

In preparing this report the relevance of the following factors has been considered: prevention of crime and disorder, equality of opportunity; and legal, financial, environmental, health, respect for human rights, personnel and property considerations.

DERBYSHIRE COUNTY COUNCIL

CABINET MEETING

22 February 2005

Report of the County Treasurer

FINANCIAL VETTING OF CONTRACTORS (REGENERATION)

1. Purpose of the Report

To ask Cabinet to approve the guidelines for the financial vetting of contractors.

2. Information and Analysis

The County Council has financially vetted contractors for over 15 years for the purposes of maintaining a select list of approved tenderers. This is a list of suppliers considered financially and technically competent to perform contracts of the types and value specified by the County Council and is used to minimise administration costs when inviting contractors to tender. This report does not cover a company's technical ability to undertake a contract.

The level of financial competence and ability is reviewed at least every five years in line with financial regulations. In addition, ad hoc financial analysis is undertaken at various times where particular contracts are let outside of those normally covered by the select list.

The financial vetting of contractors is an integral part of the award of tenders and is designed to protect both the County Council and businesses by ensuring that a contractor is financially able to perform the requirement to be imposed by the contract proposed.

In broad terms current practice consists of analysis of the company's audited accounts that cover the last 3 years of trading, using standard tests of profitability, liquidity and long-term debt. Based on these tests, and the company's turnover, advisory limits are then offered on the size of any one contract or the total value of business that should be placed with the contractor. Dependent on the financial risk, contractors may be required to provide parent company/group guarantees or performance bonds.

Recently there have been instances where suppliers have challenged the County Council's financial vetting procedure and while procedures have proved to be robust it is recognised that there is a need to formalise guidance and standards, to reflect:

- (i) the Council's current business needs, in particular the growing number of specialist contracts deriving from the Council's Change Management initiatives; and
- (ii) protect the Council's financial and operational interests.

The recommended guidelines are attached as Appendix 1.

3. Legal Considerations

The procurement process including the selection and financial vetting of tenderers should be in accordance with the constitution of the Council and its Standing Orders and meet the requirements of UK and European Law as applicable.

4. Background Papers

Financial Regulations
Standing Orders relating to Contracts

5. Key Decision

No.

6. OFFICER'S RECOMMENDATION

That Cabinet approves the financial vetting guidelines as set out in Appendix 1.

Peter Swaby
County Treasurer

16 February 2005

**Derbyshire County Council
County Treasurers Division**

SUPPLIER FINANCIAL VETTING GUIDANCE

1. Purpose

The purpose of this document is to set out standards/guidelines for the financial vetting of suppliers bidding for contracts falling within the County Council's Financial Regulations, and Standing Orders relating to contracts.

Although this guidance is primarily intended for staff responsible for County Council procurement, it should also be helpful to potential suppliers as it provides them with an insight into the scope and rigour of financial vetting procedures that the County Council undertakes.

In the context of the procurement process, financial vetting will form part of the selection (not award) criteria and is designed to identify financial risks to be assessed alongside other qualitative and quantitative factors that can be grounds for selecting a preferred supplier.

This guidance endorses an approach where risk is assessed relative to the particular factors of the requirement and the supplier rather than just the mechanistic application of financial formula.

Annexes to this policy include:

- Annex A Publication of Accounts and Exemptions
- Annex B Key Accounting Ratios for Analysis

2. Practitioners

The financial vetting of prospective suppliers for contract purposes is the responsibility of the County Treasurer and will be carried out by suitably experienced finance professionals within the Technical Section.

3. Objective

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 letting a contract to them would represent to the County Council – having regard to the terms of the contract, value and nature of the market.

4. Information Requirements

One or more of the following may as a general rule, provide proof of a supplier's financial and economic standing:

- statements of accounts relating to the business of the supplier as required by relevant legislation; and
- a statement of the overall turnover of the business of the supplier and the turnover, in respect of services of a similar type to those to be provided under the proposed contract, in the three previous years.

To evaluate a supplier's financial standing the County Council will request provision of the most recent audited accounts for the past three years of trading. In the absence of audited accounts, other information will be requested that is considered sufficient for assessment purposes (see 4.ii&iii). In addition the County Council may also require the supplier to provide supplementary information.

Annex A outlines the requirements concerning the preparation and filing of accounts.

The County Council is entitled to reject a supplier that is not able or willing to provide appropriate information to demonstrate its financial position.

(i) OJEU¹ Advertisement

The OJEU advertisement will stipulate that the County Council requires prospective tenderers to provide:

- copies of audited accounts for the previous three years financial years; and
- a statement of the tenderer's overall turnover and its turnover in respect of the services to which the contract relates, for the previous three financial years.

The County Council issues a questionnaire to prospective suppliers who respond to the OJEU notice to obtain financial details (see 4.v). This questionnaire is used at the Expressions of Interest stage for tenders following the negotiated and restricted procedures, and as part of the tender documentation for tenders following the open procedure. The information provided is used as a basis for measuring prospective suppliers against minimum standards.

¹ OJEU denotes Official Journal of the European Communities
PSR-1162

(ii) Small and Growing Companies

The County Council will endeavour to ensure effective competition and will not unreasonably exclude small or growing companies, for example where: -

- they are recently formed and therefore cannot provide audited financial information for the previous three years or provide any filed accounts at all; and/or
- they do not have a parent company that can provide a deed of guarantee as security.

Given that audited accounts may not be available the drafting of the subsequent questionnaire will be flexible to allow small and growing companies to provide other appropriate information that will equally demonstrate their economic and financial standing.

Examples of other information, which maybe appropriate to enable an assessment to be undertaken, include:

- parent company accounts (if applicable)
- bankers statements and references
- management accounts
- financial projections/business plans
- details of previous contracts won in the last three years, including contract values

The County Council only will have the right to determine the type of information and its acceptability.

(iii) Partnerships

Some County Council projects attract expressions of interest from partnerships such as accountancy practices. Partnerships are not required under law to publish a set of audited accounts and usually confine their disclosures to statements of turnover.

Where statements of accounts or extracts are not available the County Council will require the partnership to provide other information (as per ii) to prove it has the necessary financial standing.

(iv) Parent Company Guarantee

A deed of guarantee can take the form of a performance guarantee, under which the parent company undertakes to fulfil the terms of the contract.

The County Council may request a deed of guarantee to mitigate financial risk, particularly where the candidate's position is less robust than that of its parent, or if the value of the contract award exceeds the candidate's contract limit.

In cases where the County Council is considering a contract with a consortium or association, which may have two or more parent companies, it maybe appropriate to seek a deed of guarantee from each parent of the consortium or association.

A parent company guarantee is only as good as the financial standing of the parent itself. Therefore the County Council reserves the right to eliminate the candidate if sufficient doubts exist about the parent company's financial standing.

(v) Performance Bond

If appropriate the County Council may request a performance bond that in the event of the terms of the contract not being fulfilled, the County Council will be able to claim compensation.

The County Secretary will determine the terms and conditions of the bond.

(vi) Questionnaire

Information requirements relating to economic and financial standing for inclusion in the questionnaire are listed below:

- (a) A copy of the most recent audited accounts that cover the last three years of trading or for the period that is available for less than three 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 of period balance sheet, where this information is not available in an audited form (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.
- (e) Where a consortium or association is proposed, the information (a) to (c) is requested for each member company.
- (f) If appropriate confirmation of the organisation's willingness to arrange for a parent company guarantee or performance bond of contract performance.

5. Analysis

(i) Scope

The scope of the financial analysis will cover each supplier that has submitted a compliant tender and is being considered for short listing and, if applicable their ultimate parent(s). It will draw attention to significant items in the accounts, turnover, trading results, trends and balance sheet strengths and weaknesses.

(ii) Turnover and Contract Limit

A contract limit is the size of the contract which is considered reasonable to award to a supplier based on a simple comparison of the annual contract value to the annual turnover. A maximum threshold of 33% was decided upon by the County Council in the mid 1980's and is used as a guide to serve two purposes: -

- To protect the County Council from having a supplier overstretch themselves and being unable to fulfill the contract; and
- To protect the supplier from becoming too dependent on the County Council for their income.

The County Council stipulates that as good purchasing practice the contract value should not exceed 33% of an organisation's annual turnover. However the contract limit will not in isolation be used to determine whether a contract can be let to an organisation.

Issues, which relate to the supplier's ability to deliver and the nature of the product and market, will all be considered as part of the appraisal process. Examples where flexibility in the turnover criteria may apply include: -

- Contracts, which are 'product' based and involve the supplier acting as a reseller. In this case the reseller will not be carrying the risk associated with production or inventory. However to mitigate risk, the originator may need to provide the County Council with a written assurance that they will underwrite support for the product and if necessary find an alternative reseller.
- Customer specific products which are market proven and where the supplier is clearly able to demonstrate that it can manage a contract that is a high proportion of it's previous turnover.

The '33% rule' will be used as a part of the assessment to confirm the County Council's opinion of whether a supplier has the capacity to deliver the contractual requirements. Suppliers who clearly demonstrate they have insufficient capacity to deliver the contract and offer no appropriate support from a parent organisation will be eliminated on the strength of contract limit alone.

(iii) Profit & Loss Account

Profit and loss data will be reviewed by examining the results of key profitability ratios for both the supplier and the parent company (if applicable). If the supplier's profit and loss account is showing losses, this will not necessarily justify elimination and will require a degree of judgement to be applied. For example, a new company may return losses during their early years but show adequate financial resources on the balance sheet. Moreover, a financially sound company going through a period of restructuring may incur losses.

(iv) Balance Sheet

The analysis will, where possible, include:

- the calculation of key ratios for liquidity and gearing. Loans to the supplier will be identified (short and long-term borrowing) so that the overall financial stability of the supplier can be quantified. A consistent overdraft (that is, of a similar sum each year, or non-diminishing) will be treated as long-term borrowing in terms of gearing, as well as liquidity.
- the determination of 'net worth' (that element that can be mobilised in a financial crisis).

The above will assist in identifying:

- whether there are working capital or 'overtrading' issues.
- there is a risk of supplier bankruptcy.
- the extent of investment capacity.

(v) Other Statements

In addition to the core financial statements (Profit & Loss and Balance Sheet), it may be appropriate to scrutinise other statements that accompany the accounts, including:

- Cash Flow statement to establish that there is sufficient cash flow to cover working capital requirements, capital repayments and interest.
- Explanatory notes to provide explanation and analysis of key figures in the primary statements, as well as additional information to assist understanding of the supplier's financial position.
- Directors' Report to assess the past performance of the business and determine future prospects.
- For companies listed on the stock exchange, independent assessments available from for example stockbrokers.

(vi) Ratio Analysis

Although a company's accounts provide information on its performance and financial position, the figures are more useful if they are used as the basis for comparisons with earlier financial periods, with other companies carrying out similar business or with averages for the industry.

The financial assessment of the accounts will incorporate the calculation of key accounting ratios so that the performance, efficiency and the overall stability of the supplier can be assessed and compared with the previous year.

A description of each ratio currently used and method of calculation is attached at Annex B.

(vii) Credit Agency

Where appropriate, further assessment will be made through an on-line credit search facility to which the County Council has access. This facility allows further information (such as corporate structure, industry ratios, payment trends, CCJs, directors details) to be accessed and provides a risk score to highlight the financial strength, performance and creditworthiness of the company. The score takes account of a company's operating position, financial management and general prospects.

6. Assessment

The assessment produces a summary profile of the supplier's financial condition and that of its ultimate parent (if applicable). On a case by case basis, and taking into account the information and results derived above, the County Treasurer will make a recommendation on whether the prospective supplier meets the minimum standard.

If there are doubts about a supplier's financial status or unresolved questions such as whether a parent guarantee is available, the supplier will be retained in the procurement process until they are resolved. However, the Council's decision is final and binding.

(i) Insolvency

The County Council will only in exceptional circumstances consider candidates who have been placed in administration or receivership and will eliminate those placed in liquidation.

(ii) Warning Signals

The early symptoms of financial distress can be difficult to identify therefore the following list of financial warning signals will assist the compilation, for each candidate, of a financial profile of strengths and weaknesses, and a risk assessment.

Financial warning signals may include:

- falling profit margins
- deteriorating liquidity
- high gearing
- larger increases in creditors than debtors
- increasing stocks, slower stock turnover
- cash draining from the business
- increasing overdraft with static turnover
- major reductions in staffing
- late filing of accounts
- qualified accounts
- poor credit ratings
- unusual accounting policies

7. Post-award monitoring

As an essential on-going activity after a major award, the County Council will continue to monitor the supplier's financial standing, and whether it continues to have the necessary resources to manage the contract. This will enable the County Council to recognise and respond quickly and appropriately to significant external events, pressures, or new information affecting the supplier's viability or operations.

Publication of Accounts and Exemptions

Accounting Records

All limited and unlimited companies, whether or not they are trading, must keep accounting records. Generally, accounts must include:

- a Profit & Loss account (or income and expenditure account if the company is not trading for profit);
- a balance sheet;
- an auditors' report (if appropriate);
- a directors' report;
- notes to the accounts; and
- group accounts (if appropriate).

Filing of Accounts

All limited and public limited companies must send their accounts to Companies House. If they are eligible and wish to, SMEs may prepare and file abbreviated accounts.

Filing Dates

Public limited companies are obliged to file accounts within 7 months of the end of their accounting period, private limited companies within 10 months.

Small Medium-sized Enterprises (SMEs)

SMEs are allowed to file abbreviated accounts with Companies House.

To be a small company, at least two of the following conditions must be met:

- annual turnover of £2.8M or less;
- balance sheet assets of £1.4M or less;
- average number of employees of 50 or less.

Abbreviated accounts of a small company must include:

- abbreviated balance sheet and notes; and
- an auditor's report.

To be a medium-sized company, at least two of the following conditions must be met:

- annual turnover of £11.2M or less;
- balance sheet assets of £5.6M or less;
- average number of employees of 250 or less.

Abbreviated accounts of a medium-sized company must include:

- abbreviated profit and loss account;
- the full balance sheet;
- an auditor's report
- the directors' report; and
- notes to the accounts.

Small Companies

Small companies with a turnover of less than £1M and total balance sheet assets of less than £1.4M can claim exemption from audit.

An audit-exempt company is required to send unaudited accounts to Companies House in the form of an abbreviated balance sheet.

Key Accounting Ratios for Analysis

The key ratios calculated can be logically divided into two main groups (a summary table for reference is shown at the end of the appendix):

Operating Performance

The principal financial ratios used for assessing operating performance are listed below:

(i) Return on Capital Employed (ROCE)

$(\text{profit before tax} / \text{capital employed}) \times 100 = \%$

ROCE is the most important measure of the overall efficiency of the management of the business because it relates the result of operations to the total funds being used in the business. It provides a measure of profit from the business relative to the amount of capital that was used to generate it. In other words it shows how well a company uses its money. Capital employed is the total of shareholders' funds, long-term loans and other long-term liabilities.

(ii) Return on Assets

$(\text{profit before tax} / \text{total assets}) \times 100 = \%$

This ratio measures the overall efficiency with which assets are being utilised. Total assets is the sum of fixed assets and current assets.

(iii) Gross Profit ratio

$(\text{sales less cost of sales} / \text{turnover}) \times 100 = \%$

This ratio is an indicator of the efficiency of the production operations of the business as distinct from the selling and general management areas.

(iv) Pre-tax Profit ratio

$(\text{profit before tax} / \text{turnover}) \times 100 = \%$

This ratio is a measure of the efficiency of the operating management of the business and indicates management's ability to generate profits from the business before deducting costs that have nothing to do with operating efficiency.

(v) Stock Turnover

(turnover / stock)

This measures the number of times a supplier converts its stock into sales during the year.

(vi) Collection Period

(trade debtors x no. of days in accounting period) / turnover

This measures the length of time it takes a supplier to collect its debts and reflects the effectiveness of the credit control function in collecting monies outstanding. It provides an estimate of the number of days between the dates of credit sales and when payment has been received for them. It is a good indicator of the credit trends within the business and of the liquidity of debtors.

Financial Structure

Assessment of whether a supplier is likely to experience cash flow problems and whether the business is adequately financed and from what sources. The main areas are liquidity and gearing. The following ratios will be used to assist this analysis:

(i) Current ratio

(current assets / current liabilities)

This indicates the ability of a company to pay its short-term creditors from the realisation of its current assets and without having to resort to selling its fixed assets to do so. Ideally the figure should always be greater than 1, which would indicate that there are sufficient assets available to pay liabilities, should the need arise.

(ii) Acid Test ratio

(current assets less stock) / current liabilities

This is a more severe test of liquidity than the current ratio as it excludes the least liquid portion of current assets, stocks.

(iii) Debt Gearing

$(\text{long-term debt} / \text{net worth}) \times 100 = \%$

Gearing provides a comparison between the amount of borrowings a company has to its shareholders funds (net worth). The result of the calculation will show as a percentage the proportion of capital available within the company in relation to that owed to sources outside the company.

(iv) Interest Cover

$(\text{profit before tax} / \text{interest charges})$

This shows the number of times available profit covers interest charges and measures the extent to which pre-tax profits can fall without being insufficient to cover the interest charges and thereby create a pre-tax loss.

Summary Table

Area of assessment	Ratio	Calculation
Operating performance		
Efficiency	ROCE	profit before tax/capital employed x 100 = %
	Return on Assets	profit before tax/total assets x 100 = %
Profit margins	Gross profit margin	sales less cost of sales/turnover x 100 = %
	Pre-tax profit margin	profit before tax/turnover x 100 = %
Stock	Stock turnover	stock/turnover
Debtors	Collection period	trade debtors x no.of days in period/turnover
Financial Structure		
Liquidity	Current ratio	current assets/current liabilities
	Acid test ratio	current assets less stock/current liabilities
Gearing	Debt gearing	long-term debt/net worth x 100 = %
Interest Payments	Interest cover	profit before tax/interest charges