CYNGOR SIR *POWYS* COUNTY COUNCIL.

Audit Committee
19th December 2019

REPORT AUTHOR: **Jane Thomas, Head of Finance**

SUBJECT: **Assessing the Economic and Financial Standing of Suppliers**

REPORT FOR: **Information**

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1. Purpose

1.1 To advise the Audit Committee on the extent to which the Council's current procedures are in line with the Government Commercial Function's Guidance Note "Assessing the Economic and Financial Standing of Suppliers" and to seek support for recommendations to improve the Council's processes.

2. Background

2.1 Assessing and monitoring the economic and financial standing of suppliers is about understanding the financial capacity of suppliers to perform a contract in order to safeguard the delivery of public services.

2.2 In August 2019 the Audit Committee received a report on the Council's process of assessing the economic and financial standing of companies including the work undertaken when Dawnus Ltd and Jistcourt Ltd were assessed. At that time, Committee was informed of a new Policy Guidance Note that had been issued in July 2019 by the Government Commercial Function titled 'Assessing the Economic and Financial Standing of Suppliers'.

2.3 The Guidance Note provides advice on how to:

- Assess the economic and financial standing (EFS) of bidders during a procurement;
- Mitigate financial risks arising from the EFS of a bidder or changes to such standing; and
- Monitor the ongoing EFS of suppliers during the life of a contract.

2.4 The Guidance Note is relevant to all Central Government Departments, their Executive Agencies and Non-Departmental Public Bodies and those bodies were asked to test the guidance and feedback any comments.

2.5 The Audit Committee recommended that the Council review its procedures against the Guidance Note with a view to improving the assessment and monitoring of the economic and financial standing of suppliers. This report responds to this recommendation.

3. Assessing the Economic and Financial Standing of Bidders

3.1 Principles

What the guidance says

3.1.1 All assessments of bidders' EFS should be proportionate, flexible, contract specific and not overly risk averse, while ensuring protection of taxpayer value and safety and compliance with relevant procurement law. All bidders, whatever their size and constitution, should be treated fairly and with appropriate diligence during the assessment of their EFS. No SMEs (Small and Medium Sized Enterprises), public service mutuals or third sector organisations should be inadvertently disadvantaged.

3.1.2 EFS should only be considered as part of the overall selection criteria. It may not on its own reflect a bidder's ability to deliver.

3.1.3 Assessment of EFS must be transparent, objective and non-discriminatory. It should be based on a set of metrics and ratios appraised against pre-determined thresholds to provide a set of risk classifications for each bidder. Bidders should be able to see their risk classifications as they complete the financial assessment and, where relevant, be given the opportunity to explain why different risk classifications may be more appropriate.

3.1.4 In many cases the assessment can be based on a standardised set of metrics and ratios. For certain contracts, however, additional or alternative metrics and ratios may be appropriate, in particular for procurements of more critical, complex works and services or for longer periods. Minimum financial thresholds should be appropriate and proportionate to the contract being procured.

3.1.5 The assessment of a bidder's EFS should be conducted by staff with a financial background, calling on specialist in-house or external expertise as necessary.

What The Council Does

3.1.6 Powys already adopts much of the guidance in this section. The requirements for EFS assessments are included up front in any procurement process. This means that assessment and the criteria cannot be changed after receipt of tender.

3.1.7 Financial criteria required for assessment are published in a way that would enable companies to undertake their own assessment for their economic and financial status and position and disqualify themselves where they do not meet the criteria for a particular procurement.

3.1.8 Each supplier has the ability to read and replicate the scoring template and this ensures equal treatment for all bidders. The ratios used are the same for each contract, but the scoring factors in flexibility around the contract size.

3.1.9 The financial assessments are conducted by the finance team and are based on a series of standard financial ratios with various thresholds. The various metrics measure the risk of failure, from very low to high and financial strength, from unsound to strong.

3.1.10 Additional reliance has also been placed on credit scoring company reports for certain contracts. Alternative means of scoring for construction projects using ConstructionLine and for School projects, the South East & Mid Wales Collaborative Construction Framework. (SEWSCAP) framework, is also used.

3.2 <u>Financial Testing</u>

What the guidance says

3.2.1 The Note highlights the need to categorise potential contracts based on their criticality to determine the level of EFS required. The Cabinet Office has developed a Gold (most critical), Silver and Bronze (least critical) system based on the following questions:-

- What is the total contract value or expected contract value (including possible extensions)?
- How complex is the delivery or the expected delivery of the service?
- How quickly could the organisation switch suppliers or re-procure the contract?
- What is the potential impact of contract/supplier failure?
- Information Security Risk?

3.2.2 For those contracts deemed silver and gold the Financial Viability Assessment Tool is used to evaluate the financial criteria of the bidder.

3.2.3 The Tool should be monitored over a long procurement process to incorporate any updated information. Immediately prior to award the Contracting Authority should confirm if there has been any deterioration of the bidders EFS and whether it is significant enough to reconsider the award.

What the Council does

3.2.4 The Council currently sets minimum criteria for bidder progression based on an assessment of the capability to manage the contract amount awarded. There is no formal tiering policy.

3.2.5 At award stage the Council carries out due diligence to confirm the financial standing.

Recommendations

3.2.6 The contract tiering tool identified in the guidance note should be adopted prior to Pre-Qualification Questionnaire (PQQ) documentation by procurement and service officers.

3.2.7 This would involve using an off the shelf provider where the financial assessment has been identified as low risk (i.e. bronze) for example for construction projects the Council would use ConstructionLine who would conduct the evaluation and all bidders would be required to be registered with ConstructionLine. Dun and Bradstreet/Equifax would be used for non-construction contracts as the Welsh Government has a contract with Dun and Bradstreet available for the public sector which is free at the point of use. This would assist in reducing the amount of time assessing the financial information for low risk contracts. Over the last 6 months 106 financial appraisals have been undertaken, of which 52 relate to social care and 49 to construction contracts.

3.2.8 For more critical contracts (silver and gold) the Council will continue to use its existing scoring mechanism. The Financial Viability Tool used in the guidance is being trialled by Central Government, and due to the changes that would need to be made to PQQ templates and processes around gaining appropriate assurances from companies who have a high risk score, it is recommended that we await the outcome of the Government trial. The Councils process is provided in the flowchart below as Appendix 2.

3.3 <u>Demonstrating economic and financial standing & Financial Information required from bidders</u>

What the Guidance Says

3.3.1 Proof of a bidder's EFS may be provided by one or more of the following:

- appropriate statements from banks or, where appropriate, evidence of relevant professional risk indemnity insurance;
- financial statements or extracts from the financial statements, where appropriate (i.e. where publication of financial statements is required by law); and
- a statement of the bidder's overall turnover and, where appropriate, of turnover in the area covered by the contract for a maximum of the last 3 financial years available.

3.3.2 Where audited accounts are not available, other financial information that Contracting Authorities may use, in accordance with Regulation 60(7), to demonstrate a bidder's EFS includes but is not limited to:

- Parent or ultimate parent company audited accounts (if applicable);
- Guarantees and bonds;
- Bankers' statements and references;
- Management accounts;
- Financial projections (including cash flow forecasts) and order book pipeline
- Details and evidence of previous contracts, including contract values; and
- Other evidence of capital availability.

3.3.3 Management accounts and financial projections should be supported at the minimum by written representations from the Boards and/or Chief Financial Officers of bidders and ideally by independent assurance. The acceptability of different forms of information and assurance will depend on the criticality of the potential contract; where the procurement is for a 'Gold' contract the appraisal should be supported by audited financial statements or independent support of the bidder's EFS.

3.3.4 A Contracting Authority should specify in advance the thresholds at which it may eliminate a bidder from a procurement. Such thresholds may be linked to the risk rating on a single financial metric or ratio or to a combination of risk ratings across multiple financial metrics or ratios. Thresholds must be transparent, objective and proportionate to the requirement under procurement.

3.3.5 A Contracting Authority may allow bidders to proceed despite being classified overall as medium or high risk subject to agreeing a set of risk mitigations acceptable to the Contracting Authority. Such mitigations may include but should not be limited to: Enhanced contract management and financial monitoring procedures, which may include additional obligations or Financial Distress Events (see appendix 1); Restrictions on the bidder's business and/or its ability to make distributions or lend money to other group members if it wins the contract; or The provision of a collateralised cash deposit, guarantee or performance bond.

What the Council does

3.3.6 The Council requests copies of accounts for the previous two years, preferably audited. The threshold criteria are presented to the bidders at PQQ. The Council asks for performance bonds where there is a doubt on the EFS of the bidder. Where they are providing a guarantee Powys will require the submission of the Parent Company accounts.

Recommendations

3.3.7 In the cases where accounts cannot be obtained or more current information is required management accounts or financial projections should be required, supported by written representations from Boards or the Chief Financial Officer.

3.4 Framework Agreements

What the Guidance Says

3.4.1 A Contracting Authority entering into a call off contract under a framework agreement should undertake its own financial assessment of the bidders' financial capacity to deliver against the requirements specific to the call-off contract.

What the Council does

3.4.2 The SEWSCAP framework operates on behalf of certain local authorities in Wales and provides a flexible framework for appointment of school contractors according to the value of each school. The SEWSCAP3 framework requires Cardiff, the host Authority, to provide 6 monthly financial checks on the framework suppliers. Non-compliance with the financial standing criteria can result in the suspension of the contractor from the framework agreement and the exclusion from a selection procedure. The framework agreement affords a potential employer the ability to require a parent company guarantee or a performance bond on a contract-by-contract basis.

Recommendations

3.4.3 In addition to the above, the Council requests at any stage of a selection process additional information from suppliers to evidence that they continue to comply with the financial criteria. This should be done as and when required. The Council should consider requiring a bond or parent company guarantee, especially where, the contracts meet the financials standing criteria but there remains concerns about the contractor's financial position.

4 Mitigating Financial Risk

What the Guidance Says

4.1 The guidance note highlights the importance of formulating insurance intentions before commencing procurement. The levels of cover should be specific to the contract under procurement.

4.2 Guarantees and bonds, whether performance or financial should be sort where there are concerns of the supplier's capabilities for delivering the contract. When seeking a guarantee the Council must ensure that the Guarantor has adequate resources and is an entity of substance, an EFS will need to be performed on the guarantor. The Council should ensure that any guarantee will survive a change of control of the guarantor or that a mechanism exists to ensure that appropriate alternative arrangements are in place if necessary.

4.3 The Note also identifies conditional bonds, which can usually only be called on following a serious breach by the supplier (normally allowing termination of the contract) and on-demand bonds which include within their terms and conditions the trigger and mechanism for calling on them. On-demand bonds are often considered expensive and more onerous for the supplier. The note continues to say that professional advice should be sort to obtain the best choice and that they should be used proportionately.

4.4 The Note lists financial distress events (FDE) which can be identified in contracts to highlight areas of concern that require action or re-assurance from the supplier. The events identified should be specific to the contract and may arise from the procurement stage. Where requested, throughout the contract the supplier should notify the Authority if an FDE occurs.

It can be written into the contract that an annual update confirming that no FDEs have occurred.

What the Council does

4.5 For Powys construction projects the contractor is required to insure the works whilst in progress and to cover associated liabilities which may arise. The cost of this cover will form part of the overall contract sum and will be subject to the addition of overhead and profits. The main contractor will in turn usually employ sub-contractors and will seek to pass risk and insurance obligations down to the supply chain. This can introduce potential risk as insurance responsibilities may not be clearly understood and this may be exacerbated if contract conditions change.

4.6 Where there are concerns of the supplier's capabilities for delivering the contract Powys will seek a parent company bond. The Authority will usually seek a performance bond which can provide some compensation if the supplier is proven to have defaulted on its obligations. It is usually provided at contract award, for a specified percentage of the total contract value until its expiry date. A performance bond will not of itself ensure that contracts are carried out efficiently and to time, but it will be an additional incentive on the supplier to perform well.

Recommendations

4.7 An Owner Controlled Insurance Programme (OCIP) should be considered as an option for construction projects. An OCIP is an arrangement whereby the Council takes control of the arrangement and purchase of certain insurances in connection with the construction project. The cost of this type of insurance will be a factor in determining the benefit of such an arrangement and this will be assessed on an individual project basis. By taking control of certain insurances, the employer can mitigate many of the risk factors and can additionally insure against risks not catered for by the contractors' programmes, such as delay in completion and the insolvency of a contractor. An OCIP can be considered a risk management tool, and it is important to discuss the available options early in the process.

4.8 Where requested, throughout the contract the supplier should notify the Authority of any FDE. This will be written into the contract together with an annual update at which point the supplier will also have to confirm that no FDEs have occurred.

5 Monitoring the Economic and Financial Standing of Suppliers following Contract Award

What the Guidance says

5.1 Early recognition of a supplier's declining EFS or the risk of its failure may help the Council avert or be better prepared to deal with such underperformance or failure as it arises limiting the impact on potentially critical public works and services. Contracting Authorities should therefore monitor the EFS of their key suppliers.

5.2 Monitoring should reflect the criticality of the contract and, where appropriate, should cover not just the contractual FDEs (or their equivalent) but take a wider view of the supplier's business. The focus should primarily be on liquidity. Where no FDEs have been notified, boards of suppliers with critical contracts should provide formal annual confirmations that no FDE or any other matter which could cause a FDE has occurred.

5.3 Where monitoring and follow-up suggests a raised level of concern, contract managers should ensure their contingency plans are up-to-date and consider whether any further action or enhanced monitoring is required.

5.4 Critical suppliers' EFS should be monitored on an at least annual basis, this should coincide with the publication of the suppliers' annual accounts, these should be assessed by the finance department.

5.5 Credit scoring agencies should be used to provide updates/alerts of changes in their scoring of the Supplier.

What the Council does

5.6 There is currently no formal process undertaken to monitor EFS during the contract, but assessments and scoring agency scores are obtained when requested on an ad hoc basis, if no further formal accounts have been submitted during this time the scoring will not change.

Recommendations

5.7 Suppliers identified as critical should be reviewed at least annually and monitored against criteria specified in the contract. They should be required to self-notify if changes of circumstances occur during the year.

5.8 Dun and Bradstreet have recently introduced a facility which assesses the likelihood of a business continuing to trade in the next twelve months. Companies identified as critical would be added to this list and we would receive notifications from Dun and Bradstreet as soon as they are updated. Appendix 3 provides a flowchart of the process we will now undertake.

6 Summary

6.1 The Council's process for assessing the economic and financial standing of suppliers already adopts some of the approaches included in the guidance, but the addition of the recommendations identified throughout the report, will improve and add further rigour to our processes. It is proposed that the recommendations be employed for a 6 month period and then be reviewed again for their appropriateness in June 2020. The guidance itself may also have been reviewed and updated during this time and this can also be reconsidered.

Recommendation:	**Reason for Recommendation:**
That Audit Committee supports the recommendations in each of the sections of the report and that the changes are implemented with immediate effect.	To improve the assessment and monitoring of the economic and financial standing of suppliers, to better understand the financial capacity of suppliers to perform a contract in order to safeguard the delivery of public services.

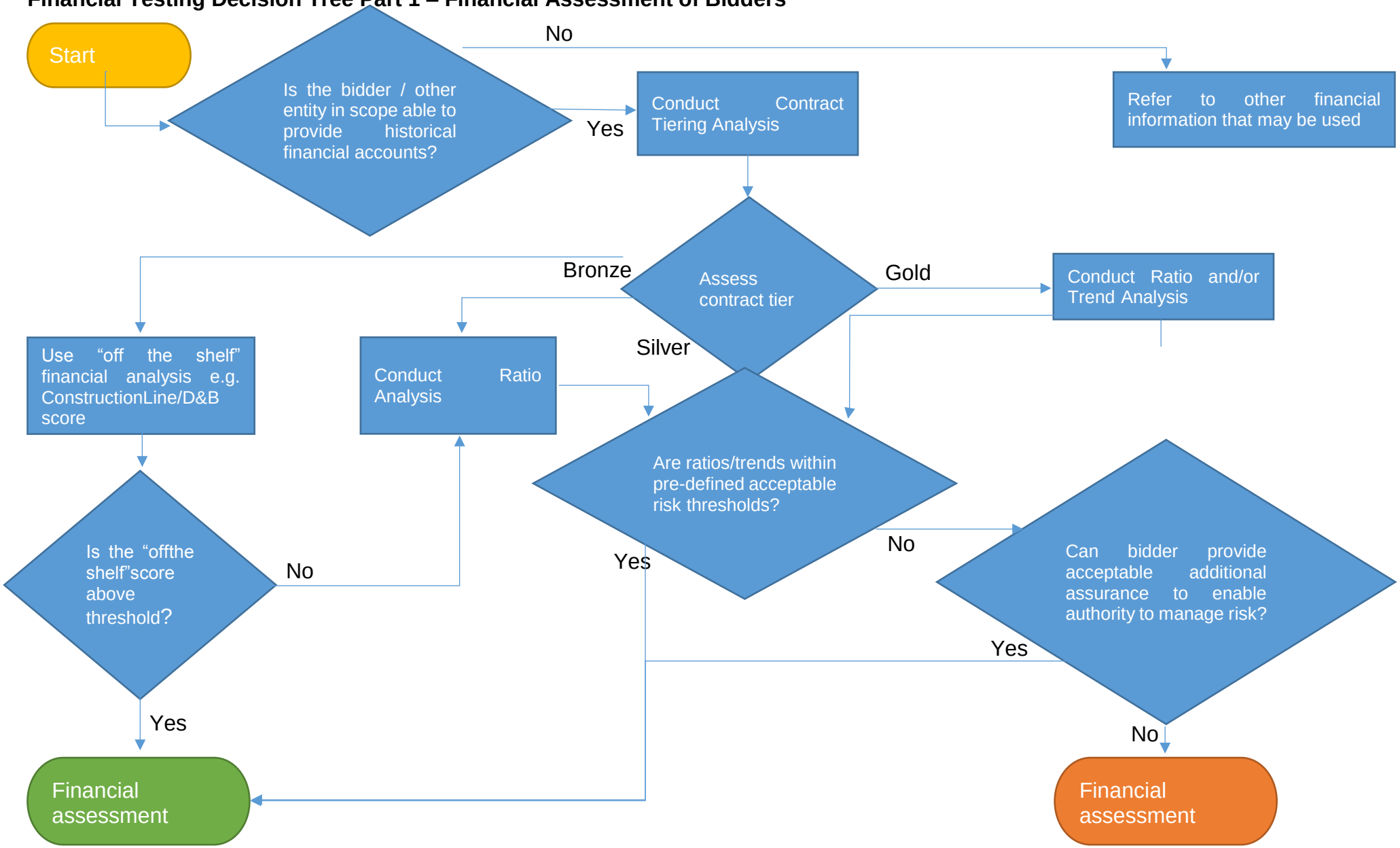
Appendix 1

Potential indicators of future financial distress

	Financial	Non-Financial
Business performance/Operating efficiency	● Adverse changes in the market / market structure ● Declining revenues ● Declining profit margins ● Declining Return on Capital Employed ● Declining cash conversion ● Public profit warnings ● Increases in creditor days / Delayed payments to suppliers ● Decreases in debtor days ● Declining stock turnover	● Unexpected resignations of key management / High employee turnover ● Weak management or overly controlling CEO ● Delayed filing of statutory accounts / late provision of management information ● Competitor gossip / market intelligence ● Regulatory action ● Declining share price / Sudden share price falls / Significant shorting of shares ● Major adverse announcements (e.g. major litigation, large contract losses, etc)
Liquidity/ Solvency	● High / Rising net debt to EBITDA ● Declining interest cover ● High / Rising gearing ● Deteriorating liquidity / Declining headroom ● Lending covenant breaches ● Increasing reliance on shortterm or uncommitted debt ● Use of non-standard financing markets ● Going concern qualifications in published accounts ● Requests for payments in advance ● Invoice discounting / Factoring / Other means of raising shortterm cash ● Rising pension deficits ● Rising contingent liabilities ● Cuts in / Cancelled dividends	● Poor or deteriorating relationship with Lenders ● Withdrawal of coverage of a supplier's debts by credit insurers ● Falls in or withdrawal of credit ratings (or announcements of credit watch with negative implications) by major credit agencies ● Company Watch H score falling below 25 / Dun and Bradstreet score falling below 10

Appendix 2

Financial Testing Decision Tree Part 1 – Financial Assessment of Bidders



Appendix 3

Financial Testing Decision Tree Part 2 – In Contract Financial Monitoring