it is desirable to reduce a large response to a more manageable number, suppliers should only be excluded from further consideration if they are clearly unrealistic candidates having inadequate resources to undertake the work (see 3.3.3).

Financial data and credit ratings from specialist on-line database providers are useful snapshot indicators but should not be used as a substitute for detailed examination of the candidate's financial statements (see 4.2).

As part of the detailed appraisal process, the Authority should, for a major award, check whether a candidate is rated by one of the leading debt rating agencies. Their rating reports take account of a company's corporate strategy, operating position, financial management and general prospects, and should be noted by the Authority (see 4.2).



2.2 Recommended approach

The key objective of financial appraisal in the procurement process is to analyse a supplier's financial position and determine the level of risk that it would represent to the Authority – having regard to the contract requirement and value, criticality, and the nature of the market. The assessment of risk should be based on sound business judgement rather than just the mechanistic application of financial formulae³.

Most significant procurements will be over the EC thresholds, and therefore the EC procurement rules will apply. Civil procurements in central government are also subject to Gateway Reviews⁴ which examine projects at critical stages to provide assurance that they can progress to the next stage. The selection and evaluation stage of the procurement lifecycle proceeds after the Gate 2 Review of procurement strategy and before the Gate 3 Review of the investment decision.

In the context of the EC rules, financial appraisal is a selection (not an award) criterion and is designed to identify the financial risks to be assessed alongside other relevant qualitative and quantitative factors that can be grounds for selecting a candidate to tender or negotiate.

In most cases, a range of factors needs to be considered and various financial statistics, ratios⁵ and figures analysed. The financial appraisal also needs to form part of a broader, holistic assessment of the candidate, which also looks at *capacity* (the ability to deliver), *capability* (to a required standard) and the degree of *dependency* on a single contract or customer.

Once the appropriate data have been obtained, the Authority must apply commercial judgement to the issues. There are some occasions when the numbers will suggest a clear-cut decision. A supplier that is consistently trading unprofitably, with a negative asset value and no apparent working capital may be a simple case for non-selection. But often the situation will not be clear-cut, and here judgement must be applied.

The following sections give more detail about the various aspects of financial appraisal and how to use them, but the underlying principle remains that the Authority must apply a broad, commercial perspective and assess the risk relative to the particular factors of the supplier and the contract rather than placing over-reliance on numerical formulae to reject or accept a candidate.

3. see also 'The Green Book' *Appraisal and Evaluation in Central Government* (Treasury Guidance)

4. <http://www.ogc.gov.uk/ogc/publications.nsf/pages/Gateway1.html>

5. see separate Annex B *Key Ratios for Analysis*



3: Financial appraisal of candidates

3.1 Objective

The objective of financial appraisal comprises the selection of candidates to minimum standards for the particular procurement. In practice, this can be a time consuming and costly process. So those that clearly fall short of the minimum standards should be identified before going on to assess the remaining candidates in more detail.

3.2 Information used

Under the EC rules, proof of the supplier's financial and economic standing may, as a general rule, be provided by one or more of the following:

- appropriate statements from the candidate's bankers
- statements of accounts or extracts from them relating to the business of the service provider where publication of the statement is required under the law of the relevant State in which the supplier is established
- a statement of the overall turnover of the business of the service provider and the turnover in respect of services of a similar type to those to be provided under the proposed contract in the three previous financial years of the supplier.

The most recent audited accounts should be provided (that show figures for the past two years of trading – if applicable); however, where the information is not appropriate or is unavailable in a particular case, a contracting authority may, under the EC rules, require a supplier to provide other adequate information to demonstrate the supplier's economic and financial standing (see 3.2.2). Also, where the supplier is unable for a valid reason to provide the information which is required, the contracting authority may accept such other information provided by the candidate as is considered appropriate to ensure equal treatment. The Authority may also require the candidate to provide supplementary information. This flexibility is particularly relevant for achieving a level playing field during the appraisal process.

3.2.1 OJEC advertisement

The Authority should stipulate in the OJEC (Official Journal of the European Communities) advertisement the information required to undertake the supplier appraisal. The 650-word limit on OJEC notices may require a follow-up letter or pre-qualification questionnaire to enable the Authority to obtain full details (see 3.2.4).

3.2.2 Equal treatment

Care must be taken to ensure that respondents are treated equally (one of the main principles of the EEC Treaty). A key Government strategy is to achieve effective competition for government business by simplifying access to the government market place for suppliers. In particular, Small and Medium-sized Enterprises (SMEs) can be inadvertently disadvantaged. There is also a need to attract innovative suppliers as well as those that are not currently competing, where they can provide better value.



SMEs may have sometimes been inadvertently excluded from further consideration because:

- they were recently formed and could not provide financial information for the previous three years (**which has been the traditional requirement, but is not recommended in this guidance – see below, and has not been required by the EC rules**) or provide any filed accounts at all; and / or
- they did not have a parent company that could provide a deed of guarantee as security.

Departments are therefore urged to exercise flexibility within the bounds of equality in specifying their financial information requirements in the OJEC advertisement or follow-up questionnaire. Given that audited accounts including a cash flow statement, may not be available, the drafting of the advertisement or the subsequent questionnaire should be sufficiently flexible to allow SMEs, or any other candidates, to provide other appropriate information that will equally demonstrate the supplier's economic and financial standing.

Examples of other information that may be appropriate to enable an assessment to be undertaken include:

- parent company accounts (if applicable)
- bankers statements and references
- accountants' references
- management accounts
- financial projections, including cash flow forecasts
- details of previous contracts, including contract values
- capital availability.

A suggested pro-forma for questions regarding financial and economic standing is outlined under 3.2.4. Audited accounts are requested, if available, that include figures for the past two years of trading rather than for the previous three years. Over-emphasis on historical accounts is not a helpful guide to a candidate's future performance. The financial position of a candidate may have significantly strengthened (or weakened) in the period between the last published accounts and the start of the new contract – a period that can be as long as two years. Many suppliers are also operating on a more global basis and there is increasing restructuring activity making historical data beyond two years less relevant for current financial appraisal purposes. In the absence of more recent audited statements, other information should be requested that is considered sufficient for a current assessment of a candidate's financial standing.



Although a major supplier may present less financial risk than an SME for the same contract, the level of risk presented by an SME may still be acceptable and manageable and may be offset by increased value for money. For example, in the fast moving field of information technology, well-established suppliers may not necessarily offer the most innovative or cost effective solutions. Candidates' financial standing should only be considered as part of the risk management exercise. It may not, on its own, reflect their ability to deliver. The financial risk should be carefully considered before a decision is made on whether to select the candidate.

3.2.3 Information from partnerships

Some projects attract expressions of interest from partnerships such as accountancy practices. Although there has been a recent trend for the major firms to bestow limited company status on their consultancy divisions, contract requirements will continue to attract proposals from firms of all sizes that prefer to remain partnerships.

Partnership accounts are not subject to a statutory audit and these firms usually confine their disclosures to statements of turnover. This presents a problem for contracting authorities because:

- without further details, the financial status of the firm is unknown
- compared to candidates that are companies, such firms appear to enjoy a privileged position in the bidding process by virtue of being a partnership entity and therefore not having to disclose the same financial information as corporate competitors.

The EC rules make provision for contracting authorities to take into account statements of accounts or extracts from them where publication of the statements is required under the law. They also permit that where the information is not appropriate in a particular case (partnerships are not required under the law to publish a statement of accounts), a contracting authority may require a supplier to provide other information to demonstrate economic and financial standing provided that the required information is specified in the contract notice. The contracting authority cannot reject an application from a partnership on the grounds of non-disclosure under the EC rules, but it is entitled to reject a candidate that is not able or willing to prove it has the necessary financial standing. In practice, a partnership is likely to release its accounts if the firm really wants the business. Partnerships may legitimately expect the contracting authority to treat this information as commercially confidential.

3.2.4 Questionnaire pro-forma

Candidates may be invited by the Authority to complete a questionnaire that can be used as the basis to measure them against the department's minimum standards. The suggested information requirements relating to economic and financial standing are listed below:



- (a) A copy of the most recent audited accounts that cover the last two years of trading or for the period that is available if trading for less than two years.
- (b) A statement of the organisation's turnover, Profit & Loss and cash flow position for the most recent full year of trading (or part year if full year not applicable) and an end period balance sheet, where this information is not available in an audited form at (a).
- (c) Where (b) cannot be provided, a statement of the organisation's cash flow forecast for the current year and a bank letter outlining the current cash and credit facility position.
- (d) If the organisation is a subsidiary of a group, (a) to (c) are required for both the subsidiary and the ultimate parent. Where a consortium or association is proposed, the information is requested for each member company.
- (e) A separate statement of the organisation's turnover that relates directly to the supply of this service for the past two years, or for the period the organisation has been trading (if less than two years).
- (f) Parent company and/or other guarantees of performance and financial standing may be required if considered appropriate. Confirmation of the organisation's willingness to arrange for a guarantee or a performance bond.

3.3 Analysis

3.3.1 Basic checks

Prior to any financial analysis, basic checks should be made on a UK based candidate company's title and its registered number at Companies House, whether the company is trading or dormant and whether it is owned by another company or supported by a venture capital organisation. The status of the company's accounts should also be determined, that is, the last accounting period for which statements have been filed and whether there are later accounts that are overdue.

A non-chargeable company names and address index that provides basic UK registered company details is available from the Companies House website⁶. The chargeable Companies House Direct service is also accessible from the same site, providing UK Company reports and details of company directors, dissolved companies, disqualified directors and insolvency details. Companies that are in receivership, administration or liquidation can be identified from other specialist subscription based websites.

See also 'Credit agencies and on-line databases' and 'Filings in the US' under 4.2.

6. <http://www.companies-house.gov.uk>



3.3.2 Scope

The scope of analysis should cover each candidate responding to the advertisement and, if applicable, their ultimate parent(s). It should draw attention to any significant items in the accounts, including turnover and trading results and their trends, cash movements, and balance sheet strengths and weaknesses. However, when addressing these items, procurement staff are encouraged to think in a broad, commercially focused manner by reviewing financial criteria in the context of the key characteristics and requirements of the contract.

Turnover and contract limit

A contract limit is the size of contract which is considered 'safe' to award to a supplier based on a simple comparison of the annual contract value to the annual (or average annual) turnover. Departments using this concept have tended to apply a maximum threshold of 25% (annual contract value to turnover). The concept of contract limit could be used as a guide in terms of:

- a **financial** strength issue – can the candidate cope financially with this size of contract or the asset requirement?
- a **capacity** issue – does the candidate have the resource to carry out the work?
- or a **dependency** issue – will the candidate become over-dependent on this contract or contracting authority?

While turnover can be a useful indicator for any of these questions, the more rounded, commercial approach that is now recommended means that the contract limit as a *clear cut 'yes or no' factor* should not be used as a matter of course. It is too simplistic a concept to carry such weight.

Turnover may be a useful indicator as to capacity, but it is far from the only factor. A supplier may have recently invested in productive capacity and be able to show very clearly that it can manage a contract that is a high proportion of previous turnover. The contract limit also looks backwards; young or rapidly growing companies can easily double in size between the period relating to the accounts under consideration, and the actual period of the new contract - although another consideration is that a rapidly growing company could be overstretching itself.

Issues of financial position, capacity, capability and dependency should all be considered as part of the appraisal process. If a candidate is not selected, there must be clear and demonstrable evidence of financial risks, capacity or capability issues over and above a simple turnover or ratio measure. If a candidate meets the minimum standards, it may still be unsuccessful if other suppliers score better on the key selection criteria.

A notional calculation of contract limit should therefore only be used as **part** of the assessment to confirm the Authority's opinion of whether a candidate is substantial enough to provide the appropriate capacity. **Candidates should only be eliminated on the strength of contract limit alone if they *clearly* have insufficient capacity to deliver the requirement and there is no appropriate support available from a parent organisation or other third party.**



Profit & Loss Profit & Loss data should be noted and considered for both the candidate and the ultimate parent company (if applicable). If the candidate's Profit & Loss account is showing losses, this per se does not justify the elimination of the supplier from the competition. For example, start-up companies often return losses during their early years but the balance sheet may, nevertheless, show adequate financial resources. Moreover, financially sound companies sometimes make losses for a short period if undergoing a restructuring.

Cash flow **The Profit & Loss account and balance sheet alone do not provide sufficient information to enable a thorough financial assessment of a candidate. The Profit & Loss account may be distorted by items not directly related to the current trading performance of the company, and the balance sheet may contain substantial assets, which cannot easily be turned into cash. Cash is the immediate requirement for working capital needs.**

The Companies Act 1985 requires accounts, other than those prepared by small or medium-sized companies (as defined by the Act), to state whether they have been prepared in accordance with applicable accounting standards. A cash flow statement is not specifically required by law but has been a Financial Reporting Standard (FRS) since 1992. Cash flow information should be requested from a candidate (see 3.2.4).

The cash flow statement shows the inflows and outflows of cash for the relevant past period, classified under the following headings:

- operating activities
- returns on investments and servicing finance
- taxation
- investing activities
- financing.

The statement shows cash generation and cash absorption of the business for the period. This arises not only from operating activities but also, for example, from investment in new equipment. It also eliminates the effects of accruals accounting (depreciation, pre-payments etc) to reveal the underlying cash performance of the business. This should be carefully assessed to establish whether there is sufficient cash flow to cover working capital requirements, capital repayments and interest. The candidate's cash generating ability is a major influence on investment capacity and the level of debt that can be carried. As with all financial statements, the cash flow statement should be considered in the light of the background knowledge the Authority has on the company.



Balance sheet

The analysis should, where possible, include:

- the calculation of the key ratios for liquidity and gearing. Loans to the supplier should be identified (short and long-term borrowing) so that the overall stability of the candidate can be quantified. A consistent annual overdraft (that is, of a similar sum each year, or non-diminishing) should be treated as long-term borrowing in terms of gearing and operating performance, as well as the acid test
- the debtors element of current assets: any 'after one year' component should be excluded for the acid test of liquidity
- the value of any goodwill, intellectual property and other intangibles as capitalised on the balance sheet
- the determination of net worth (and that element that can be mobilised in a financial crisis).

This will assist in identifying (a) whether there are working capital or 'overtrading' issues, (b) the risk of supplier bankruptcy and (c) investment capacity. The candidate's capital structure should reflect a reasonable balance between business and financial risk.

3.3.3 Assessment

The assessment is undertaken to produce a summary profile of the candidate's financial condition and that of its ultimate parent (if applicable). On a case by case basis, and taking into account the information derived above, a recommendation has to be made on whether a candidate meets the minimum standard. Although it is desirable to reduce a large response to a more manageable number, suppliers should only be excluded from further consideration if they are *clearly* unrealistic candidates having inadequate resources to undertake the work. If there are doubts about the company's financial status or unresolved questions such as whether a deed of guarantee is available (from whatever source), the supplier should be retained for further consideration. The 'bottom line' is that general formulae should not be applied mechanistically without also considering the specific situation of each supplier in the context of the requirement as well.

The assessment can be used to identify the level of risk presented by each candidate: for example, Low Risk (proceed); Medium Risk (proceed with caution) and High Risk (consider elimination). This can be a qualitative assessment based on the interpretation of all the relevant information.



4: Detailed appraisal

4.1 Objectives

The aim of the detailed financial appraisal will be:

- to focus appraisal effort on a thorough examination
- to use this analysis to establish the number of candidates to be invited to negotiate or to tender.

4.2 Information used

After the assessment of each candidate and their ultimate parents (if applicable), further financial appraisal of candidates should include a detailed analysis of their latest available audited and interim accounts (if applicable) and cash flow information. This appraisal should also cover consortia members and subcontractors (if applicable/known).

Other information provided by commercial service providers or otherwise in the Authority's possession, that may have a bearing on a candidate's financial position or ownership (such as credit facilities, debt ratings, current take-over activity, restructuring, new capital investment, or relevant contractual / commercial information from other departments etc) can also be assessed. Departments should ensure that the material relates to those types of information and criteria in the EC rules.

Credit agencies and online databases

Financial data and credit ratings from specialist on-line database providers are useful indicators for getting a snapshot view of a supplier, but should not be used as a substitute for detailed examination of the candidate's financial statements by the contracting authority. Such databases tend to hold only a summary of the financial information that has been filed at Companies House. They may not hold information on recent results or foreign parents and their data may lack interpretation. These databases do not, therefore, provide a complete picture. The candidate should, where applicable, supply its accounts to the Authority, including the statements of any ultimate parent (including overseas-based parents).

Debt ratings

Debt ratings of the various rating agencies reflect each agency's opinion of the financial strength and ability of the issuer to repay obligations punctually. Lower ratings generally result in higher borrowing costs. As part of the comprehensive appraisal process, the Authority should, for a major award, check whether a candidate supplier is rated by one of the major agencies such as Moody's or Standard & Poor's. Their rating reports take account of a company's corporate strategy, operating position, financial management and general prospects, and should be noted by the Authority.



Filings in the US

Some candidates are either based in the US or have a US parent. Public companies with assets and investors of at least \$10 million and 500 respectively are required to file their financial reports with the Securities and Exchange Commission⁷ and have to publish more detailed information than suppliers provide in the UK. This includes revolving credit arrangements and risk factors such as litigation details, the company's assessment of competitive pressures and other factors that may affect future results and business prospects.

4.3 Analysis

The scope and depth of analysis will reflect the size of the contract and the scope and criticality of the requirement. Particular care should be taken if doubts exist about a supplier's financial standing, particularly when a large value, long duration contract is being let. The contracting authority must be confident of a supplier's ability to deliver.

Although administration, receivership or creditors' voluntary liquidation demonstrably constitute the outright failure of the business, the early symptoms of financial distress are more difficult to identify. The checklist below will assist the compilation, for each candidate, of a financial profile of strengths and weaknesses, and a risk assessment.

Warning signals

Financial warning signals may include:

- cash draining from the business
- falling profit margins
- increasing overdraft with static turnover
- major reductions in staffing
- increasing employment with static turnover
- increasing debtor and creditor days
- larger increases in creditors than debtors
- increasing stocks, slower stock turnover
- deteriorating liquidity
- over-reliance on short term debt
- high gearing
- heavy write-offs of foreign or subsidiary holdings
- late filing of accounts
- qualified accounts
- County Court Judgements (CCJs)
- poor credit ratings
- unusual accounting policies
- changing auditors and bankers
- debt rating downgrades/alerts
- investment bank prospect reports
- adverse press reports.

7. <http://www.sec.gov>



Accounts review

Suppliers' audited annual reports and accounts should be reviewed. In addition to the core financial statements (Profit & Loss, cash flow and balance sheet – if these are all published), the explanatory notes should also be scrutinised. They may include a detailed breakdown of turnover by specific activity, changes in management staff, contingent liabilities, financial commitments and post balance sheet events. Analysis of turnover may identify or confirm a candidate's core business and whether it is over-dependent on a particular customer.

The status of the candidate's accounts should be reviewed. The Companies Act 1989 requires that accounts are filed with Companies House within ten months after the end of the relevant accounting period for a private company, or seven months in the case of a public company (small companies can file abbreviated accounts – but under the Companies Acts are still required to prepare full accounts for their shareholders. For the purposes of the financial appraisal, the full shareholder accounts should be provided in all cases where these are available). The contracting authority should determine when the last accounts were filed and the date of signature on the directors' and auditor's reports. The Authority should also establish if more up-to-date information is available or should be available. If the latter, establish why it is not – for example, have later accounts been audited but not filed and would the candidate be prepared to release draft or management accounts?

Cash flow

Where possible, cash flow should be reviewed to determine the operating and liquidity position of the candidate. Moreover, additional information may have become available.

Projections: Companies are not required to produce cash flow forecasts as part of their accounts, but usually produce them for internal management information and control. If such a forecast is available, it will provide useful information but it should be borne in mind that it need not have been produced in accordance with approved accounting practices and standards, nor will it have been the subject of an independent audit. If projections are significantly more favourable than past data, there should be convincing evidence to support the optimism.

Any available forecast will usually cover a year and the length of individual periods to be forecast is usually a month. It is compiled by entering the opening cash balance, forecasting for each period the cash receipts (noting that cash may not be received until some months after the date of sale) and the cash outgoings. Total payments are deducted from total receipts and adding (cash increase) or deducting (cash decrease) from the opening balance gives the closing cash balance. If this is a minus, the company will need to get an overdraft or reduce expenditure.



A review of each month's closing balance enables the cash needs of the business to be estimated. Often there is provision to include the actual amounts received and paid alongside the budgeted figures to aid the monitoring of results.

The estimation of cash flows relating to a proposal will involve consideration of several factors including capital costs, the timing of expenditures, the estimated life of the project, future receipts, savings and costs.

Financial support

Details of overdrafts, short-term loans and revolving credit arrangements should be reviewed and considered as part of the overall financial assessment. In particular, this should include the ability of the candidate to meet its short-term debt obligations in the context of its cash flow and balance sheet strength.

Ratio analysis

The more detailed financial assessment should, where possible, include the calculation of a wider set of key accounting ratios so that the performance, efficiency and overall stability of the candidate can be quantitatively determined and compared with the previous year. The ratios should also be compared with the industry averages in the sector the supplier operates, so that trends can be identified. However, ratios should not be considered solely at face value; all the other relevant factors referred to above must be taken into account.

4.4 PFI

Private Finance Initiative (PFI) deals and other Public Private Partnerships (PPP) tend to be intricate, particularly for large projects. In long-term, capital intensive ones the private sector partners often form a separate company, a Special Purpose Vehicle (SPV), as the contractual party ('Contractor') responsible for delivering the required service.

The Contractor will often obtain the bulk of the capital required to undertake the project from external funding providers such as banks or other financial institutions which will undertake their own 'due diligence' investigations. Where the funding requirements are less, a single company Contractor may fund the project on its own balance sheet.

In all deals, whether funded through project or corporate finance, the financial arrangements are likely to be complex. A project cannot proceed until the required financing is in place, including, where appropriate, the direct agreement between the external funding provider and the Authority.

In a PFI deal the Contractor will not normally receive any payment until service delivery to the contracted standard commences. This could cause funding difficulties for single suppliers that may be used to receiving staged payments to support the pre-service delivery, development phase of projects.



In addition to an assessment of the ability of bidders (whether SPVs or single companies) to provide the service required, a detailed appraisal of their financial and economic standing should be undertaken as part of the pre-qualification procedures. This will establish the viability of a bidder at the outset. This applies irrespective of their size, and whether or not they will be seeking external funding. If the bidder is an SPV it will need to demonstrate fully that it is a cohesive entity rather than a disparate collection of constructors and service providers.

Having shortlisted bidders, the Authority will need to examine in detail the deliverability of the Contractor's proposed funding structures (reviewing and checking the accuracy of their financial models, and assessing whether their assumptions are likely to be realised without seeking further price variations).

It is likely the Authority will need suitably qualified and experienced external financial advice from investment banks or specialist accountancy firms (which should be procured through competition), not least to ensure the adequacy and availability of funding. The Authority will need to ensure that there is no conflict of interest between its provider of advice and the provider of funding to the Contractor.

Both the relationship between members of the SPV and proposals for funding the project may develop during the procurement process and subsequently. The Authority should keep such aspects under review.

If the project is financed using corporate finance rather than through specific project finance, the Authority should nevertheless examine in detail how the Contractor intends to fund the project, using external advice if appropriate.

Further information on PFI may be found on the OGC website under 'Procurement'.

4.5 Pre-award monitoring

A monitoring and review process should be undertaken solely to take into account any significant new financial and commercial information that may become available from discussions with the candidate, from its customers, or from searches of general commercial intelligence sources. Where new information relating to a candidate's standing comes to light, it may, under the EC rules, still be taken into account (that is, after the selection process).

4.6 Deed of guarantee/ indemnity

Parent

A deed of guarantee can take the form of a performance guarantee, under which a third party, the guarantor, often the parent company, undertakes to fulfil the terms of the contract and/or a financial guarantee that ensures the Authority receives financial compensation if the contract is not fulfilled.



The contracting authority may need to obtain a deed of guarantee, particularly where a candidate's financial position is less robust than that of its parent, or if the potential value of a strategic service award exceeds a supplier's contract limit. The Authority should request a suitable guarantor and draw up the guarantee documentation following negotiations between the three parties and their legal representatives.

The deed of guarantee is not always sought from the parent company. A parent company guarantee is only as good as the financial standing of the parent itself. Sometimes, the parent is a mere 'shell' and another group or associate company, with the most assets, should be the guarantor. Although a guarantee can usually be obtained from a parent based in other member states of the EC, or in the USA, it is more difficult to obtain payment of a debt or to seek specific performance of the contract from a company not based in the UK.

Bank

A deed of guarantee can also be provided by a bank or insurance company. This can be a financial guarantee where the guarantor agrees to indemnify the Authority against losses, liabilities and expenses incurred if the supplier defaults on its contractual obligations. This may be less advantageous than a parent company guarantee if the guarantor is obliged to complete the contract.

There are a variety of alternative financial guarantees (bonds) that can be provided by the financial market. An advance payment bond, rarely used in Government, is an acceptable safeguard, particularly as the security is issued through a bank. The bond provider (supplier) usually bears the cost. Such instruments may be financially onerous on the candidate and are likely to be appropriate only in the absence of other credible guarantees. [See CUP Guidance No. 48 *Bonds and guarantees*.⁸]

Contracting authorities are advised to seek professional advice on the best choice, use and drafting of guarantees and bonds. The OGC Supply Intelligence Service can provide departments with a draft model deed of guarantee that can be used as a starting document.

A candidate should indicate in its response to an OJEC advertisement or follow-up questionnaire whether it would be willing to arrange a guarantee if this is subsequently required. The contracting authority should notify a candidate as soon as possible during the selection stage if a guarantee will be sought.

JVCs & SPVs

In cases where the Authority is considering a contract with a Joint Venture Company (JVC) or a Special Purpose Vehicle (SPV) company, which may have two or more parent companies and which may not be adequately capitalised or have sufficient strength of covenant on its own to support the risk and obligations it has under the contract, the Authority can seek 'joint and several' guarantees / indemnities from each parent of the JVC or SPV. This could be based on a deed of guarantee /

8. <http://www.ogc.gov.uk/ogc/procurement.nsf/pages/CUPGuidance.html>



indemnity given by joint parent companies of a subsidiary from each of the parent companies. The objective is to avoid a situation in which identified risks that the Authority has placed with the contractor, being passed back to the Authority by virtue of the JVC or SPV not having sufficient strength of covenant on its own to support those risks.

The parent companies of the JVC or SPV are unlikely to allow the JVC or SPV to fail. However, one of the possible consequences of not seeking 'joint and several' guarantees / indemnities is the risk that the Authority may not achieve full recovery if the JVC or SPV and one or more of the parent companies were to fail. If the Authority has accepted only proportionate liability (that is, 'several' guarantees / indemnities) from the parent companies, it risks a shortfall.

4.7 Insolvency

According to the Insolvency Act 1986, a company is deemed unable to pay its debts:

- if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due; *or*
- if it is proved to the satisfaction of the court that the value of its assets is less than its liabilities, taking into account its contingent and prospective liabilities.

There are three basic areas of risk for the contracting authority in dealing with insolvent companies:

- the risk of involvement in fraudulent trading with a supplier that is being wound-up under provisions in the Companies Act 1985 and the Insolvency Act 1986, regarding criminal and civil liability respectively
- the risk of involvement in wrongful trading as a shadow director
- the risk of non-performance of contracts.

Placing a contract with an insolvent supplier should be avoided.

If the latest audited accounts show net liabilities, that is, a negative net worth, the company can be regarded as technically insolvent as at the date of the referenced balance sheet. This means that it is potentially insolvent but not deemed to be incapable of debt repayments under the Insolvency Act. If the supplier is found to be technically insolvent, the relevant data should be carefully interpreted before deciding whether the financial risk is unacceptable.

The nature of the contingent liabilities should first be determined and then a judgement made about the likelihood of them becoming payable. Many suppliers continue to trade, some profitably, and develop successfully despite having net liabilities. Moreover, start-up costs often give new companies a negative balance sheet in the early years of trading. Where data are available, recent trends and the supplier's cash position should be determined. In addition, a review of cash flow



and trading forecasts, if provided, would identify whether a candidate could realistically trade out of technical insolvency. The supplier should be asked what its plans are to improve the financial outlook.

Where a candidate appears technically insolvent and is a member of a group that is solvent overall, there may be the following options for mitigating the financial risks:

- obtaining a suitable parent company indemnity from the ultimate holding company (see section 4.6 Deed of Guarantee); or
- placing the contract with the ultimate holding or parent company.

It should be emphasised that it is not illegal to trade with a technically insolvent supplier; it might after all trade its way successfully back to financial health. The business and financial risks involved should be carefully calculated and weighted against the benefits.

5: Post-award monitoring

As an essential on-going activity after a major award, the Authority should continue to monitor the supplier's financial and commercial standing, and whether it continues to have the necessary resources to manage the contract. The market in which it operates should also be reviewed. This will enable the Authority to recognise and respond quickly and appropriately to significant external events, pressures, or new information affecting the supplier's viability or operations. Effort should of course be appropriate to the size and importance of the contract.

6: Supply Intelligence Service

OGC provides a comprehensive Supply Intelligence Service (SIS) to assist departments with their supplier appraisal activities⁹. The SIS team can be contacted by:

Telephone: 01603 704680 or
E-mail: sis@ogc.gsi.gov.uk

9. <http://www.ogc.gov.uk/ogc/services.nsf>

Further information

Contacting the SIS

Telephone: 01603 704680
e-mail: sis@ogc.gsi.gov.uk

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