Section No. 3

Sourcing Toolkit

Selection and Award

Version Control

Version No.	Amendments	Date	Document Reference No.
1.0	First published version	30/09/22	FI1/22/787018
2.0	NICCAP3 Climate Adaption Questions added at 3.4	30/04/24	FI1/22/787018
3.0	Updated to take account of Procurement Act 2023 and updates to the CO Sourcing Playbook	19/02/26	FI1/25/113673

Contents

Foreword

It has been acknowledged there are a number of strategic drivers requiring a transformation in public procurement practice and procedure. This requires a shift in focus away from procedural instruction to a more commercial approach to help deliver the Programme for Government commitments through public procurement.

In recognition of this, the Procurement Board agreed to apply the themes contained within the Sourcing Playbook, published by Cabinet Office, to public procurements in Northern Ireland with the aim of improving commercial focus.

As a result of this work, the Sourcing Toolkit was developed to incorporate the best practice guidance from the Cabinet Office's Playbook, along with guidance developed for public procurement here.

The Toolkit is a living document which will be updated to include any relevant topics added to the Cabinet Office Playbook.

The Toolkit is not mandated. It is a compilation of helpful guides and templates which public bodies may wish to use, as appropriate.

A proportionate approach should be taken to achieve a balance between the value of the contract and the transactional cost of applying the guidance outlined in the Toolkit.

The information set out in this document is neither legal advice nor statutory guidance and is not intended to be exhaustive. If there is any conflict between the Toolkit and The Public Procurement Policy Statement or Procurement Policy Notes (PPNs), the Public Procurement Policy Statement and PPNs will take precedence.

The Procurement Pathway is a tool developed by the Government Commercial Function which provides guidance on the end-to-end commercial lifecycle. It is broken down into four phases to support decision making and will help you plan, define, procure, and manage your procurement activities.

Training on the different sections within the toolkit is provided through the Government Commercial College.

SECTION 3 - SELECTION AND AWARD

3.1 Evaluating Tenders and Contract Award

The purpose of this section is to identify best practice which can be used by evaluation panel members (which will be referred to as the panel/s throughout the document) and procurement practitioners on the principles involved in the selection and tender evaluation stages[1]. The guidance has taken due cognisance of the recommendations of the Public Accounts Committee Report on the Investigation of Suspected Contract Fraud, advice received from the Northern Ireland Audit Office and relevant case law. It also takes account of:

- The Procurement Act 2023
- The Procurement Regulations 2024

Following these guidelines not only ensures that the selection and tender evaluation process is fair, but will reduce the risk of complaints and legal challenges, which are both very time consuming and costly. Procurement Policy Note 02/21 sets out the Procurement Policy in relation to the procurement of Social and Other Specific Services (Light Touch Services) with a value greater than the relevant UK Procurement Threshold (currently £663,540 inclusive of VAT).

Background

The selection of economic operators and the evaluation of tenders are crucial stages in the overall procurement process to achieve best value for money. The selection and tender evaluation processes must be compliant with UK law, and appropriate standards of probity.

The selection and tender evaluation stages are two distinct processes. The selection stage examines, amongst other things, if the economic operator meets the conditions of participation (which must relate to its legal and financial capacity; or technical ability to perform the contract) and whether it could/should be excluded etc. The tender evaluation stage, on the other hand, examines how the economic operator, in its tender, proposes to deliver the contract in question. Selection is usually a precursor to the evaluation of tenders. However, in the open procedure, contracting authorities may decide to evaluate tenders in advance of checking if economic operators meet the conditions of participation and grounds for exclusion. Economic operators are

[1] The tender evaluation stage is also known as the award stage

permitted to self-declare with only the winning economic operator having to submit various certificates and documents for verification.

3.2 Selection and Tender Evaluation Panels

General

A Chairperson and the members of the panels should be appointed at the outset of the procurement. The typical roles and responsibilities of each panel including the Chairperson are listed in Appendix XIII.

The size, makeup and experience of the panels will reflect the scale and complexity of the procurement, including the degree of specialist input required. Generally, a panel should have a minimum of three members and experts in the relevant field(s) if necessary, to ensure a full and thorough evaluation of each economic operator and tender. A representative of the relevant Centre of Procurement Expertise (CoPE) should either be a member of a panel or act as a non-scoring adviser to a panel.

Before commencing the selection or tender evaluation process, the panel should have the relevant skills and knowledge (supported by professional procurement advice), to exercise judgement in the:

- process by which each economic operator and tender will be assessed;
- criteria against which the economic operators and tenders will be evaluated;
- regulatory environment and policy surrounding public procurement; and
- subject matter of the contract.

Best procurement practice would advocate that, where possible, the membership of the selection panel should be consistent with that of the tender evaluation panel if a two-stage process is being used. This helps to ensure retention of knowledge and a consistent approach during both stages of the procurement process.

It is important that panel members adhere to the principles underlying probity. Their behaviour must be consistent with the Principles of Public Life, the NICS Code of Ethics and any ethical standards governing the particular professions of those involved in the process. In addition, the panel should be suitably trained and have no conflict of interest at any stage of the process.

If a panel member is a current contract manager or end user, they should ensure their previous experience of, or relationship with, the economic operator does not influence the evaluation. Economic operators and tenders must only be assessed against the published criteria based on the information provided.

Conflict of interest

Part 5 of The Procurement Act 2023 deals with Conflicts of Interest and clearly states that a contracting authority must take all reasonable steps to identify, and keep under review, any conflicts of interest or potential conflicts of interest. This should at least cover any situations where relevant staff members have directly, or indirectly (for example, through a family member), a financial, economic or other personal interest that might compromise their impartiality and independence or be reasonably perceived to do so. A relevant staff member is someone who is involved in the conduct of the procurement procedure or may influence the outcome of that procedure.

Panel members should complete a Conflict of Interest declaration to confirm they do not have any external personal, professional or monetary interests in the responses they are evaluating.

Gifts or hospitality from economic operators must not be accepted by panel members or any person involved in the procurement process. Panel members should not discuss any part of the procurement process with an economic operator in the course of their normal working interactions. Any possible conflict of interest or issue of bias should be discussed with the Chairperson of the evaluation panel as soon as it arises and brought to the attention of the CoPE. The Chairperson will decide on the appropriate course of action, taking account of advice from the CoPE, to ensure there is no distortion of competition. The Chairperson should likewise decide on any personal conflict of interest, taking account of CoPE advice.

Confidentiality

To protect the integrity of the procurement process, tenderers should be confident that their interactions with the contracting authority will not be disclosed to any party outside of the procurement process. Tenderers proposals should be viewed as commercial in confidence until after the disclosure of the award decision. A confidentiality agreement for panel members who are not public servants is recommended.

Due diligence during selection

The selection process is used to determine whether tenderers are able to comply with exclusion grounds and demonstrate suitability to carry out the contract.

It is particularly important that the assessment of the Conditions of Participation are correct. The key principle is to safeguard the delivery of public services, while being proportionate, fair and not overly risk averse. Guidance on how to do this is included in Section 3.3 Economic and Financial Standing.

Some key principles of appropriate financial testing:

- objective is to determine tenderers' financial capacity to perform the contract;
- mitigations should be considered;
- forms part of the overall judgement of suitability during selection;
- assessments shall be proportionate to the size and nature of the contract, flexible and not overly risk averse;
- all tenderers, whatever their size or constitution, should be treated fairly and not inadvertently disadvantaged by the tests employed; and
- mechanisms such as the Contract Tiering Tool[2] can be used to determine criticality of the contract and the stringency to which tenderers should be tested.

The skills, efficiency, experience and reliability of suppliers should also be taken into account when selecting tenderers. The Selection/Pre-Qualification Questionnaire (PQQ) questions can include criteria for human and technical resources and experience. These requirements shall focus on the tenderer itself and its past experience.

Conditions of participation

The Procurement Act 2023 (Act) allows contracting authorities to set conditions of participation which a supplier must satisfy in order to be awarded/compete for a public contract following a competitive tendering procedure. The conditions must only relate to the supplier's: legal and

[2] https://khub.net/group/gcf-community/cm-guide/-/knowledge_base/b-3-1-tiering-the-contract (KHub account required)

financial capacity; or technical ability to perform the contract. Conditions of participation are primarily covered in section 22 of the Act.

Assessing the conditions of participation

Contracting authorities will need to consider how to evaluate supplier responses to the conditions set for the procurement, and if used, what the criteria will be for assessment. This includes setting out what is required to meet the condition.

Conditions of participation are separate from award criteria and in any procedure the responses to the conditions of participation must be assessed separately from the tender response and award criteria. In practice, it may happen in parallel (for example, in an open procedure) but once a supplier has met the conditions of participation, their tender must be assessed in relation to the award criteria only and not with any reference to any score or ranking determined as part of the assessment of the conditions of participation.

Under a competitive flexible procedure, a contracting authority may, using objective criteria which have been set out in the tender notice, use conditions of participation in order to limit the number of suppliers that progress or to create a shortlist of suppliers (section 20(4)(a)). For example, following a tender notice that invites requests to participate, all interested suppliers may submit their response to the conditions of participation and, following an assessment against the conditions of participation published in the tender notice, a limited number of suppliers could be selected to proceed to the next stage. In all cases, the number of suppliers the contracting authority intends to progress should be sufficient to ensure genuine competition.

Verifying the conditions of participation

The Act is not prescriptive about the types and sources of information contracting authorities can use to verify conditions of participation. Section 22(6) allows a contracting authority to require evidence that is verifiable by a third party to satisfy a condition of participation. For example, assertions as to the financial stability of a supplier may be independently verifiable by reference to data provided by the supplier's bank (at the supplier's behest) or by reference to credit ratings by a rating agency.

Nevertheless, means of proof and supporting evidence should not be overly arduous for suppliers and must meet the proportionality requirement in section 22. For example, requesting site visits, samples and audits might be appropriate in some circumstances but not all. If supporting evidence is required, contracting authorities should consider when it would be appropriate for suppliers to submit that evidence, having regard to the procurement objectives and what is required to ensure the proper conduct of the procurement.as to the financial stability of a supplier may be independently verifiable by reference to data provided by the supplier's bank (at the supplier's behest) or by reference to credit ratings by a rating agency.

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More information on conditions of participation including suppliers relying on other suppliers to pass them and how they affect frameworks and dynamic markets can be found at: https://www.gov.uk/government/publications/procurement-act-2023-guidance-documents-procure-phase/guidance-conditions-of-participation-html

Exclusions

Exclusion is a broad term used to describe a number of different circumstances where suppliers are not permitted to participate in a covered procurement, to have their tender considered or to be awarded a public contract.

Sections 26 and 27 of The Act cover how the exclusion grounds must be considered and applied in different procurement procedures. Section 28 deals with excluding suppliers by reference to sub-contractors and section 29 applies where a contracting authority intends to exclude a supplier on a discretionary basis for national security reasons. The mandatory exclusion grounds are set out in Schedule 6 and discretionary exclusion grounds in Schedule 7.

A supplier is an 'excluded supplier' where the contracting authority considers, firstly, that a mandatory exclusion ground applies to the supplier (or where relevant a connected person) or an associated person and, secondly, that the circumstances giving rise to the exclusion ground are continuing or likely to occur again. A supplier will also be an excluded supplier where a Minister of the Crown has already determined this; i.e. where the supplier or an associated person is on the debarment list because of a mandatory exclusion ground.

A supplier is an ‘excludable supplier where the contracting authority considers, firstly, that a discretionary exclusion ground applies to the supplier (or where relevant a connected person) or an associated person and, secondly, that the circumstances giving rise to the exclusion ground are continuing or likely to occur again. A supplier will also be an excludable supplier where a Minister of the Crown has already determined this; i.e. where the supplier or an associated person is on the debarment list because of a discretionary exclusion ground.

In other words, the supplier will be an excluded supplier or an excludable supplier either where the contracting authority considers this to be the case in the context of a particular procurement or where the supplier or associated person is already listed on the debarment list.

The exclusion grounds

Schedule 6 of the Act sets out the mandatory exclusion grounds, which are the most serious, high risk scenarios. The grounds in Part 1 require a conviction of specific offences in the UK. They also cover convictions for an offence outside of the UK which would be an offence if it had been committed in the UK. For example, if a supplier is convicted of a fraud offence in another country, this will be a mandatory exclusion ground if that misconduct would have been an offence in the UK had it been conducted in the UK. Part 1 also includes ancillary offences, such as aiding and abetting.

The grounds in Part 2 do not require a conviction for an offence and cover national security threats in relation to particular contracts and certain tax misconduct and competition law infringements. The tax misconduct and competition law infringement grounds include misconduct and infringements that occurred outside of the UK. Part 2 also includes failure to cooperate with a debarment investigation as a mandatory exclusion ground, which only a Minister of the Crown can determine.

Schedule 7 of the Act sets out the discretionary exclusion grounds, which mostly do not require a conviction but represent situations which may pose unacceptable risks. These cover a broad range of situations, such as insolvency, potential competition law infringements, professional misconduct, breach of contract and poor performance, general national security threats, as well as misconduct in areas like labour and the environment. The grounds in Schedule 7 cover situations where misconduct has occurred outside of the UK. They also include a discretionary exclusion ground where the supplier has acted improperly in another procurement.

Self- cleaning

When establishing whether the circumstances giving rise to the application of an exclusion ground are continuing or likely to occur again, contracting authorities should look at a range of evidence and factors, as set out in section 58. These include:

a. evidence that the supplier, associated person or connected person has taken the circumstances seriously, for example by paying compensation;

b. steps that the supplier, associated person or connected person has taken to prevent the circumstances occurring again, for example by changing staff or management, or putting procedures and training in place;

c. commitments that such steps will be taken, or to provide information or access to allow verification or monitoring of such steps;

d. the time that has elapsed since the circumstances last occurred; and

e. any other evidence, explanation or factor that the authority considers appropriate.

Applying the exclusions provisions during the procurement process

Preliminary market engagement: Contracting authorities should use this opportunity to familiarise or remind suppliers of the exclusion grounds. All exclusion grounds must be considered for all covered procurements but contracting authorities can also use preliminary market engagement to focus due diligence efforts on a supplier by understanding if there are exclusion grounds that may be particularly relevant. For example:

a. if a supplier has an overseas supply chain for low cost goods, there may be a higher likelihood of labour market misconduct; or

b. if a supplier is operating in the agriculture sector, the environmental misconduct grounds may be particularly relevant.

Supplier information: At the start of a competitive flexible procedure, contracting authorities must check the debarment list on gov.uk. Each supplier’s exclusion grounds information either provided directly by the supplier or provided via the central digital platform must also be checked, including details of connected persons, associated persons and sub-contractors (where relevant) and any additional information requested by the contracting authority at that stage. Contracting authorities may undertake the same check at some or all stages of a competitive flexible procedure. The check must be made when assessing final tenders in both competitive flexible and open procedures.

Identification of an excluded supplier or an excludable supplier: If the contracting authority determines that the supplier is an excluded supplier or an excludable supplier at any point in the procedure prior to assessment of tenders, the supplier should not be allowed to continue with the procedure if the supplier is an excluded supplier or, if the supplier is an excludable supplier, consideration should be given as to whether to allow the supplier to continue or not. At the point of assessment of tenders, the contract cannot be awarded to an excluded supplier and consideration should be given to awarding to an excludable supplier. Contracting authorities should provide suppliers with the reasons for any exclusion.

Excluding on the basis of an associated person or sub-contractor: If the supplier is an excluded supplier or an excludable supplier by virtue of an associated person or an intended sub-contractor, the supplier must be given the opportunity to replace that person or sub-contractor before they are excluded.

Reporting: Contracting authorities must notify the appropriate authority (for transferred Northern Ireland authorities, this is a Minister of the Crown, via the PRU) within 30 days of excluding a supplier. Exclusion can be reported to the PRU via gov.uk.

Contracting authorities may wish to consider the implications of a supplier being investigated or added to the debarment list during a live procurement, particularly if the decision is taken towards the end of a competitive tendering procedure and consider setting out in the tender documentation how it will progress to contract award in such a circumstance.

More information on exclusions including self-cleaning, exceptions and time can be found at: https://www.gov.uk/government/publications/procurement-act-2023-guidance-documents-procure-phase/guidance-exclusions-html

3.3 Economic and Financial Standing

Overview

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

This guidance provides advice on how to:

- Assess the EFS of tenderers during a procurement;
- Monitor the ongoing EFS of suppliers during the life of a contract; and
- Mitigate the financial risks identified from the EFS evaluation of a tenderer, either upfront or during the course of the contract.

Assessing the economic and financial standing of tenderers

Purpose

The purpose of assessing the EFS of tenderers as part of a procurement is twofold:

- To assess the bidders' financial capacity to perform the contract; and
- To assess whether appropriate risk mitigations can be put in place to address any identified issues with bidders' financial capacity.

Failure to assess EFS effectively could result in the appointment of a financially challenged supplier which may subsequently:

- Adopt sub-optimal behaviours;
- Fail to deliver aspects of a contract to a satisfactory standard; and
- Fail to deliver all elements of the contract if it subsequently experiences financial distress or becomes insolvent.

A contracting authority may then:

- Incur additional time and cost in managing and re-procuring the contract or bringing the delivery of the service in-house,

- Potentially bear an increased contract price, particularly if urgent short-term or interim arrangements are required.
- Suffer from delays to the provision of important public works and/or risks to the quality and continuity of critical public services.

Principles

The Procurement Act 2023 allows contracting authorities to set conditions of participation that a supplier must satisfy in order to participate in a competitive tendering procedure. Any conditions must be a proportionate means of ensuring suppliers have this capacity or ability, having regard to the nature, cost and complexity of the contract. This includes conditions relating to a supplier's financial capacity. Bidders EFS should be assessed as part of the conditions of participation, and tailored to the contract. Contracting authorities must also have regard to the importance of delivering value for money

All tenderers, whatever their size and constitution, shall be treated equally and without discrimination during the assessment of their EFS(unless a difference between them justifies different treatment). No SMEs (small and medium sized enterprises), public service mutuals or third sector organisations should be inadvertently disadvantaged by the EFS assessment approach and metrics applied (unless justified by relevant differences). This may be done by allowing all tenderers to propose relevant mitigations where risks are identified that arise from an organisation's size or structure.

Assessment of EFS must be transparent and objective. It should be based on performance against using appropriate scales to indicate lower and higher financial risk for each tenderer. a set of metrics and ratios using appraised against pre-determined thresholds to provide a set of risk classifications for each tenderer. Tenderers should be able to see performance against these scales as they complete the financial assessment and, where relevant, be given the opportunity to explain why different risk classifications may be more appropriate.

In many cases the assessment can be based on a standardised set of metrics and ratios, although these should be reviewed to ensure they are related and proportionate to the contract and are appropriate. For example, for certain contracts, such as procurements of more critical, complex services, or for longer periods, additional or alternative metrics and ratios may be appropriate.

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

There are alternative standardised ratios that can be used for voluntary, community, and social enterprises (VCSEs); these are set out in ‘APPENDIX IV – Standard Financial Ratios’. The Act (section 12) provides that “in carrying out a covered procurement, a contracting authority must treat suppliers the same unless a difference between the suppliers justifies different treatment. If a contracting authority considers that different treatment is justified in a particular case, the authority must take all reasonable steps to ensure it does not put a supplier at an unfair advantage or disadvantage.”, therefore the different accounting requirements for entities that fall under the provisions of the Companies Act 2006 (CA 2006) and those VCSE’s who are outside the scope of CA 2006 may warrant the use of alternate ratios. Where this approach is to be followed it should be identified in advance and set out in the tender notice (or associated tender documents).

The assessment of a bidder’s EFS should be conducted by staff with appropriate finance skills, calling on specialist expertise as necessary

Regulation 6 of the Procurement Regulations 2024 requires contracting authorities to obtain confirmation from suppliers that they have submitted up-to-date ‘core supplier information’ on the central digital platform, and that such core supplier information has been shared. This includes certain financial information (such as financial accounts). However, any other information relating to conditions of participation required by the contracting authority, which is not covered by the central digital platform, will need to be obtained from the supplier by other means.

Contracting authorities may wish to assess EFS after confirming other elements of the conditions of participation are met, in order to reduce the number of assessments required.

Contract categorisation and setting a risk assessment scale

Categorising contracts

In order to determine what constitutes a proportionate assessment of EFS it is important contracting authorities should, prior to commencing a procurement, determine the criticality of the potential contract or framework lot. The criticality should drive the level of EFS assessment and the scale used for each of the metrics as well as any associated contract management requirement or need for financial assessment subject matter expertise.

One mechanism for categorising the criticality of a contract is by using a Contract Tiering Tool[3]. The Tool takes into account various criteria, including the potential impact of service failure, the speed and ease of switching suppliers and the contract value.

The tool will allow easy and consistent categorisation of contracts between 'Gold' (most critical), 'Silver' and 'Bronze' (least critical) contracts.

As detailed in the table below, the Gold:Silver:Bronze categorisation will then inform both the level of financial analysis of tenderers and the financial thresholds utilised for this analysis. This does not preclude the requirement to ensure the assessment uses conditions that are related, proportionate and appropriate. Contract classification will be made known to suppliers as part of the EFS assessment process.

	Description	**Assessment**
Bronze (least critical)	Bronze contracts are typically smaller, simpler contracts for non-critical works and services. In these cases it may be appropriate to carry out a more basic financial assessment.	In order to keep the assessment proportional Contracting Authorities may wish to use, 'off-the-shelf' financial analyses and risk assessments from a credit scoring or ratings agency. Examples include Experian (credit score), Company Watch (risk score) and Dun & Bradstreet (failure score) and Moody's (credit rating) Higher Risk could be defined as the scores or ratings that indicate high risk of default, for example:

[3] https://khub.net/group/gcf-community/cm-guide/-/knowledge_base/b-3-1-tiering-the-contract (KHub account required)

		≤35 for a Company Watch H score; ≤50 for a Dun & Bradstreet failure score. If an assessment indicates higher risk, a more detailed assessment, including ratio analysis, should be undertaken, with bidder clarification or mitigation as required. Off-the-shelf' scores **should not,** on their own, be used to conclude that a tenderer is higher risk, without further investigation.
Silver	Silver contracts are typically contracts for important but not critical works and services. In these cases a more detailed financial assessment is appropriate and risk thresholds should be set accordingly.	The assessment should use the the standard financial metrics and ratios set out in 'APPENDIX IV – Standard Financial Ratios' and appropriate and proportionate values at the same level or higher than those for Silver; these can be tailored from 'APPENDIX V– Interpreting standard financial metrics.'
Gold (most critical)	Gold contracts are typically larger, longer contracts for complex or critical works and services. In these cases a very detailed financial assessment is appropriate; risk thresholds should be set at the	The assessment should normally include as a minimum the standard financial metrics and ratios set out in: ***'APPENDIX IV – Standard Financial Ratios'*** and appropriate and

	same level as for Silver contracts or higher.	proportionate values at the same level or higher than those for Silver, these can be tailored from: **'*APPENDIX V – Interpreting standard financial metrics*'.** Contracting authorities should also consider whether to carry out additional analysis, for example the use of additional financial metrics, ratios and/or trend analysis.

Tailoring Scales for risk assessment

In setting an appropriate scale of values for risk assessment, contracting authorities should always seek to reflect industry specific circumstances. APPENDIX V sets out some suggested thresholds that Contracting Authorities should tailor to ensure they are related and proportionate to the contract or lot.

Decision tree

A decision tree showing the route to determining the recommended approach to assessment of EFS is set out in **'*APPENDIX VI – Financial Assessment Flowcharts*'.**

Application to frameworks

Where a contracting authority is procuring a framework, it should assess the EFS of bidders in a similar manner to the procurement of a standard contract, consider the cumulative value of awards that could be made and should also monitor the ongoing EFS of suppliers on the framework.

To manage a potential high volume of EFS testing, a contracting authority procuring a framework could explore reducing the numbers of periods of accounts tested or the use of simplified ratios. Any measure should remain consistent with the principles outlined in this guidance and the legal frameworks in place at the time. The financial assessment level should be fully articulated in the framework documentation for the benefit of bidders and customers.

Where permitted in the framework, section 46 of the Act allows a contracting authority to also set ‘conditions of participation’ at the stage of awarding a call-off contract based on a competitive selection process under a framework. To do so a contracting authority must be satisfied that they are a proportionate means of ensuring that suppliers have the financial capacity to perform the contract (amongst other things). Therefore, contracting authorities establishing a framework, should ensure that the framework permits the application of conditions of participation in the competitive selection process for call-off contracts, to ensure an appropriate EFS assessment can be undertaken at call off where appropriate

A condition of participation for the award of a call-off contract may include a stipulation that the conditions of participation for award of the framework must be met or may include some or all of the same conditions. It may also include additional conditions that did not apply to the award of the framework, for example, bespoke insurance requirements relevant to the particular call-off contract to be awarded.

A contracting authority entering into a call off contract under a framework should always have regard to the criticality of the call off contract. If the framework does not permit EFS assessment appropriate for the criticality of the call off contract, then an alternative framework or route to market should be used.

Demonstrating economic and financial standing

Contracting authorities are encouraged to exercise flexibility when specifying the financial information they require from bidders. Contracting authorities are prohibited from requiring, as a condition of participation, the provision of audited annual accounts from suppliers that are not otherwise required to have their accounts audited by Part 16 of the Companies Act 2006 or an overseas equivalent.

Where audited statements are not available, other financial information that contracting authorities may use to assess 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;
- Other evidence of capital availability;
- Annual Returns (in the case of charities with an annual income of more than £10,000 or where the charity is a charitable incorporated organisation (CIO)).

Contracting authorities should be aware that use of historical financial information is subject to various shortcomings such as timeliness and lack of forward view

The majority of companies are only legally required to file accounts nine months after their year-end, or ten months after year-end for an unincorporated charity submitting its accounts to the Charity Commission. Where the latest published financial statements have been drawn up to an accounting reference date more than 12 months previous to the submission of the EFS information, contracting authorities should consider requesting management accounts drawn up to a more recent date to evaluate the bidder's EFS. Such accounts may need to cover a 12-month period to reduce the need for extrapolation. In addition, where the backward-looking information generates a medium or high-risk outcome in the financial tests, contracting authorities may, subject to legal advice, consider requesting forward-looking information as part of the permissible additional information if such information is appropriate in the particular case. However, the requirement for permissible additional information needs to be clear in the procurement documents and offer a few options so that bidders can select the most appropriate evidence (e.g. forecasts for listed entities may be market sensitive).

Management accounts and financial projections should be supported, as a minimum, by written representations from the boards 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 the latest audited financial statements or, where an entity is not required to have their financial statements audited, other independent support of the bidder's EFS.

Bidding entities may be registered in different countries, have similar names to subsidiaries or have recently changed their names. Where a bidding entity is registered overseas, provision of translated accounts and appropriate supporting documentation should be requested.

Any non-public information shared with a contracting authority during the procurement process should be treated as confidential and used solely for the purposes of assessing the financial standing of the bidder on that particular procurement.

For procurements involving sequential contracts, such as multi-phase projects contracting authorities may wish to provide for reassessing the EFS of the supplier before entering subsequent contract phases. This is particularly relevant where a significant period has elapsed since the initial contract award. In these cases, contracting authorities should ensure that the possibility of this additional EFS assessment is clearly articulated within the procurement documentation, alongside an explanation of the actions that will be taken if a satisfactory EFS cannot be demonstrated prior to the award of a subsequent contract phase. The EFS assessment should include the assessment of any significant sub-contractors to be deployed at implementation stage.

Clarifying risk classifications

Tenderers should be able to see their risk classifications as they complete their financial assessments and offer a written explanation as to why different risk classifications may be more appropriate. Clarification questions from contracting authorities should:

- Clearly specify the source of the concern;
- Ask why this is the case;
- Probe how the bidder is seeking to address the issue raised;
- Invite additional evidence to be provided as required.

Tenderers explanations may include:

- Non-underlying or one-off items;
- Improvements in a bidder’s EFS since the accounting reference date used in the assessment due to management actions, improved financial performance or raising of additional capital for example;
- Adoption of new accounting policies/standards;
- Alternative ratio calculations; and
- One-off use of restricted reserves accumulated by a charity.

A contracting authority should consider the validity of such explanations (Appendix IV provides an outline set of possible mitigations for each metric) and take them into consideration in its assessment of a bidder’s EFS. Where a significant period of time has passed since the bidder last published financial accounts, contracting authorities might consider asking bidders for latest management accounting data to confirm that these are consistent with narrative explanations provided.

The contracting authority may share EFS assessments with another government body subject to taking appropriate care to protect any confidential information provided by bidders. As each contracting authority may have different risk appetites and different assessment requirements and methodologies tailored to individual procurements, the relevance of shared EFS assessments may be limited.

In multi-stage procedures, the bidder's EFS is assessed at the selection stage of a procurement but should be monitored throughout the procurement process until award and establishment of EFS monitoring under the contract. Contracting authorities can include provision in the procurement documentation obliging bidders to disclose any change in circumstances promptly after occurring; some forms of model contract, including the Model Services Contract and Mid-Tier Contract require bidders to warrant no Financial Distress Events have occurred or are subsisting at the time of entering into a contract.

n multi-stage procedures, immediately prior to contract award, a contracting authority should confirm whether there has been any change to a bidder's EFS which would have resulted in a different risk assessment if it had been known at the time of the original assessment. If such a change has occurred, a contracting authority should consider whether adequate risk mitigations can be implemented. If the EFS of a winning bidder is considered to have deteriorated to such an extent as to pose an unacceptable risk, the contract should not be awarded to that bidder

Where there has been a change in circumstances affecting a bidder, a contracting authority may seek to calculate pro forma ratios based on the event or change of circumstances. This should be considered in light of circumstances at the time and would normally only be appropriate where updated figures are available from the bidder or a reputable independent source, or can be estimated with reasonable certainty

The contracting authority should explain how it has derived the pro forma ratios and give a bidder the right to explain in writing why application of a different risk classification would be more appropriate before using the pro forma ratios as a basis for its appraisal of EFS. Examples of changes in circumstances in which use of pro forma ratios might be appropriate include but are not limited to:

- The announcement of an acquisition or a change of control;
- The declaration or payment of large dividends or other distributions; and
- Publicly announced interim or final results or profits warnings.

Where bidders are not yet felt to have addressed raised concerns satisfactorily, contracting authorities should now consider whether they should be asked to commit to relevant mitigations as a condition of being taken forward. Where mitigations cannot be agreed or are not sufficient to allow the bidder to meet the conditions of participation, the contracting authority should consider whether the bidder should be excluded from the procurement

A Financial Viability Risk Assessment Tool is available which can be completed by individual tenderers.

The model automatically calculates a series of financial ratios and, subject to the insertion of the desired individual ratios and thresholds, and appropriate values for risk assessment, can generate a risk assessment by ratio for each bidder subject to override by the contracting authority as set out above. Input of information should be checked by the contracting authority back to the source material provided by the bidder. Where there is a compelling rationale, the contracting authority may tailor its Tool to be more suited to the assessment of EFS of potential bidders

A short-form 'lite' version of the FVRA is also embedded within the tool which can be used for the least critical procurements. It requires fewer inputs, allowing the EFS assessment to be proportionate to the requirement.

Further guidance around steps the contracting authority can take in this clarification stage are set out at **Appendix IX.**

The tenderer's EFS is assessed at the selection stage of a procurement but may be revisited if there are any concerns subsequently based on a change in circumstances or new information available since the initial assessment. It is good practice to monitor any changes to the EFS of tenderers in the case of a long procurement. It is also prudent for contracting authorities to include provision in the procurement documentation obliging tenderers to disclose any such change in circumstances promptly after occurring.

In any event, immediately prior to contract award for Gold and Silver potential contracts, a contracting authority should confirm whether there has been any change to a tenderer's EFS which would have resulted in its elimination if it had been known at the time of the original assessment. If such a change has occurred, a contracting authority should consider whether adequate risk mitigations (such as those set out in the *Section on 'Demonstrating economic and* *financial standing'* above) can be implemented. If the EFS of a winning tenderer is considered to have deteriorated to such an extent as to pose an unacceptable risk to public services and/or public money, the contract should not be awarded to that tenderer.

Financial information required from tenderers

Contracting authorities are encouraged to exercise flexibility when specifying the financial information they require from tenderers.

Standard information required from a tenderer would normally comprise audited accounts for the past two years of trading (this may be extended to three years where the criticality of the potential contract requires use of trend analysis) and information on the structure and ownership of any group of which it is a member. Assessments should be based on the most recent audited accounts available even if these have not been filed. Tenderers should be encouraged to provide narrative where appropriate to reduce the need for subsequent clarifications.

Where audited accounts are not available, other financial information that contracting authorities may use to demonstrate a tenderer'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.

The timeliness of the accounting data provided through the Financial Viability Risk Assessment tool (FVRA) by tenderers shall also be considered, in particular when assessing tenderers' EFS for 'Gold' and 'Silver' contracts. Contracting authorities may be using published tenderer financial statements which are almost two years old at the time of procurement and therefore may be inappropriate. Authorities should look to mitigate this risk by clearly setting out in the procurement documentation that tenderers may be required to provide updated FVRA - or equivalent– analysis utilising latest available management accounts data.

Where the latest published financial statements have been drawn up to an accounting reference date more than 12 months previous to the submission of the EFS information, contracting authorities should consider requesting management accounts drawn up to a more recent date to evaluate the tenderer's EFS. Such accounts may need to cover a 12 month period to reduce the need for extrapolation. In addition, where the backward looking information generates a medium or high-risk outcome in the financial tests, Contracting authorities may, subject to legal advice, consider requesting forward-looking information as part of the permissible additional information if such information is appropriate in the particular case. However, the requirement for permissible additional information needs to be clearly disclosed at the PQQ stage and offer a few options so that tenderers can select the most appropriate evidence (e.g. forecasts for listed entities may be market sensitive).

Management accounts and financial projections should be supported at the minimum by written representations from the Boards and/or Chief Financial Officers of tenderers 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 the latest audited financial statements or independent support of the tenderer's EFS.

A number of frequent tenderers have registered with central information repositories such as the Supplier Registration Service. In order to reduce the burden on tenderers, contracting authorities are encouraged to use central repositories, such as the Supplier Registration Service and Companies House, as sources of financial information on tenderers. Contracting authorities should check or seek confirmation from tenderers, however, that the information is the most recent available and that it relates to the correct bidding entity, particularly in group situations.

Bidding entities may be registered in different countries, have similar names to subsidiaries or have recently changed their names. The PQQ requires tenderers to submit their company name and company registration numbers (this may be from Companies House or an equivalent). You should check that the company registration number has been completed and if the tenderer is a UK based company, check at Companies House that the number correlates to the company name that the tenderer has provided. Where a bidding entity is registered overseas, provision of translated accounts and appropriate supporting documentation should be requested.

Application to groups and guarantors

Where a tenderer is a member of a group, it may benefit from the greater financial resources available to the group. Conversely, there is a risk that a parent could cause a bidding subsidiary to use its financial resources to support other members of the group or that the financial failure of another group member could trigger the financial failure of the potential supplier as a result of their inter-connectedness. As a result, where the procurement is for a Gold or Silver contract and the tenderer is not the ultimate parent company[4] of the group, the tenderer should ideally be supported by a guarantee from the ultimate parent company of the group where this has sufficient EFS. At the selection stage a written commitment from the ultimate parent company to provide such a guarantee if the tenderer wins the procurement would normally be sufficient.

The assessment of the tenderer's EFS should cover each of (a) the tenderer (b) any guarantor and (c) and key sub-contractors *(see application of key-subcontractors below).*

Application of joint ventures and consortia

Where a contracting authority is considering a contract with a Joint Venture Company (JVC) or a Special Purpose Vehicle (SPV), or other specified entity which may have two or more major shareholders/stakeholders and which may not be adequately capitalised or have sufficient financial strength on its own to support the risks and obligations it will assume under the contract, the contracting authority should normally seek 'joint and several' guarantees from the major shareholders of the JVC or SPV. The purpose is to avoid a situation in which identified risks that the Contracting authority has transferred to the supplier are effectively passed back to the Contracting authority by virtue of the JVC or SPV having insufficient EFS on its own to support those risks. A written commitment to provide such guarantees would normally be sufficient at selection stage.

If a contracting authority has accepted only 'proportionate' liability from each of the shareholders (i.e. 'several' rather than 'joint and several' guarantees), then it may not achieve full recovery if the JVC or SPV and one or more of the shareholders was to fail.

Similar considerations apply in the case of consortia. Where tenderers rely on the EFS of specific consortium members within a bidding group, contracting authorities should normally seek joint and

[4] Unless the ultimate holding company acts as a pure investor and the bidder has no direct or indirect financial or other dependence on it in which case references to the ultimate parent company should be read as references to the highest parent company in the group which does not act as a pure investor.

several guarantees from those particular members covering the liabilities of the entire bidding group; the assessment of EFS should then be based on those consortium members. A written commitment to provide such guarantees would normally be sufficient at selection stage.

Application to key sub-contractors

In this paragraph, references to key sub-contractors means:

a) a sub-contractor that the tenderer is relying on in order to meet the Contracting Authority's requirement for EFS; and/or

b) a sub-contractor that the tenderer proposes will deliver the whole or a substantial or critical part of the works or services.

A PQQ can require tenderers to set out whether they will be using sub-contractors and to include the approximate percentage of the contractual obligations to be performed by each sub-contractor.

Where a tenderer is relying on the financial status of a key sub-contractor in order to meet the requirement for EFS under a procurement, the Contracting Authority can assess the EFS of that key sub-contractor in addition to the tenderer. The tenderer should also be required to prove to the contracting authority that it will have at its disposal the resources necessary, for example by producing a commitment by the key sub-contractor to that effect.

In addition, where a tenderer is proposing to use key sub-contractors to deliver the whole or a substantial or critical part of the services under procurement, the contracting authority should also test the EFS of those key sub-contractors prior to contract award. The contracting authority should explain this, including how they will carry out the assessment, in the PQQ or other procurement document. For example, the contracting authority may wish to apply the same tests, may adjust the thresholds pro-rata to represent the proportion of the services to be delivered by the key sub-contractor or may use a different test for key sub-contractors.

It is for the contracting authority to decide when EFS assessment of subcontractors will be required, but as a guide where any sub-contractor is delivering at least 20% of the contract –either by value or key contract activity it is expected that a full EFS assessment would apply and this would be carried out as appropriate at PQQ, Invitation To Tender or other appropriate stage.

If the tenderer is unable to demonstrate the EFS of a key sub-contractor, the contracting authority shall require the tenderer to replace the key sub-contractor, or, if this is not possible, exclude the tenderer from the assessment process.

Application to projects where tenderers are asked to provide financial models

The financial assessment tests are designed to test the EFS of tenderers at the selection stage of a procurement. They do not test the deliverability of tenderers' proposed solutions which may need to be evaluated at the assessment stage. For many procurements, tenderers will be asked to provide financial models of their proposed solutions as part of their tenders.
The financial robustness of these models should then be tested in evaluating the deliverability of tenderers' solutions. Such models could cover, for example, the amount of finance required, forecast cash flow, its sourcing and the ability to mitigate any adverse contingencies.

Use of credit ratings and credit scores

Credit ratings issued by major credit rating agencies (such as Moody's, Standard and Poor's and Fitch) generally provide a good, but not infallible, indication of a tenderer's EFS. A comparison of the credit ratings issued by different agencies is set out at Appendix VII; note in particular the difference between 'investment grade' and 'non- investment grade' (popularly known as junk). However, the cost of such ratings (which is paid by the companies being rated) means that they are generally limited to larger tenderers.

Contracting authorities should not use the lack of a credit rating, a minimum credit rating or its accompaniment by a negative outlook on the tenderer's rating as a reason to eliminate a tenderer; other financial ratios should also be considered.

Credit ratings should be distinguished from the credit scores issued by credit scoring agencies such as Company Watch, Dun & Bradstreet and Experian. Credit scores are based on algorithms; while they provide a predictive indication, their usefulness is limited by their dependence on backwards-looking published financial information which can be out of date. Credit scores should be used to corroborate other analysis or to assist identifying potential risk for investigation, but should not be relied upon as the sole measure of EFS.

Mitigating financial risk

Introduction

This section reviews ways to mitigate risks arising from a tenderer's EFS which have been identified at the procurement stage. It also reviews ways to manage changes to a supplier's EFS which may occur over time during the life of the contract. Contracting authorities should ensure that any such additional commitments agreed to by the tenderer in the procurement, for example more regular financial monitoring, appear in any contract awarded to the tenderer, should the tenderer be successful.

Some of these mitigations, for example bonds and other financial instruments, can be expensive and their cost and availability can be impacted by the wider economic conditions at the time of procurement. The requirement and choice of a mitigation should be proportionate to the identified risk and procurement. The selected mitigation should also be carefully assessed against the costs and expected protection for the contracting authority. Contracting authorities should ensure that the cost of any such security is included in the tenderer's price.

Insurance

Employers' Liability Insurance is generally required by law to cover employees and many insurers incorporate it into their business insurance policies.

Public Liability Insurance provides cover where a customer, contractor or member of the public is injured and the service provider is at fault. This is often combined with Employers' Liability Insurance.

Professional Indemnity Insurance is typically required to cover the provision of professional services such as financial services or IT consultancy. It may be required if advice is being provided to customers, if data belonging to a customer is being handled or the service provider is responsible for a customer's intellectual property.

Levels of cover: A contracting authority will typically wish to specify the level of insurance cover required; it should therefore formulate its intentions before commencing a procurement.

A blanket approach to levels of cover should be avoided. The level of cover should be based on the risk inherent in the contract under procurement. Adopting a blanket approach can create unnecessary expense and friction for small businesses which do not trade regularly with the public sector.

Contracting authorities should therefore be proportionate in their specification of insurance requirements having appropriate regard to the balance of risk and value for money in setting the level of cover required. Contracts should be considered on an individual basis.

Unless the employer is exempt, Employers' Liability Insurance minimum cover of £5m is fixed by law. In construction contracts, the minimum level should be £10m to cover potential liabilities.

If at the tenderer selection stage a tenderer does not hold the level of insurance cover required, an undertaking to secure the cover if it should be awarded the contract should normally be sufficient. It is not necessary at the tenderer selection stage to insist that the cover be in place.

Guarantees and bonds

Guarantees and bonds can be either performance or financial guarantees, or a hybrid of both. They only crystallise when a supplier has failed to perform services (performance guarantee) or to pay a sum due (payment guarantee). As such, they provide a remedy once a supplier has failed to deliver the service rather than directly supporting performance of the contract.

The financial markets can provide a variety of alternative financial instruments to protect customers. Since these can be expensive and their cost is likely to be reflected in tenderers' tenders, it is generally preferable to seek a parent company guarantee first where this is available and credible. It should be noted however that tenderers' existing debt terms may prevent the creation of new guarantees in some cases.

Guarantees

Under a guarantee, another party (the guarantor) undertakes to fulfil the terms of the contract (a performance guarantee) and/or make payments due but not made by the supplier and/or provide financial compensation to the contracting authority (a financial guarantee) if the contract is not fulfilled or a sum of money not paid.

Where a potential supplier's EFS appears lower than the thresholds required and subject to any clarifications with the potential supplier in this regard, contracting authorities can ask it to procure a guarantee from a guarantor with greater EFS or alternative means of support. It is important that any guarantor has adequate assets and is an entity of substance as a guarantee is only as good as the EFS of the entity providing it (see also the *Section on 'Application to groups and guarantors'* above). An assessment of the guarantor's EFS will need to be performed. Contracting authorities 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.

A guarantee can be provided by a member of the supplier's group or by a bank or insurance company. The latter would normally provide a financial guarantee where the guarantor agrees to indemnify the contracting authority against specific financial losses, liabilities and expenses incurred if the supplier defaults on its contractual obligations. These guarantees may be less advantageous, assuming the guarantor remains solvent, than a performance guarantee from the supplier's parent company or another company in the group which obliges the guarantor to perform the contract if the supplier fails to do so (which is what the Contracting authority ultimately wants).

Bonds

Bonds are typically provided by independent third parties, such as lenders and specialist surety providers / insurance companies, and provide financial compensation in the event of supplier failure. A range of different types of bonds are available.

A **performance bond** can provide some compensation if the supplier is proven to have defaulted on its obligations. It is usually provided at contract award, for an agreed 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.

Conditional bonds can usually only be called on (invoked) following a serious breach by the supplier (including becoming insolvent, which would normally allow the contracting authority to terminate the contract). These bonds provide a third party incentive to the supplier not to default under a contract it has entered into. They also provide compensation to the contracting authority where there is a proven default. They may be required where there are identifiable risks of default by the supplier, subject to value for money considerations.

On-demand bonds include within their terms and conditions the trigger and mechanism for calling on them. These are expensive and therefore more onerous for the supplier; they should typically only be used for high risk and/or high value projects where the costs and/or consequences of default by the supplier are high. They can be called on at the sole discretion of the customer, i.e. there may be no need to establish that the contract has been breached; if the agreed conditions for calling are met, the payment shall be made.

Contracting authorities should seek professional advice on the use, best choice, and drafting of bonds, taking into account that the availability and cost of bonds can be affected by the wider economic climate. In particular, they should be used proportionately as they can be burdensome requirements for small/medium value contracts and their costs are likely to be reflected in tenders. They should only be used where appropriate to the procurement in question. Consideration should also be given to whether any requirements for bonds could effectively preclude smaller firms from bidding.

Contract management and monitoring procedures should help ensure that contractual services are delivered in accordance with the terms and conditions of the contract. Active and thorough contract management is essential; monitoring reports provide the basis for deciding whether action should be taken if there is a specific performance issue. In many cases, the contract will also contain specific financial (service credit) and non-financial (correction plan) remedies in the event of poor performance.

Step-in rights allow a contracting authority to take over some or all of a supplier's contractual obligations for a temporary period to rectify a problem (usually a major performance failure), after which control is returned to the supplier. A trigger could be where a failure by the supplier causes the contracting authority to be in breach of a statutory duty where the contracting authority has no option but to assume control of the service in order to remedy the statutory breach. A permanent replacement supplier cannot be appointed under these measures; that would require a fresh competition in accordance with applicable procurement law. The Model Services Contract contains standard step-in rights for services contracts and they are often contained in collateral warranties on construction projects or other complex procurements.

Escrow arrangements can be used, where appropriate, to protect critical software and technology assets. Escrow services are provided by neutral third party escrow and verification specialists. Risk is mitigated by ensuring the contracting authority has access to source code and other proprietary information needed to maintain technology should the service provider go out of business or fail to provide support. The trusted third party escrow specialist will securely hold the source code and release it under specific contractual conditions.

Whether an escrow arrangement is entered into and who bears the cost[5] is subject to agreement between the parties. Escrow arrangements should not be required for open source software since the source code would normally be provided with the software.

Suppliers of Gold (critical) contracts and certain other suppliers should be required to provide resolution planning information to allow contracting authorities to understand better the potential impact of a supplier's insolvency.

This should enable contracting authorities to work more closely with suppliers to develop mitigations to protect short-term service continuity together with plans for the accelerated transfer of responsibility for service provision to protect longer-term service continuity.

Monitoring the economic and financial standing of suppliers following contract award

Background

The EFS of suppliers (previously tenderers) can change throughout the term of a contract. Therefore, contracting authorities should regularly monitor the EFS of their suppliers.

Identifying and monitoring Key Suppliers

Contracting authorities should identify their key contracts and suppliers using mechanisms such as a Contract Tiering Tool which categorises contracts between 'Gold', 'Silver' and 'Bronze' based on their criticality. Key suppliers include all suppliers of critical (Gold) contracts or important (Silver) contracts. Contracting authorities should also consider whether any other suppliers should also be regarded as "Key Suppliers".

The EFS of suppliers of 'Gold' and 'Silver' contracts and any other key suppliers should be reviewed at least once per year.

Monitoring should include a review of performance against EFS metrics, Financial Distress Event triggers under the contract, KPI and contractual performance and commercial behaviours (including supply chain payments, requests to customers to be paid early, payment mechanism

[5] These arrangements normally attract charges/fees

and recoverable cost challenges) and wider business performance. This should be undertaken using the latest financial results alongside additional public and/or reported information under the contract. More regular reviews are particularly recommended for suppliers flagged by contracting authorities as critical for their services or which are perceived to have other than a low risk of financial failure.

Where monitoring and follow-up with a supplier suggests a raised level of concern, more regular monitoring and supplier reporting may be appropriate. In such cases, contract managers should ensure their contingency plans are up-to-date and consider whether any further action (including invocation of relevant financial distress contract clauses) or enhanced monitoring is required.

Monitoring teams should also regularly review any financial conditions included within the Contract Terms and Conditions including Financial Distress Event clauses to ensure that the supplier is compliant with any contract specific financial conditions.

Whilst monitoring should be undertaken by staff with sufficient appropriate financial skills, contract managers are well placed to undertake regular monitoring of suppliers due to their understanding of the supplier's business operations and the contract. Where there are concerns about a supplier's financial health, it can be beneficial for specialist financial teams within the contracting authority to support the assessment. Several authorities ask their finance function to provide this support

EFS should be a standing item on the agenda of supplier relationship meetings and, in the case of Gold contracts, should occur on receipt of the annual statement of compliance. Monitoring teams should establish ‘alert’ systems under which they are immediately informed, in respect of Key Suppliers, of:

- any change in a measure that forms part of the EFS assessment, for any change in a measure that forms part of the EFS assessment, for example changes in credit scores or ratings (where specified and available);
- any stock exchange announcements (where suppliers are quoted);
- press articles commenting on a supplier’s profitability or financial standing

“more regular reviews (e.g. every 6 months or less) are particularly recommended for public sector dependent suppliers and suppliers flagged by contracting authorities as critical for their services or other than low risk of failure.”

Coverage

Monitoring of key suppliers should cover not just the contractual Financial Distress Events but take a wider view of a supplier’s business and financial health and the level of risk. Although suppliers can collapse suddenly and unexpectedly, declines in financial health typically occur over a longer period as a result of changes in the market and/or business performance which then lead to a longer-term solvency problem. It is therefore helpful to be aware of the wider business context and performance metrics, the trends over time and non-financial indicators.

Financial monitoring should cover the supplier, key sub-contractors, any guarantor or monitored supplier specified in the contract and, if this is not the ultimate holding company, the ultimate holding company. Exceptions to this would be where the supplier and/or any guarantor have been deliberately ring- fenced, operationally and financially, from the remainder of the group or where the ultimate holding company acts as a pure investor (as in the case of a private equity investor for example) and the supplier and parent company guarantor have no other financial dependence on the ultimate parent company in which case references to the ultimate parent company should be read as references to the highest parent company of the ring-fenced entity or the highest parent company in the group which does not act as a pure investor.

The contracting authority should also take whatever steps are appropriate to monitor the EFS of key sub-contractors.

The Importance of access to liquidity

In terms of immediate risk, lack of access to liquidity is the typical cause of financial failure. It is therefore important to understand a supplier's, or a supplier group's, funding strategy and the nature of any borrowing arrangements. Relevant items include:

Committed	If uncommitted, access to credit may be withdrawn by the lender if they determine the supplier's risk profile has deteriorated. A supplier relying on uncommitted facilities may be an indicator of risk.
Covenants	These are conditions, often financial ratios, that the borrower must meet. These are sometimes attached to the extent drawn down. A supplier close to breaching covenants could be an indicator of risk (this may also be described as limited "headroom").
Headroom	How much space is there between the potential future peak cash needs and the borrowing already in place? Any lack of headroom should be identified and handled by management.
Extent Drawn Down	How much of the total credit line the supplier has received. A supplier drawing the maximum could be an indicator of risk.
Maturity profile	The dates at which debts fall due. Borrowers typically need to start looking at replacing funding lines 12-18 months prior to maturity. A supplier with a maturity profile that is not spread evenly or is coming up very soon could indicate a higher level of risk.
Repayment type	The capital and interest profile. For example, is it repaid regularly throughout the life of the loan or is it a "bullet loan" whereby there is no payment until the maturity date? On construction projects lenders may permit the 'roll up' of interest during the build phase, only commencing payments once the building is complete.

Other items to consider:

- How much reliance is there on other group entities for liquidity?[6]
- What is the working capital profile of the supplier? Where the business has a negative working capital cycle it collects cash in advance of need. the opposite is true there will always be a cash working capital requirement.
- Has the supplier or its group provided security to its lenders?
- Are there any restrictions on how liquidity can be used, for example grants provided for specific activities? This is particularly relevant in the VCSE sector where “restricted” funds denote balances that can only be used for particular purposes.
- If a supplier has been identified for enhanced monitoring, what further detail can the aged debtors and “work in progress” report provide in the supplier’s ability to meet its short term liabilities? This is particularly relevant for construction companies with complex supply chains

Not all of this information is readily available in the public domain; some suppliers may be reluctant to provide details of their borrowing facilities such as details concerning covenants and headroom for example. Contracting authorities should consider whether their reluctance to provide such information stems from genuine concerns over commercial confidentiality or potential issues in the supplier’s financial standing. Where increased financial risk is identified pre contract award, including contractual terms for the provision of additional financial information can support monitoring.

Access to forward looking information

The limitation of using published information for ongoing financial monitoring is that it is backward-looking and can often be a year or more out of date. Monitoring should therefore include access to forward-looking information where possible. In the case of publicly quoted suppliers, the share price performance relative to its peers or a relevant stock market index can provide a useful indication of investor sentiment towards the company. The short percentage of a supplier's shares can also be useful as this indicates some investors are “betting against” the company.

In the case of private suppliers which are not members of a publicly quoted group, it may be appropriate to seek access to forward-looking information such as financial projections or a

[6] See Metric 8: Group Exposure Ratio for further detail on reliance upon other Group entities.

simplified business plan. Many suppliers will provide this information to their banks as a matter of course to support their credit lines so will have a standard pack available on request.

Suppliers which are publicly quoted (or part of publicly quoted groups) are generally very reluctant to provide access to forward-looking information as such information may be price sensitive. In extreme situations, for example, if a Financial Distress Event contractual clause is triggered, government may be willing to become an insider and to enter into appropriate non-disclosure agreements; contracting authorities should always take legal advice first in such circumstances because of the obligations involved.

Where analyst research reports are available, these provide a view on investors' expectations of a supplier's future performance (the most useful reports are typically those issued by a supplier's retained stockbroker). Note however that these can only ever represent a third-party view, that such reports are written without access to the supplier's internal budget and forecasts, that they cannot be relied upon and that they are written for the benefit of investors, not customers.

Annual confirmation of compliance

Standard Conditions of Contract typically require suppliers to promptly notify a contracting authority following the occurrence of a Financial Distress Event or any matter which could cause a Financial Distress Event. Where no Financial Distress Event or any matter which could cause a Financial Distress Event has been notified, boards of suppliers of critical (Gold) contracts should provide an annual confirmation in writing to the contracting authority that no Financial Distress Event or any matter which could cause a Financial Distress Event has occurred and/or is subsisting. For Public Sector Dependent Suppliers of critical contracts that are subject to more frequent monitoring, it is recommended that confirmation by boards should be six monthly.

Follow up

Whether or not a review indicates any concerns, it should be discussed promptly with the Contract Manager. Any concerns should normally then be discussed with the supplier and reassurance sought; it is good practice to hold at least an annual meeting with key suppliers to discuss their financial health and strategy.

Where financial monitoring and follow-up suggest a raised or continuing 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. Any concerns and actions should be raised with a senior business owner at an early stage.

Financial Distress Events

Financial Distress Events or triggers can be included in ‘Gold’ and ‘Silver’ contracts. Their purpose is to provide an early warning signal of a supplier’s possible future financial distress and give a contracting authority the time and opportunity to investigate and take further action if required.

Contracting authorities should also consider whether to include any additional Financial Distress Events to reflect the particular circumstances of the requirement under procurement.

Financial Distress Events should generally be applied to each of (a) the supplier, (b) any guarantor, (c) any key sub-contractors and (d) ‘monitored suppliers’. Monitored suppliers would normally be limited to key members of the supplier’s group on which the supplier depends financially or to provide a substantial or critical part of the works or services.

Suppliers of Gold and Silver contracts should be required to warrant to the contracting authority, on entering into a contract, that no Financial Distress Event or any matter which could cause a Financial Distress Event has occurred and/or is subsisting.

If a Financial Distress Event is triggered, a contracting authority should promptly discuss the position with the supplier.

If a contracting authority is concerned that the supplier could be entering financial distress, it should actively pursue the situation. See Guidance on Corporate Financial Distress for further assistance.

3.4 Tender Evaluation (Award) Stage

Overview

The tender evaluation (award) stage examines how the tenderers propose to deliver the contract. Whether for a complex procurement, or a more straightforward contract, a well-planned and implemented tender evaluation process is critical to deliver best value for money.

Process

Tender evaluation is the process of assessing tenders to identify the most advantageous tender (MAT) submitted for a project. MAT may not be the lowest cost tender and is determined by evaluating tenders against published award criteria to get the right supplier to deliver works, goods or services.

A good evaluation is not only about the final award decision - it is about the design and execution of the whole process, leading up to that decision, including ensuring the process is properly documented and can stand up to internal and external scrutiny.

Right at the start

Compliance with the procurement legislation

The evaluation process must comply with current procurement legislation, from design of the evaluation methodology to evaluation of tenders. This includes compliance with the core principles of transparency, non-discrimination, equal treatment and proportionality.

Create a timetable

Good project management is critical to an effective evaluation process. The overall procurement timetable should reflect all the activities required for tender evaluation as well as appropriate contingency in the event of unexpected or unplanned overruns.

Each procurement will have different requirements, however adequate time should always be allocated to:

- Identifying and agreeing appropriate resources;
- Issuing evaluator guidance and Conflict of Interest forms (including time for the forms to be returned by evaluators);

- Developing and testing the evaluation model before the contract is advertised, including to ensure it contains relevant, clear and focused qualitative evaluation criteria;
- Completing the evaluation at each stage of the procurement process, as appropriate e.g. when using the competitive dialogue or competitive procedure with negotiation procurement routes;
- Raising clarifications with tenderers during the evaluation and taking responses into account;
- Planning and completing moderation meetings; and
- Collecting all notes taken through the process prior to making any award decision.

Plan sufficient resources

The time needed for evaluation can vary widely, depending on the type of procurement, number of tenders received, whether tenders are evaluated at multiple stages (to reduce the number of solutions), and resources available. Applying the evaluation criteria and finalising the award process can take as little as a month for a simple process, but will often take longer and additional time should be included for complex procurements. When publishing the timetable, always state that it is indicative and reserve the right to change it.

Early consideration should be given to the number and type of evaluators required. Tenders should be independently scored by an evaluation panel, who have sufficient knowledge and understanding of the criteria they are evaluating.

It is best practice to have the same evaluator evaluate all responses to a particular question. This is to help ensure consistent scoring, as each response being evaluated by the same person will make it more likely each is evaluated in the same way. Similarly, where a question is subdivided into various subsidiary questions, the same evaluator should evaluate all the corresponding subsidiary responses.

All evaluators and the Chairperson need to be appropriately trained. Training materials and records of training attendance should be retained as part of the wider record-keeping and audit process to demonstrate good quality training has taken place. Training should cover:

- Overview of tender evaluation including the primary purpose of achieving the right outcome;

- Procurement legislation and core principles;
- The evaluation process, including compliance checks, individual scoring and the consensus scoring process;
- Selection stage assessment (mandatory and discretionary exclusions, selection against published assessment criteria);
- Price and qualitative evaluation against published evaluation criteria;
- Clarifying tenders (if this is possible and if so how it should be carried out);
- Pass/fail criteria; and
- Record keeping (both why it matters and how to do it effectively).

Set up a record keeping process

A robust evaluation process involves good record keeping. Failure to keep a thorough and well documented evidence trail can make it difficult to justify why a particular tenderer won. Records need to be kept of why each tenderer was awarded a particular score for internal processes, and also to be able to provide a full and helpful debrief to the unsuccessful tenderers in the event of any legal challenge against the award.

At the end of any evaluation process, an evaluation report should be developed (which will assist with providing an assessment summary as required under Section 50 of the Procurement Act 2023. The purpose of the transparency notices are to demonstrate that the evaluation has been performed properly and to provide evidence supporting the scores given to each tender.

It is essential to embed a robust process at the early stages of a procurement to keep thorough, evidenced records of all discussions, meetings and decisions between evaluators and the moderator which are relevant to the evaluation. Evaluator and moderator records should reflect the requirements and use language consistent with the evaluation criteria. Where evaluators change scores in moderation, the reason and underpinning evidence for that change must be documented and securely stored.

Creating the evaluation model

Effective design

The evaluation model should reflect the desired business objectives, outputs and outcomes of the procurement. It should include a consideration of:

- How the importance of price and quality (including social value[7]) will be balanced;
- How quality will be evaluated (including, where appropriate, how social value will be evaluated); and
- How price will be evaluated.

At the core of the evaluation model there should be a list of relevant and measurable criteria against which each tender will be evaluated.

Contracts must be awarded on the basis of the MAT. The definition of MAT allows contracts to be awarded on the basis of the best price/quality ratio but also allows them to be awarded on the basis of price or cost only. When cost is used as an award criterion, it should be done so on the basis of a cost effectiveness approach. Life cycle costing is an example of this approach (see below).

PPN 01/21 - Scoring Social Value excludes the use of price only on services and works contracts over the UK Procurement Threshold[8] and states that consideration of quality, cost and social value should be factored into procurement exercises above the threshold where the Procurement Regulations apply.

The Regulations contain a non-exhaustive list of award criteria (that should be linked to the subject matter of the contract), including social, environmental and innovative characteristics, technical merit, after sales service and delivery conditions such as delivery date.

Evaluation criteria should:

- **Be proportionate and linked to the subject matter of the contract.** Evaluation criteria need to be proportionate to the contract value and objectives and relate to the

[7] PPN 01/21 - Scoring Social Value | Department of Finance (finance-ni.gov.uk)
[8] UK Procurement Thresholds

works, supplies or services to be provided under that contract. Criteria should not be taken from similar or previous programmes without being properly considered as to whether they are proportionate and relevant to that particular procurement. Criteria are considered to be linked to the subject matter of the contract where they relate to:

- the specific process of production, provision or trading of the works, supplies or services; or
- a specific process for another stage of their life cycle,

Even where such factors do not form part of their material substance;

- **Not be based on price alone.** Evaluation criteria need to also include the consideration of qualitative criteria, i.e. tenderers' ability to meet technical requirements, e.g. to manage business change programmes or compliance with commercial terms and conditions; and
- **Be clear and unambiguous.** Evaluation criteria and the overall evaluation methodology should be able to be interpreted in the same way by all reasonably well-informed and normally diligent tenderers. The methodology should accurately explain how tenders will be scored.

The evaluation model should be developed iteratively, with early outline evaluation criteria tested with potential tenderers as part of early market engagement.

Evaluation criteria may also be developed through early testing phases of a project

Scenario test the model before finalising to check it works as expected.

The evaluation model must be published in the contract notice or procurement documents. A standard score sheet and guidance for the tender evaluation panel should also be prepared. This should precisely replicate the evaluation methodology given to economic operators.

Where evaluation criteria are pass/fail, ensure that this is both appropriate and proportionate.

If it is mandatory that a particular threshold is met then it is necessary to exclude any tenderer that doesn't meet it. You should therefore consider carefully whether the requirement in question is significant enough to merit rejecting a bid regardless of its other benefits.

Balancing the importance of price, quality and social value

Achieving value for money

Executive policy is to award contracts on the basis of Best Value for Money. Northern Ireland Public Procurement Policy defines Best Value for Money as:

"The most advantageous combination of cost, quality and sustainability to meet customer requirements".

This must be in-line with requirements under the Procurement Regulations to base the award of the contract on the basis of the MAT, which allows for a balance between price and quality. The rules relating to award criteria are designed to ensure that obtaining value for money is done in a transparent and non-discriminatory way. The weighting of price and quality should reflect the characteristics of the service and potential outcomes should be tested with the market before the weighting is fixed. Consider the potential impact of any criteria within the quality weighting.

Be aware that the relative weightings may be undermined by the nature of the criteria. If the quality criteria are designed in a way where most tenderers will tend to receive the same score then the procurement may still be decided on price (even if quality has a higher weighting).

Separate guidance is available in relation to Scoring Social Value[9].

In order to contribute to the Northern Ireland Climate Change Adaptation Programme 2024–2029 (NICCAP3) Commissioners/procurement staff should also address the following questions:

i) Is the supply of this product or delivery of relevant service potentially vulnerable to the impacts of climate change?

ii) Is there an opportunity to minimise the effects on supply or service delivery, as a result of anticipated climate change?

Examples include:

- Risks to infrastructure and buildings/ facilities;
- Risks to local supply and service continuity;
- Risks to supply continuity from other areas vulnerable to climate change;
- Risks to users of services.

[9] For contracts above the Procurement Thresholds, from 1st June 2022 tenders must allocate a minimum of 10% of the total award criteria to social value. See PPN 01/21 - Scoring Social Value | Department of Finance (finance-ni.gov.uk)

Figure 1: key considerations to create an effective evaluation model

Sequential evaluation of price and quality

As an alternative to relatively weighting price and quality, sequential evaluation of price and quality is an option.

One way of doing this involves setting a minimum quality score threshold. This starts with tenderers being evaluated against the published quality criteria. Only tenders which meet or exceed the quality threshold are taken forward to the next stage of the evaluation (which is the price evaluation). Tenders which do not meet the quality threshold are rejected. Tenders taken through to the price evaluation stage will then be evaluated on price alone, with final award being made to the lowest priced tenderer (provided it is not rejected as an abnormally low bid). This approach works best where a contracting authority has a clear view as to its minimum quality requirements (which may be set fairly high) and is indifferent to whether tenders exceed that quality.

Another option is for the cost element to take the form of a fixed price or cost and tenderers compete on quality criteria only.

When using this sequential evaluation of price and quality, as with all tenders, it is important to verify that the solution is underpinned by a robust costing model. Any contingent pricing elements should be clearly identified and evaluated, and tenderers should have evidenced how their pricing relates to their proposals on quality (i.e. confirming that the threshold quality level can be delivered at the price bid).

Consider deliverability

The level of deliverability (or delivery risk) in a solution should be taken into account during the evaluation of tenders. There are a number of methods which can be applied, including:

- An evaluation of risk within the quality evaluation; or
- A separate scored and weighted section on risk.

Having a separate scored and weighted section on risk provides for a greater focus on risk and is more useful for complex procurements where an assessment of delivery risk is critical. Including the evaluation of risk within the main qualitative evaluation may be more appropriate for lower value/low complexity requirements.

As with any aspect of the evaluation methodology, how risk is evaluated should be transparent and clear to tenderers.

Evaluating quality

Overall approach

Evaluating quality effectively requires:

- Objective, proportionate, clear quality criteria which are relevant to the service requirement, iteratively developed by subject matter experts and tested with the market;
- Weightings set according to the importance of criteria; and
- A scoring approach which enables clear differentiation of tenders.

Evaluating innovation

Quality may also refer to innovation. Adopting innovative solutions and emerging technologies enables the Government to improve our ways of working and achieve better public service outcomes. To drive innovation, consider:

- **Having an open technical specification with clearly defined outcomes.** Being overly prescriptive can prevent suppliers from proposing new and innovative solutions to deliver better outcomes.

- **Removing the cap on cost.** This allows suppliers to propose innovative solutions which may drive additional value.

Consider potential unintended barriers to innovation.

Even where innovation is not the primary goal of a particular procurement, contracting authorities should carefully consider whether their evaluation criteria inadvertently discourages innovation, for example by discouraging suppliers from offering solutions with additional benefits not directly linked to the primary service.

Objective, proportionate, relevant, clear quality criteria

Quality criteria will typically be developed by the subject matter experts responsible for developing the specification of requirements. Commercial input can help provide guidance as to what good criteria look like and to test and challenge the criteria as they develop.

Criteria must be objective, proportionate to the contract value and objectives, relevant to the subject matter of the contract and unambiguous. It can help to apply SMART principles - are the criteria specific, measurable, achievable, realistic (and relevant) and is there a time by which they are to be delivered.

Consider how to use ‘open’ and ‘closed’ questions appropriately when designing tender questions in order to determine the right outcome and their impact on the tenderers’ responses.

- **Closed questions are particularly helpful to clarify whether a supplier will do something specific now or after contract award** - for example sign up to particular terms, conditions or standards;

- **Closed questions are also very useful for mandatory questions.** If the only possible answer is yes or no (or something similarly capable of being pre- defined) the scope for subjectivity in evaluation is removed; whereas

- **Open questions are very helpful to establish how tenderers will meet quality requirements.** Questions should still be clear as to the nature of the information sought and how responses will be evaluated. Open questions are the most likely to be able to differentiate between quality tenders.

Experience tells us that evaluating quality effectively requires time and expertise. Market testing can help to overcome any pre-existing bias and ensure that criteria are fit for purpose. It is good practice to peer review quality criteria and include feedback from previous contract managers before they are finalised to ensure the right factors are being assessed through evaluation.

Consider whether word or page limits (with prescribed font and size e.g. Arial 12) are appropriate for tenderers' responses. If included, limits should be sized proportionally to the response required to demonstrate the tenderers' ability to meet your requirements, which is likely to reflect the weighting for the question they relate to. Limits can reduce the time taken to review tenders but also limit the amount of evidence a tenderer can supply. If limits are set then information in excess of the limits must not be considered by evaluators. Be clear on how images or embedded files will be taken into account as part of word or page limits.

Consider whether evaluators should be allowed to take account of information contained in one question response when evaluating a separate question response - if so, you should explain to tenderers that they can cross refer to other answers when answering a particular question (cross references must be specific). This can make evaluation more time consuming however, allowing evaluators to cross-refer may assist in building a better understanding of the overall proposal.

Carefully consider the use of tenderer presentations, interviews, scenario tests or site visits as part of the evaluation process. You must clearly and transparently set out in the procurement documents whether and how these activities will be evaluated, and the approach should be agreed with legal before proceeding.

Note: A supplier's response to the conditions of participation must be assessed separately from the tenderconflict, the tender (only) being assessed against the award criteria. The Procurement Act 2023 allows the qualifications, experience, ability, management or organisation of staff (where those factors are likely to make a material difference to the quality of goods, services or works being supplied), to be taken into account in award criteria

Weighting quality criteria

Within the overall quality score there will be a number of individual quality criteria (and, in some cases, sub criteria), each of which will need to be weighted against the others. This should be done in order of importance to the overall contract and its objectives.

Weightings should be set on a case by case basis taking account of factors such as the nature of the goods/services being procured, the objectives of the procurement, the overall criticality of the services being procured, the relative importance of different parts of the services being procured and deliverability or other risk. It is vital that stakeholders, including if possible end users, are as involved as possible in the process of determining the relative importance of quality criteria. Appendix III provides more information on weighting approaches.

Each evaluation criteria must be distinct from the other evaluation criteria to avoid double counting. It may be appropriate to sub-divide an evaluation criteria into lower level sub-criteria (with sub-criteria weightings). Where practical and appropriate, try to avoid giving any two criteria the same weighting, as this will make it less likely that different responses are awarded the same score.

Design a scoring approach to allow differentiation

An effective scoring approach should be appropriate for, and tailored to, the individual procurement and allow clear differentiation between tenderer's responses to the quality criteria. Clear consideration should be given to scoring bands. A 0-5 scoring mechanism can help to reduce bid-bunching.

Evaluating Price

Considering price

As well as quality, the other key element in determining MAT is price. There are a number of different types of pricing evaluation. This guidance covers a small selection of potential pricing approaches:

- **Relative price scoring.**
- **Price per quality point.**
- **Benchmark price scoring.**

When considering price evaluation, it is important to consider the pricing data set against which the evaluation will be tested. These should be realistic, need to be published, and may need to take account of both fixed and variable cost elements.

Whole-life cost should be considered. Whole- life cost can be very different from initial cost and takes into account the total cost of a product or service over its life cycle, including costs relating to acquisition (e.g. capital costs), maintenance, management, operating and disposal costs. It may also include any post-contract residual value benefitting the contracting authority.

These costs may include the cost of emissions of greenhouse gases and of other pollutant emissions and other climate change mitigation costs.

Relative price scoring

Relative price scoring has the potential to increase the risk of “bid-bunching”, and can benefit tenderers hoping to win by submitting the lowest price rather than focusing on quality (even where quality carries a higher weighting in the evaluation than price). It may also result in scores that do not take account of the real difference in price between tenders where there are only two tenderers. For example, if the methodology provides for the lowest priced bid to receive the maximum score, with scores for other tenders awarded depending on how they compared to the least expensive bid, this would mean that one of the tenderers would score 40 on price, while a tenderer with an only marginally higher price could score significantly less.

Price per quality point and benchmark price scoring

Alternatives to relative price scoring such as price per quality point (PQP) should be considered as these provide an absolute standard against which tenders are evaluated (see Appendix II). The PQP is established by dividing each tenderer’s price by its quality score. This enables true comparison of what the contracting authority will pay between per quality point and tenderers are not being compared against each other, but only assessed based on their own bid. However, one disadvantage is that the same PQP could be achieved by two very different tenders - e.g. both £80 price/40 points quality and £100 price/50 points quality result in a PQP of 1.2.

Evaluation against a benchmark price also provides an objective standard. Consideration should be given as to how any benchmark may be set and whether the presence of the benchmark could distort tenderer behaviours.

Contingent and assumption based pricing

As part of the price evaluation to determine whole-life cost, evaluators should identify any assumptions, dependencies or risks which could impact the pricing.

Price evaluation should take into account the risk of price increases.

This can be done by:

- **Limiting price assumptions and dependencies**: Permit only a specified list of price assumptions and dependencies, and be clear that any tenders which include additional assumptions will be non-compliant. Be careful not to exclude risks that concern tenderers as this may lead to a high risk premium (reducing value for money), or result in a limited number of tenderers. It is essential to market test the list of price assumptions and dependencies before proceeding with this option. Tenderers' prices can then be adjusted by reference to the probability that these authority-set assumptions and dependencies will impact their tenders. The basis on which any such price adjustment would be determined needs to be published. In most cases the use of allowable assumptions (see below) will be preferable to this approach due to the difficulty of setting objective adjustment criteria.

- **Allowable assumptions**: Allow tenderers to include in their bid 'allowable assumptions' in addition to their main pricing. This is a mechanism allowing specified price increases where certain assumptions prove false. The price impact of the allowable assumption should be added to the bid price to arrive at the total price of the tenders for evaluation purposes. If allowable assumptions are permitted, these must be precisely defined and you should set aside time before tenders are submitted for clarifying with tenderers how price increases are triggered. This should only be where highly specific and objective criteria are met, so that if the assumption proves valid the price remains unchanged. While the Model Services Contract does not itself address evaluation issues, it does contain allowable assumptions drafting for inclusion in a contract.

- **Assess likelihood of assumptions, dependencies and risks**: Evaluate the likelihood that tenderer-set assumptions, dependencies and risks may impact the price. The tenderers' price could then be adjusted by reference to the probability of price increases from those factors. If this approach is taken, it is critical that objectivity and transparency are maintained. The basis on which assumptions, dependencies and risks are assessed and exactly how prices are adjusted for them needs to be published. In most cases the use of allowable assumptions will be preferable to this approach due to the difficulty of setting objective adjustment criteria.

Low cost tenders

The bid price should be interrogated to ensure it is robust, that all costs are included and that there are no unauthorised assumptions or caveats that could impact price further down the line. If contracting authorities fail to understand the true cost of delivery or have a bias towards low cost tenders they risk, once the contract is entered into:

- contracts running into trouble as a result of actual costs being higher and suppliers needing to find ways to cut costs post award;
- suppliers focusing their efforts on cost reduction measures rather than the delivery of quality services;
- suppliers seeking contract changes to counter the fact that they are unable to deliver to the contracted cost;
- the supplier may be less likely to support the contracting authority during a crisis, and will manage strictly to the letter of the contract;
- may be in a weaker bargaining position;
- the need to inject significant levels of further funding into contracts to ensure critical services are not disrupted (not the only cause of this issue, but a common one); and
- measures being taken (such as those above) that may amount to a substantial modification, which may be in breach of the procurement regulations.

In order to help avoid a bias towards low cost tenders the following questions should be considered before formally commencing a procurement:

- has the pre-market engagement phase been used to inform the design of the evaluation methodology and robustly test that suppliers can deliver the required services at an affordable cost?
- has a ‘Should Cost Model’ been developed and used to inform the evaluation methodology in terms of what the right cost (or cost-range) is and what financial elements should form the whole-life cost calculation? A ‘Should Cost Model’ shall be produced for all complex outsourcing projects. Where the Should Cost Model is used as

part of the evaluation methodology itself (e.g. as a comparator for bid costs), this must be disclosed to tenderers.

- is a minimum quality threshold applicable and, if so, is that quality threshold clear and the minimum requirement appropriate?

- do the quality evaluation criteria and weightings recognise and reward tenders that offer highest value and low delivery risk in the areas that are most critical to successful delivery?

- does the scoring methodology avoid 'bid bunching' by differentiating between tenders offering the minimum quality (an acceptable bid) and those offering above the minimum requirements and offering added value?

An abnormally low bid is a bid with a price so low as to make the contracting authority question whether it is correct and/or deliverable. Where a bid appears to be abnormally low, the contracting authority must require the tenderer to explain their proposed price. Separate guidance is available on the process to follow if you identify a potentially abnormally low tender.

Process to follow if you identify a potentially Abnormally Low Tender

Section 19 of the Procurement Act 2023 places a duty on a contracting authority to investigate tenders it considers abnormally low.

A tender offer is considered abnormally low where the offer hits one of the following trigger points:

(i) it appears much lower compared to the prices of other tenders or the 'should cost model' or estimate specified in the tender notice.
(ii) it is unlikely, even with efficient working, to cover the tenderer's costs.
(iii) it seriously calls into question the tenderer's ability to resource and perform the contract satisfactorily.

An abnormally low offer brings with it risks for procurers and you should not accept such an offer without detailed and careful consideration.

A tender that, because of its particularly favourable terms, raises a suspicion, either that the economic operator will not be able to perform lawfully, according to the terms offered (which may create a risk of non-performance/unlawful performance) and/or a danger that the tenderer will seek extra payments (this includes endless wrangling over sums due).

If one of the trigger points listed above is reached the following process is recommended to manage the consideration of Abnormally Low Tenders (ALTs). You must allow time for this and the tender process must be paused if necessary.

Stage One - Explanation

Contracting authorities must request that the tenderer 'explains' the abnormally low price, or costs.

As a minimum contracting authorities should inform the tenderer the price has met one of the trigger points above and:

(i) Outline the concern that the tenderer will not be able to provide the works/goods/services at the tendered price; or
(ii) Ask tenderer how it proposes to deliver the contract at that price, which is significantly lower than other tenderers; or
(iii) State that, where other tenderers have same characteristics, it is difficult to understand how the prices can be offered.

The abnormally low price or costs may only relate to a few key prices. The tenderer should be told that it is free to offer any explanation it considers appropriate, and should be informed that all information will be treated as confidential. The tenderer should be informed that simply stating they can offer very keen prices, or are very efficient is not helpful.

Contracting authorities must give enough information to tenderer to allow it to respond in meaningful way. Care must be taken not to reveal commercially sensitive information of other tenderers. Adequate time must be allowed and the CA may need to extend any deadline for response if there is good reason.

Stage 2 - Deciding whether tender is actually abnormally low

It is recommended that a panel of at least 3 persons sit to assess explanations provided by the tenderer.

Each person should read papers and consider the issues and record what he/she considers are the main points, make a preliminary decision and have brief reasons for it. The principles of Equal Treatment; Non-Discrimination; Transparency; and Proportionality must be adhered to.

Each person should then meet with other panel members. They should share individual notes in advance. There should be an open discussion and a consensus decision arrived at.

One person should acts as a note taker. The note taker should keep a note of the issues discussed, the decision arrived at and the reasons for it. This should be circulated immediately after the meeting for comment/correction by the panel members. This will enable a final note to be produced which is fair and balanced and reflects the discussion. The final note should be proofread for errors. It may be read later by a court. It should be signed and dated by all panel members.

If a fair procedure is adopted, a court will only interfere where there is a manifest error.

The court will want to see that serious and skilled people have approached matter with intent of getting to heart of the issue.

If a tender is found to be abnormally low and rejected the reasons for its rejection should be recorded in the evaluation report.

Test and publish evaluation model

Calculating MAT

When calculating MAT, scores are calculated using a formula which takes into account the best price to quality ratio. This can be done in a number of ways and the methodology can have a significant impact on the final result. The formula, methodology and scoring approach for tenders should be scenario tested with a number of dummy tenders (including low tenders) and scores to ensure that results are as expected.

The contracting authority must disclose the evaluation methodology, including the evaluation criteria and their weightings (including sub-criteria) to tenderers in the procurement documents. Once this is published, it must be followed and evidenced. The methodology should be clearly set out and easily understood by tenderers, particularly those who may be unfamiliar with public procurement bidding processes, e.g. small and medium sized enterprises.

Apply the evaluation model

Use the published model

Tenders must be evaluated in accordance with the published criteria and evaluation methodology. A copy of the published criteria and scoring approach should be kept on-hand by evaluators so they can refer to it as they evaluate.

It is critical that the scores awarded are supported by records which provide the justification for the scores awarded. This will help to demonstrate that the process is consistent and can be used to provide the basis for debriefing unsuccessful tenderers and, if necessary, in the event of a challenge to the award decision.

Unless they can be certain that tenderers' identities can be truly anonymised, contracting authorities should not propose that tenders are anonymised before evaluation. This is due to the practical difficulties in ensuring tenders genuinely are and remain anonymised, and the risk of inadvertently breaching that anonymity.

Sometimes the evaluation phase takes longer than planned. Consider tenderers costs during the evaluation phase. Tenderers may have to ring-fence or recruit resources to start immediately upon award and thus incur unforeseen costs. Be clear in communications with the tenderers if or when there are going to be periods of no activity at all so they can respond appropriately and stand teams down.

Clarification of tenders

During evaluation, evaluators may encounter points in tenderer responses which appear to be incomplete or erroneous, or where specific documents are missing. Where this occurs, the contracting authority may ask the tenderer to submit, supplement, clarify or complete the relevant information or documentation provided this is done in full compliance with the principles of equal treatment and transparency. Clarification is not an opportunity for tenderers to improve their tenders. Clarification questions must be sent in writing to the tenderer and tenderer must respond in writing within an appropriate timescale set by the contracting authority.

Evaluators should not raise clarification questions directly with tenderers as the proposed clarification may go beyond what is permitted under procurement regulations.

Clarification questions should be submitted to the CoPE who will review and, if appropriate, send to the tenderer. Before submitting clarification questions to tenderers, the contracting authority should consider whether any of the questions need to be reviewed by legal advisors to ensure they are permissible.

Responses should be reviewed by the procurement or commercial team before being shared with evaluators to ensure they provide only the information requested and in some cases steps may need to be taken to remove information that goes beyond this - e.g. by redacting some text before sharing the response.

Clarifications to tenderers' responses should be shared with all evaluators evaluating that particular area of the bid, not just the evaluator raising the clarification question.

Post tender negotiations cannot be carried out after tenders are received in the open or restricted procedure or after final tenders are received in the competitive procedure with negotiation. The competitive dialogue procedure allows for negotiation with the preferred tenderer to confirm financial commitments or other terms contained in the tender by finalising the terms of the contract.

Consensus scoring

If there is a selection stage, panel members must individually score the expression of interest submitted by each economic operator. They must also individually score all the tender proposals submitted at the award stage. Once they have been scored individually, the panel must meet to develop consensus scores. Such meetings encourage open debate among panel members and help ensure nothing is overlooked. The panel must consider each expression of interest/tender against each of the mandatory and discretionary exclusions, minimum requirements/standards, and selection and award criteria used. They should discuss the strengths and weaknesses of each economic operator/tender. The discussion may provide additional insights, correct any misperceptions of individual panel members and, hence, the consensus score arrived at may differ from the initial scores of some panel members.

It should be noted that the final consensus score does not involve the individual panel members changing their original individual scores. The final consensus score is simply the score that the panel members are prepared to agree on. It is imperative that a summary of the reasons for agreeing the consensus score is recorded. The Chairperson will act as Moderator during the consensus meeting and ensure the reasons for the consensus scores are recorded contemporaneously, especially where a consensus score diverges significantly from an individual score. In this way, the notes should provide a clear, transparent and fair summary of the discussions that led to the consensus scores, and give a sufficient account of the reasoning that led panel members to arrive at the consensus scores and comments they did.

The online evaluation functionality in eTendersNI can be used for completing the individual and consensus scoring, and the reasons for them.

These records will provide an audit trail leading up to the decision to award a contract and form the basis of debrief information to be provided to economic operators. The records should be stored in accordance with the contracting authority’s disposal schedule.

Note: Section 98 of The Procurement Act 2023 requires contracting authorities to keep sufficient documentation to justify decisions taken at all stages of the procurement procedure (not just at the evaluation stage); for example, documentation on communications with suppliers and internal deliberations, etc.

Finalise the award process

Notify tenderers and provide feedback

Once the award decision has been internally approved the next step is to notify successful and unsuccessful tenderers. The mandatory standstill period commences once the contracting authority has notified the unsuccessful tenderers.

Before entering into a contract a contracting authority, in accordance with section 50(3) of the Procurement Act 2023 and Regulation 31 of the Procurement Regulations 2024, must provide an assessment summary to each supplier that submitted an assessed tender This notice must contain certain prescribed information; this includes details of the winning tenderer, their own and winning tenderer’s scores

Good feedback to tenderers can be extremely useful to help suppliers to understand what they did well, what they could have done better, and points to consider in the future. Feedback to the unsuccessful tenderers should be based on evaluators’ consensus comments, and should be sufficient to inform each tenderer why they received the score they did. Feedback should be of the same quality for all tenderers.

It is good practice to consider the following in providing feedback to tenderers:

- Include details such as the evaluation approach & scoring criteria, tenderer's and winner's scores and comments for each criterion;
- Use tables to present this information to make it easier for tenderers to understand and act upon;
- Give specific examples from the tender to make feedback more understandable;

Section 3 Appendix I: Calculating the Number of Evaluators Required

In the following example, the commercial lead has estimated that each evaluator will need one week in order to evaluate their part of each bid and that no more than ten tenderers are likely. It is important to test any estimates of time required with the subject matter experts involved.

Based on that information, the commercial lead can work out how many evaluators are potentially required by reference to the time available for evaluation.

	1 bid	2 tenders	3 tenders	4 tenders	5 tenders	6 tenders	…	10 tenders
1 week	2	4	6	8	10	12		20
2 weeks	2	2	4	4	6	6		10
3 weeks	2	2	2	4	4	4		8
4 weeks	2	2	2	2	4	4	…	6

This exercise may lead to a need to revise the wider programme timetable. If only six subject matter expert evaluators are available, but it is thought there may be up to ten tenders, then on this example less than four weeks for evaluation will not be appropriate.

Section 3 Appendix II: Price Per Quality Point

Price per quality point (PQP) is an evaluation technique designed to make it easier to consistently and fairly compare tenders of varying quality and price. It also makes it easier for tenderers to judge how they may score overall.

In this approach a PQP is calculated for each bid by:

- determining the bid price;
- determining the quality score for each bid, expressed as a whole number rather than as a percentage (though the whole number may still be points out of 100); and
- dividing the bid price by the quality score to give an output price per quality point.

$$\frac{\text{Price}}{\text{Quality score}}$$

The number arrived at is the PQP. The bid with the lowest PQP is the MAT.

The chief advantages of PQP as an approach are that:

- it discourages tenderers from simply chasing the lowest price possible, which may not be sustainable and which may distort behaviours during project delivery; and
- it makes it easier to assess value for money, rather than simply cost.

One potential downside of PQP is that highly disparate tenders can result in the same PQP score. This can be mitigated by appropriately structuring the wider evaluation model. In particular, by setting minimum price or quality thresholds (which would need to be disclosed to.

Section 3 Appendix III: Potential Weighting Methodologies

This appendix sets out two potential methodologies for weighting evaluation criteria. The first is known as MoSCoW prioritisation, while the second is a weighting guidelines template that can be used to assist in developing the weightings to attach to each evaluation criterion.

MoSCoW prioritisation

MoSCoW prioritisation means identifying which of the requirements are Must haves, which are Should haves, which are only Could haves, and which are Won't haves. In MoSCoW:

- Must haves are those requirements without which the procurement would not proceed. If you would ultimately go ahead without it it's not a must have;
- Should haves are important requirements which are strongly desired, but the procurement would not be cancelled if they weren't met. It may be that key deliverables would not be met or cumbersome workarounds required, but not to the extent that there would no longer be any point in making an Award;
- Could haves are contingent requirements which are desirable, but which are not particularly critical. They may be areas which you would like delivered in a best case scenario, but which don't form part of your minimum sought requirement;
- Won't haves are requirements that are not being sought in the current procurement, either because they are not a priority (so won't pay more for them) or would actively prefer not to have them (if it is the latter that should be made clear).

With MoSCoW, be particularly careful when setting "Must haves". Failure to meet these will likely result in exclusion, which could discourage innovative solutions.

Weighting guidelines template

The weighting guidelines template provides one method to assist in assigning weightings to the evaluation criteria. The template is used to rank the criteria by giving each individual involved in developing the weightings a vote in the relative importance of criteria. Once the weightings have been calculated in accordance with the mechanism described, the team may discuss further to refine the relative weightings.

For each criterion set out horizontally (1 – 8 etc.):

- each individual is asked whether they consider that criterion is more important than each of the other criteria
- each cell not blanked out is completed by adding how many people considered the criterion more important
- the total number of "votes" for each criterion should then be entered into the "Total" column
- the totals are converted into percentages to arrive at the relative weightings of all of the criteria i.e.(Criteria Total/total Votes) x 100

Table 1: Template

UNWEIGHTED CRITERIA	1	2	3	4	5	6	7	8	Etc.	Total	Weight
1											
2											
3											
4											
5											
6											
7											
8											
Etc.											

Worked example (see Table 2 below):

Three people are involved in considering the evaluation criteria and three criteria are identified: (i) solution quality; (ii) transition approach; and (iii) price. These are entered into the matrix. Each cell not blanked out must be completed.

Reading across row one:

- The first question is, “Is Solution Quality more important than Transition Approach?” Two members of the team vote yes, one votes no. The red figures show how this is entered into the matrix.

- The second question is “Is Solution Quality more important than Price?” Three of the team vote yes. The blue figure three in row one shows how this is entered into the matrix.

- Row one is now complete and row two is partly complete.

Reading across row two:

- The relative importance of Transition Approach to Solution was already considered in the first question.

- The third question is “Is Transition Approach more important than Price?” One of the team votes yes, two vote no. The green figures show how this is entered into the matrix.

Reading across row three, a blue zero is added into column one as the total number of votes in each colour must add up to the total number of people voting. As there were three blue votes in line one, a zero must be added to the first column.

Table 2: Worked Example

UNWEIGHTED FACTORS		1	2	3	Total	Weight
1	Solution Quality		2	3		
2	Transition Approach	1		1		
3	Price	0	2			

Once each cell is completed, the figures in each row are totalled. The purple figures show how this is entered in the matrix. This gives the relative importance of the factors and can be converted into a percentage weighting (see pink text). These weightings are suggested weightings and the team may wish to amend the weightings based on wider considerations.

UNWEIGHTED FACTORS		1	2	3	Total	Weight
1	Solution Quality		2	3	5	(5/9*100) = 56%
2	Transition Approach	1		1	2	(2/9*100) = 22%
3	Price	0	2		2	(2/9*100) = 22%

Section 3 Appendix IV: Standard Financial Ratios

This Appendix provides guidance on the standard ratios and metrics that should be used when assessing the economic and financial standing (EFS) of tenderers and suppliers. Where the tenderer and/or supplier is a VCSE, some alternative ratios have been suggested that consider the different financial priorities within the VCSE sector.

The list is not exhaustive and should be tailored to the particular requirement under procurement. Any ratios used should be transparent, objective, proportionate and non-discriminatory.

The methodology for assessing EFS should be clearly described and any minimum values for ratios and metrics clearly stated in procurement documentation.

Where bidders are asked to insert figures in a response or model, a copy of the underlying financial statements or other document supporting those figures should be sought so that they can be checked if required. A check of all bidders' inputs may be appropriate during the selection stage but should always be performed on the winning bidder. Where the procurement relates to a critical or important (Gold or Silver) contract, checks should be performed on all bidders at the selection stage to mitigate against delay to the procurement.

Bidder commentary / mitigating explanation

Where a bidder's ratio score results in an indicative higher risk classification, there is an opportunity within the Financial Viability Risk Assessment tool for the bidder to provide explanations in the form of mitigating commentary. If an alternative tool is used the same opportunities should be provided to bidders. In addition to those detailed under each metric, other mitigations should also be considered such as those detailed in Section 3 of this guidance

Terminology and locating figures The terms used in the ratio calculations are intended to describe financial statement line items largely found on the face of the primary statements in published accounts; Statement of Financial Position, Statement of Comprehensive Income and Cash Flow Statement; or a Statement of Financial Activities (SoFA) for VCSE suppliers which sets out a charity’s financial performance in line with the charity Statement of Recommended Practice (SORP).

If an entity is not a UK private or public company, the closest matching line item should be used, even if the terminology is slightly different.

Groups

Where the entity is the holding company of a group and prepares consolidated financial statements, the consolidated figures should be used.

Currency conversion

The contracting authority should specify in procurement documentation the exchange rate for conversion to Sterling. This could be specified at current exchange rates (i.e. the rate prevailing at the date of issue of the Procurement Specific Questionnaire) or the rate at the relevant date for which the financial metric is being calculated. The Financial Viability Risk Assessment tool offers space to specify the rate and input non-Sterling figures on the input sheets.

Treatment of non-underlying items

Ratios should generally be based on reported International Financial Reporting Standards (or appropriate accounting framework) from the financial statements.

Where this produces other than a low risk outcome, contracting authorities should permit adjustment for non- underlying items or ‘exceptional’ items, subject to satisfying themselves that the items are material and out of the ordinary course, on the basis that this is likely to provide a better representation of underlying performance. It is recommended that the authorities allow such adjustment after they have engaged with the affected tenderer for additional information around the non-underlying items and the overall financial performance.

A contracting authority may also adjust for non-underlying items which are material and out of the ordinary where this would move the categorisation to a higher risk banding. Where adopted, the contracting authority should:

- include explanation in the procurement documentation,
- disclose the proposed adjustments to the tenderer,

- allow the bidder adequate time to respond and
- appropriately consider any representations the tenderer wishes to make

Note that within the Financial Viability and Risk Assessment tool, exceptional and non-underlying items are not included in ratio calculations where the net total entered is positive (i.e. income). This means operating profit for the purpose of ratio calculation may be less than the operating profit reported as it is net of exceptionals where the total entered is negative.

Accounting periods of other than 12 months: Where metrics are measured for a period rather than at a specific date (for example, operating profit), they should generally be based on figures for periods of 12 months to allow for potential seasonality and comparability. Contracting authorities should discuss the basis of the adjustments with their Finance Teams if any adjustments are required.

Post balance sheet events ('PBSEs'): Tenderers may draw attention to post balance sheet events in explaining why application of a different risk threshold may be more appropriate than that generated by the ratios. Similarly, contracting authorities may adjust for post balance sheet events in preparing proforma ratios.

Modifications of Independent Auditor's Opinions and Reports: Where the Independent Auditor's Opinion on the entity's financial statements is not modified / unqualified or contains additional disclosures[10] contracting authorities should review the qualification or emphasis of matter and decide how to proceed. Additional assurance may be required to confirm the entity's EFS. Particular care should be taken with any auditor commentary in relation to the going concern assumption.

Metric 1 – Turnover Ratio

Assesses whether winning the contract could have such a material impact on the organisation that it might struggle to deliver the contract

Turnover Ratio = Tenderer Annual Revenue / Expected Annual Contract Value

[10] Additional disclosures in the Independent Auditor's reports do not necessarily affect or change the auditor's opinion, which remains unqualified. These include key audit matters, an emphasis of matter and certain disclosures relating to going concern.

Definition

Revenue should be shown on the face of the Income Statement in a standard set of financial statements. It should exclude the entity's share of the revenue of joint ventures or associates.

Interpretation

The Turnover Ratio is used to understand how large the contract is compared to the annual revenue of a tenderer for the contract. A larger number might suggest that the tenderer can accommodate the contract more easily and be better able to deliver the contract.

Where the contact will exceed one year and where the Contract Value is expected to vary over time it is recommended that the highest anticipated Annual Contract Value is utilised in the calculation above.

Benchmark

Turnover thresholds should be set at a reasonable level so as to provide assurance of the capacity of the tenderer to deliver the goods and services required, without imposing inappropriate and unfair barriers to smaller, particularly social sector, suppliers. Contracting authorities should normally not exclude tenderers solely on the basis of the Turnover Ratio, unless the ratio indicates an exceptionally high level of risk and, following clarification and consideration of proportionate mitigations, the authority concludes the risk remains unacceptable

For assessments relating to frameworks, where there is no single estimated contract value, authorities may use an adapted approach. For example, where a supplier seeks to bid for more than one lot, the maximum contract value across all of the relevant agreement lots could be used in place of an estimated contract value.

Potential mitigations

Where application of the test generates a ratio which would fall into the medium or high risk band, potential mitigations could include:

- Extension of the test to the tenderer's wider group where the tenderer is part of a group and the tenderer is supported by a parent company guarantee;

- Inclusion of new contracts won by the tenderer since the publication of its financial results or the full impact of which is not reflected in the financial statements used for the assessment.
- Assessment of historic turnover trends or forward looking order books.

Metric 2 - Operating Margin

Measures what proportion of revenues remain after deducting operating expenses

Operating Margin = Operating Profit / Revenue

Definition

The elements used to calculate the Operating Margin should be shown on the face of the Income Statement in a standard set of financial statements. Figures for Operating Profit and Revenue should exclude the entity's share of the results of joint ventures or associates.

Where an entity has an operating loss (i.e. where the operating profit is negative), Operating Profit should generally be taken to be zero.

Since Operating Margin can vary, the test should normally be based on the higher of (a) the Operating Margin for the most recent accounting period and (b) the average Operating Margin for the last two accounting periods.

Interpretation

Operating Margin is a measure of an entity's profitability or ability to generate a surplus. A higher ratio would normally suggest, other things being equal, that the entity's business is more sustainable and able to withstand any change in business and financial circumstances. Conversely, a low or negative ratio may raise doubts over the sustainability of the business and hence the entity.

Contracting authorities who have completed Should Cost Models should use these as a benchmark to evaluate whether tenderers' may have submitted financially unsustainable tenders.

Benchmark

See standard ratios by sector in '***APPENDIX V – Interpreting standard financial metrics***'.

Potential mitigations

The Operating Margin may not be representative of a tenderer's future profitability and hence sustainability. It may also not reflect a tenderer's mission. Where application of the test generates a ratio which would fall into the medium or high risk band, potential mitigations could include:

- Adjustment for any one-off costs or expenses that unduly affected the Operating Margin for the period(s) under consideration and are unlikely to be repeated to the same extent in future years;
- Adjustment for profitable new business won or loss-making business closed since the publication of its financial results or the full impact of which is not reflected in the financial statements used for the assessment; or
- Recognition that the Operating Margin may not be an appropriate indicator of sustainability where, for example, if the tenderer is a charity or other non-profitmaking organisation with a mission to subsidise provision of services the tenderer may well make a deficit in any one period. Where this is the case it is important to understand the longer term trends, reserve position and what is driving the deficit. A VCSE-specific ratio which considers its reserve position (operating reserve ratio), is included at the end of this appendix.

Metric 3(A)* – Free Cash Flow to Net Debt Ratio

Shows what percentage of the supplier's debt could be repaid in one year if all free cash flow was used to repay debt

* (Metrics 3(A) and 3(B) are alternative measures. Metric 3(A) is more relevant to capital intensive sectors and Metric 3(B) to less capital intensive sectors.)

Free Cash Flow to Net Debt Ratio = Free Cash Flow / Net Debt

Definition

Free Cash Flow = Net cash flow from operating activities – Capital expenditure

Capital expenditure = Purchase of property, plant & equipment + Purchase of intangible assets

Net Debt = Bank overdrafts + Loans and borrowings, including balances owed to other group members + Finance leases + Deferred consideration payable – Cash and cash equivalents, including short-term financial investments

The majority of the elements used to calculate the Free Cash Flow to Net Debt Ratio should be shown on the face of the Statement of Cash Flows and the Balance Sheet in a standard set of financial statements.

- **Net cash flow from operating activities**: This should be stated after deduction of interest and tax paid.

- **Capital expenditure**: The elements of capital expenditure may be described slightly differently but will be found under '*Cash flows from investing activities'* in the Statement of Cash Flows; they should be limited to the purchase of fixed assets (including intangible assets) for the business and exclude acquisitions of other companies or businesses. The figure should be shown gross without any deduction for any proceeds of sale of fixed assets.

- **Net Debt**: The elements of Net Debt may also be described slightly differently and should be found either on the face of the Balance Sheet or in the relevant note to the financial statements. All interest bearing liabilities (other than retirement benefit obligations) should be treated as borrowings as should, where disclosed, any liabilities (less any assets) in respect of any hedges designated as linked to borrowings (but not non-designated hedges). Borrowings should also include balances owed to other group members.

Deferred consideration payable should be included in Net Debt despite typically being non-interest bearing. Cash and cash equivalents should include short-term financial investments shown in current assets.

Where an entity has net cash (i.e. where application of the formula would produce a negative figure), the outcome of the test should be treated as 'low risk' Interpretation. An entity's free cash flow represents the cash generated from its operations which is available for other purposes after ongoing capital expenditure. The Free Cash Flow to Net Debt Ratio effectively shows the proportion of its outstanding net debt (debt less cash), which it could pay off in a year if all its free cash flow went towards repaying debt and is a measure of the tenderer's leverage. A high ratio would normally indicate, other things being equal, that an entity is better able to pay back its debt and/or may be able to take on more debt if necessary. Conversely, a low ratio may raise doubts over an entity's ability to service its existing debt. Where a tenderer is scored as other than low risk, the authority may want to consider whether the tenderer has any supply chain finance or invoice factoring facilities in place,

Benchmark

See standard ratios by sector in 'APPENDIX V – Interpreting standard financial metrics'.

Of note, Free Cash Flow to Net Debt Ratio is less relevant and not commonly used by VCSEs. A more appropriate measure of a VCSE's ability to cover debt would be Operating Cash Ratio which considers current liabilities only; this is detailed at the end of this Appendix.

Potential mitigations

A tenderer's free cash flow for one year in isolation may not be representative of its future ability to generate cash. It may also have other means to service its debt or its debt may not be due for repayment for a significant period. Where application of the test generates a ratio which would fall into the medium or high risk band, potential mitigations could include:

- Adjustment for any one-off costs that unduly affected the free cash flow for the year under consideration and are unlikely to be repeated to the same extent in future years;
- Adjustment for profitable new business won or loss-making business closed since the publication of its financial results or the full impact of which is not reflected in the financial statements used for the assessment;
- Adjustment for exceptionally high capital expenditure which unduly depressed the free cash flow for the year under consideration and is unlikely to be required at the same level in future years;
- A tenderer's ability or plans to repay debt from sources other than the generation of free cash flow from operations, for example through other available unused debt facilities, the sale of an asset or business currently generating limited cash flow or through the use of parent company resources where the tenderer' is a member of a wider group;
- Access to further liquidity, for example, level of undrawn facilities available; access to financial markets and/or new equity through equity markets. If the bidder plans to

repay existing debt with new debt, clarification as to why this would be sustainable should be provided;

- Adjustment for elements of debt or deferred consideration which are only due for repayment in the long-term (for example beyond the maturity of the contract under procurement) or debt which is held with other companies in the same group which is not likely to be required to be repaid;
- Adjustment for changes in relevant financial reporting guidance impacting on financial results. Changes in UK and non-UK financial reporting standards could result in a change in the outcome of the assessment, even though there has been no actual commercial impact on the reporting entity;
- Adjustment for contingent deferred consideration to the extent that the liability is unlikely to crystallise in practice.

Metric 3(B)* – Net Debt to EBITDA Ratio

Shows how many years it would take to repay net debt if EBITDA remained constant and was used in full to repay financial debt

*(Metrics 3(A) and 3(B) are alternative measures. Metric 3(A) is more relevant to capital intensive sectors and Metric 3(B) to less capital intensive sectors. Please see text box below for a new alternative metric for the construction sector).

Net Debt to EBITDA ratio = Net Debt / EBITDA

Definition

Net Debt = Bank overdrafts + Loans and borrowings, including balances owed to other group members + Finance leases + Deferred consideration payable – Cash and cash equivalents, including short-term financial investments

EBITDA = Operating profit + Depreciation charge + Amortisation charge

The majority of the elements used to calculate the Net Debt to EBITDA Ratio should be shown on the face of the Balance sheet, Income statement and Statement of Cash Flows in a standard set of financial statements but will otherwise be found in the notes to the financial statements.

- **Net Debt**: The elements of Net Debt may be described slightly differently and should be found either on the face of the Balance Sheet or in the relevant note to the financial statements. All interest bearing liabilities (other than retirement benefit obligations) should be included as borrowings as should, where disclosed, any liabilities (less any assets) in respect of any hedges designated as linked to borrowings (but not non- designated hedges). Borrowings should also include balances owed to other group members.

Deferred consideration payable should be included in Net Debt despite typically being non-interest bearing.

Cash and cash equivalents should include short-term financial investments shown in current assets.

Where an entity has net cash (i.e. where Net Debt is negative), the outcome of the test should be regarded as '*Low Risk*'.

- **EBITDA**: Operating profit should be shown on the face of the Income Statement and, for the purposes of this test, should include the entity's share of the results of any joint ventures or associates.

The depreciation and amortisation charges for the period may be found on the face of the Statement of Cash Flows or in a Note to the Accounts.

Where EBITDA is negative, the outcome of the test should be regarded as '*High risk*' unless Net Debt is also negative in which case the outcome of the test should be regarded as '*Low Risk'.*

Interpretation

An entity's EBITDA is a proxy for the cash flow it generates from its ongoing operations. The Net Debt to EBITDA Ratio is often used by lenders as a measure of an entity's ability to service its debt. A low ratio would normally indicate, other things being equal, that an entity is better able to pay back its debt and/or may be able to take on more debt if necessary.

Conversely, a high ratio may raise doubts over an entity's ability to service its existing debt. Where a tenderer is scored as other than Low risk, the Authority may want to consider whether the tenderer has any supply chain finance or invoice factoring facilities in place.

Benchmark

See standard ratios by sector in '***APPENDIX V – Interpreting standard financial metrics***'.

Of note, Net Debt to EBITDA ratio is less relevant and not commonly used by VCSEs as EBITDA is not a metric commonly used by VCSEs. As noted previously, a more appropriate measure of a VCSE's ability to cover debt would be Operating Cash Ratio which considers current liabilities only; this is detailed at the end of this Appendix.

Potential mitigations

A tenderer's EBITDA for one year in isolation may not be representative of its future ability to generate cash. It may also have other means to service its debt or its debt may not be due for repayment for a significant period. Where application of the test generates a ratio which would fall into the medium or high risk band, potential mitigations could include:

- Adjustment for any one-off costs that unduly affected EBITDA for the year under consideration and are unlikely to be repeated to the same extent in future years; or
- Adjustment for profitable new business won or loss-making business closed since the publication of its financial results or the full impact of which is not reflected in the financial statements used for the assessment;
- A tenderer's ability or plans to repay debt from sources other than the generation of cash flow from operations, for example through the sale of an asset or business currently generating limited cash flow or through the use of parent company resources where the tenderer is a member of a wider group;
- Access to further liquidity, for example, level of undrawn facilities available; access to financial markets and/or new equity through equity markets. If the tenderer plans to repay existing debt with new debt, clarification as to why this would be sustainable should be provided.
- Adjustment for changes in relevant Financial Reporting guidance impacting on financial results. Changes in UK and non-UK Financial Reporting standards could result in a change in the Red:Amber:Green Ratio result produced by the

FVRA, even though there has been no actual commercial impact on reporting entity.

- Adjustment for elements of debt or deferred consideration which are only due for repayment in the long-term (for example beyond the maturity of the contract under procurement) or debt which is held with other companies in the same group which is not likely to be required to be repaid;

- Adjustment for contingent deferred consideration to the extent that the liability is unlikely to crystallise in practice.

- The use of the bidder's average month-end Net Debt to EBITDA ratio, if the contracting authority believes this could be a better reflection of the entity's financial indebtedness or they are found to be an average net cash position through the year.

Definitions and calculations- average month end Net Debt: Net Debt: Balances owed to other group undertakings + all interest bearing liabilities (other than retirement benefit obligations) + finance leases + deferred consideration payable – Cash and cash equivalents. Note that this does not include hedges linked to borrowings or supply chain finance.

The Average Month End Net Debt is the preceding 13 month-end positions divided by 13.

Metric 4 - Net Debt + Net Pension Deficit/Surplus to EBITDA Ratio

Incorporates an organisation's net pension deficit/surplus into Metric 3

Net Debt + Net Pension Deficit/Surplus to EBITDA ratio = (Net Debt + Net Pension Deficit) / EBITDA

Definition

Net Debt = Bank overdrafts + Loans and borrowings, including balances owed to other group members + Finance leases + Deferred consideration payable – Cash and cash equivalents, including short-term financial investments

Net Pension Deficit = Retirement Benefit Obligations – Retirement Benefit Assets
EBITDA = Operating profit + Depreciation charge + Amortisation charge

The majority of the elements used to calculate the Net Debt + Net Pension Deficit to EBITDA Ratio should be shown on the face of the Balance sheet, Income statement and Statement of Cash Flows in a standard set of financial statements but will otherwise be found in the notes to the financial statements.

Net Debt: The elements of Net Debt may be described slightly differently and should be found either on the face of the Balance Sheet or in the relevant note to the financial statements. All interest bearing liabilities (other than retirement benefit obligations) should be included as borrowings as should, where disclosed, any liabilities (less any assets) in respect of any hedges designated as linked to borrowings (but not non- designated hedges). Borrowings should also include balances owed to other group members

- Deferred consideration payable should be included in Net Debt despite typically being non-interest bearing.
- Cash and cash equivalents should include short-term financial investments shown in current assets
- **Net Pension Deficit**: Retirement Benefit Obligations and Retirement Benefit Assets may be shown on the face of the Balance Sheet or in the notes to the financial statements.

  They may also be described as pension benefits / obligations, post-employment obligations or other similar terms.

  Where calculation of Net Debt + Net Pension Deficit produces a negative figure, the outcome of the test should be regarded as '*Low Risk*'.

  <u>Various events can trigger a mandatory reassessment of the pension fund which could impact the pension deficit (e.g. a change of ownership of the supplier).</u>

- **EBITDA**: Operating profit should be shown on the face of the Income Statement and, for the purposes of this test, should include the entity's share of the results of any joint ventures or associates.

The depreciation and amortisation charges for the period may be found on the face of the Statement of Cash Flows or in a Note to the Accounts.

Where EBITDA is negative, the outcome of the test should be regarded as '*High risk*' unless the Net Debt + Net Pension Deficit calculation also produces a negative figure in which case the outcome of the test should be regarded as '*Low risk*.

Interpretation

Pension deficits have some similarities to debt in that they represent obligations repayable over time on which interest accrues. An entity's EBITDA is a proxy for the cash flow it generates from its ongoing operations. The Net Debt + Net Pension Deficit to EBITDA Ratio measures the scale of an entity's debt and any pension deficit relative to the entity's size. A low ratio would normally indicate, other things being equal, that an entity is better able to pay back its debt and fund its pension fund deficit and/or may be able to take on more debt if necessary. Conversely, a high ratio may raise doubts over the sustainability of the entity.

Benchmark

See standard ratios by sector in '*APPENDIX V – Interpreting standard financial metrics*'.

Potential mitigations

A tenderer's pension deficit may not need to be paid off for many years and may be overstated against its actuarial value. A tenderer's EBITDA for one year in isolation may not be representative of its future ability to generate cash. It may also have other means to service its debt or pension deficit or its debt and pension deficit may not be due for repayment for a significant period. Where application of the test generates a ratio which would fall into the medium or high risk band, potential mitigations could include:

- Adjustment for any one-off costs that unduly affected EBITDA for the year under consideration and are unlikely to be repeated to the same extent in future years; or

- Adjustment for profitable new business won or loss-making business closed since the publication of its financial results or the full impact of which is not reflected in the financial statements used for the assessment;

- A tenderer's ability or plans to repay debt from sources other than the generation of cash flow from operations, for example through the sale of an asset or business currently generating limited cash flow or through the use of parent company resources where the tenderer is a member of a wider group;
- Access to further liquidity, for example, level of undrawn facilities available; access to financial markets and/or new equity through equity markets.
- Adjustment for elements of debt, deferred consideration or pension deficit which are only due for repayment in the long-term (for example beyond the maturity of the contract under procurement) or debt which is held with other companies in the same group which is not likely to be required to be repaid;
- Adjustment for contingent deferred consideration to the extent that the liability is unlikely to crystallise in practice;
- Consider whether the deficit in the most recent triennial valuation (as adjusted for subsequent deficit recovery payments) is significantly lower than that shown for accounting purposes.
- Check the date for the next triennial valuation and whether an updated pension deficit repayment plan, including annual outlays, has been agreed after the publication of the latest accounts used for the EFS assessment.

Metric 5 - Net Interest Paid Cover/Times Interest Earned

A measures of how many times an organisation can cover its annual interest payments out of its available earnings

Net Interest Paid Cover = Earnings Before Interest and Tax / Net Interest Paid

Definition

Earnings Before Interest and Tax = Operating profit

Operating profit should be shown on the face of the Income Statement in a standard set of financial statements and, for the purposes of this test, should include the entity's share of the results of any joint ventures or associates. Where the entity has an operating loss (i.e. a negative operating profit), operating profit should generally be taken to be zero.

Interest paid should be shown on the face of the Cash Flow statement.

Interpretation

Interest Paid Cover measures how easily an entity can pay interest on its debt out of the profits it generates from its operations, and therefore provides a measure of the entity's solvency. A higher number would normally indicate, other things being equal, that the entity is better able to service interest on its debt, and/or is more likely to be able to borrow additional money if required. Conversely, a low figure may raise doubts over an entity's ability to service the interest on its existing debt.

Benchmark

See standard ratios by sector in '***APPENDIX V – Interpreting standard financial metrics***'.

Potential mitigations

A tenderer's EBIT for one year in isolation may not be representative of its future EBIT. A tenderer may also have plans to repay its debt from other sources reducing the level of future interest or the interest may be rolled up and not due for payment until a future date. Where application of the test generates a ratio which would fall into the medium or high risk band, potential mitigations could include:

- Adjustment for any one-off costs that unduly affected EBIT for the year under consideration and are unlikely to be repeated to the same extent in future years; or
- Adjustment for profitable new business won or loss-making business closed since the publication of its financial results or the full impact of which is not reflected in the accounts used for the assessment; or
- A tenderer's plans to repay debt, for example through the sale of an asset or business currently generating limited profits or through the use of parent company resources where the tenderer is a member of a wider group; or
- Access to further liquidity, for example, level of undrawn facilities available; access to financial markets and/or new equity through equity markets. If the tenderer plans to repay existing debt with new debt, clarification as to why this would be sustainable should be provided.

Metric 6 - Acid Ratio / Quick Ratio

A liquidity ratio which measures an organisation's ability to use Cash and other assets it can quickly translate into cash to meet short-term liabilities falling due

Acid Ratio = (Current Assets – Inventories)/ Current Liabilities

Definition

All elements that are used to calculate the Acid Ratio are available on the face of the Balance Sheet in a standard set of financial statements.

Interpretation

The Acid Ratio (also commonly referred to as The Quick Ratio) provides a measure of an entity's ability to meet its short term liabilities. A high ratio would normally suggest, other things being equal, that it can more easily meet its liabilities as they fall due. Conversely, a low ratio may raise doubts over its ability to meet its liabilities as they fall due.

Benchmark

See standard ratios by sector in '***APPENDIX V – Interpreting standard financial metrics***'.

Potential mitigations

The Acid Ratio ignores inventories and focuses just on an entity's more liquid assets relative to its short-term liabilities. It ignores the availability of other sources of funding with which to pay short-term liabilities, the possibility that its inventory may be capable of swift realisation and an entity's ability to take credit from its suppliers. Where application of the test generates a ratio which would fall into the medium or high risk band, potential mitigations could include:

- A tenderer's ability to raise cash through new borrowings, equity issuance, the sale of an asset or the use of parent company resources where the tenderer is a member of a wider group;
- A tenderer's stock turn, i.e. the speed with which it can sell its inventory to raise cash;

- The nature of the tenderer’s short-term liabilities which may include creditors and accruals not immediately due for settlement.

The nature and level of the tenderer’s deferred income in current liabilities.

Metric 7 - Net Asset Value

The value of all of an organisation’s assets minus all of its liabilities.

Net Asset Value = Net Assets

Definition

Net Assets are shown (but sometimes not labelled) on the face of the Balance sheet of a standard set of financial statements. Net Assets are sometimes called net worth or Shareholders’ Funds. They represent the net assets available to the shareholders. Where an entity has a majority interest in another entity in which there are also minority or non-controlling interests (i.e. where it has a subsidiary partially owned by outside investors), Net Assets should be taken inclusive of minority or non-controlling interests (as if the entity owned 100% of the other entity).

Interpretation

The Net Asset Value provides a basic view of whether an entity’s assets exceed its liabilities and its overall solvency. Where an entity has a negative Net Tangible Asset Value this may suggest the business and hence the entity is less sustainable in the event of any deterioration in performance.

Benchmark

See standard ratios by sector in ‘***APPENDIX V – Interpreting standard financial metrics***’.

Potential mitigations

The value of an entity’s Net Assets provides a very basic assessment of its worth. Assets are stated at accounting values which may be substantially higher or lower than their market or realisable values, particularly in the case of non-current assets.

The test provides no indication of an entity's ability to pay its creditors as they fall due, with no recognition of its ability to generate funds, of the funding available to an entity or of when liabilities are due for payment.

Where application of the test would suggest medium or high risk, potential mitigations could include:

- Considering the value of any intangible assets such as goodwill which have not been included in the balance sheet (although the value of purchased goodwill is included in balance sheets, the value of self-generated goodwill is not);
- Considering any other assets (for example property) which may have been included at an undervalue;
- Considering the ability of the entity to generate EBITDA sufficient to meet its liabilities as they fall due;
- Considering other sources of funding available to the entity.

Tenderers should normally not be eliminated on the basis of the Net Asset Value test alone.

Metric 8 - Group Exposure Ratio

Measures the ability of the tenderer to withstand the non-recovery of balances owed to it by other members of the group and/or the crystallisation of contingent liabilities linked to the wider group.

Group Exposure Ratio = Group Exposure / Gross Assets

Definition

Group Exposure = Balances owed by Group Undertakings + Contingent liabilities assumed in support of Group Undertakings

Gross Assets = Fixed Assets + Current Assets

Group Exposure: Balances owed by (i.e. receivable from) Group Undertakings are shown within Fixed assets or Current assets either on the face of the Balance Sheet or in the relevant notes to the financial statements. In many cases there may be no such balances, in particular where an entity is not a member of a group or is itself the ultimate holding company of the group.

Contingent liabilities assumed in support of Group Undertakings are shown in the Contingent Liabilities note in a standard set of financial statements. They include the value of guarantees and security given in support of the borrowings of other group companies, often as part of group borrowing arrangements. Where the contingent liabilities are capped, the capped figure should be taken as their value. Where no cap or maximum is specified, the outcome of the test should automatically be regarded as '*High risk*'.

In many cases an entity may not have assumed any contingent liabilities in support of Group Undertakings, in particular where an entity is not a member of a group or is itself the ultimate holding company of the group.

Gross Assets: Both Fixed assets and Current assets are shown on the face of the Balance Sheet

Interpretation

This test is relevant to subsidiaries and controlled entities which may have exposures (actual or contingent) to wider group entities whose results are not reflected in the entity's own financial statements. The test is designed to establish whether an entity could withstand a significant adverse event elsewhere within the group of which it is a member; such an event could lead to the non-recovery of balances owed to it by other group members or to the crystallisation of a contingent liability linked to the wider group (e.g. a call under a guarantee).

Where Group Exposure represents a high or uncapped percentage of an entity's Gross Assets, this suggests the entity is more exposed to the performance or position of other entities within its wider group. Typical exposures arise where an entity is a member of a borrowing group the members of which have provided cross guarantees and/or security to the lender.

Benchmark

See standard ratios by sector in '***APPENDIX V – Interpreting standard financial metrics***'.

Potential mitigations

The value of an entity's Gross Assets may be a poor reflection of the size and value of the entity. Where application of the test would suggest medium or high risk, potential mitigations could include:

- A comparison of Group Exposure relative to the size of the tenderer as measured by should the next line be a continuance of this Revenue or Operating profit rather than Gross Assets;

- Inclusion within Gross Assets of the value of any intangible assets such as goodwill which have not been included in the balance sheet (although the value of purchased goodwill is included in balance sheets, the value of self-generated goodwill is not).

Where an entity has uncapped exposure to wider group entities, the solution is often to seek a parent company guarantee. Other potential mitigations might include:

Analysis of the EFS of those other group entities to which the entity is exposed to determine whether or not the risk of an exposure crystallising is limited (for example, an entity may be a member of a borrowing group and act as guarantor of its parent company's drawings under a debt facility but the facility itself is capped or is unlikely to be drawn down).

VCSE Metric 1 – Operating Reserve Ratio

Assesses how long the organisation can continue to operate without funding

Operating Reserve Ratio = (Unrestricted Net Assets / Expenditure) x 12

Definition

Unrestricted Net Assets: Unrestricted assets are assets (fixed and current) that the VCSE can use for any operating purpose or general expenditure; its use is not restricted to a particular charitable purpose - hence the term "unrestricted." Liabilities are subtracted to derive the unrestricted net asset value. This value can be found on the Balance Sheet; it equates to the VCSE's Total Unrestricted Funds which is detailed within the separate Funds / Reserves section.

Expenditure: Total expenditure can be found on the Statement of Financial Activities (SoFA) directly below the income activities. It includes expenditure on raising funds, charitable activities and other.

Interpretation

The Operating Reserve Ratio is used to measure the number of months that expenditure could be covered by reserve funds which are not otherwise tied up for a specific purpose, should the VCSE / charity cease receiving donations or incur an unexpected expense or event.

A high ratio would normally suggest, other things being equal, that it can more easily maintain its current levels of expenditure.

Benchmark

A higher ratio indicates a stronger financial position and suggests the VCSE has sufficient operating reserves to provide a safety net for unforeseen circumstances such as loss of funding, unexpected expenses or a crisis. Three months is considered reasonable for a VCSE. Anything above that is lower risk while anything below that, or a downward trend, could indicate a higher financial risk.

Potential mitigations

Where application of the test generates a ratio which would fall into the medium or higher risk band, potential mitigations could include:

- Extension of the test to the bidder's wider group where the bidder is part of a group and is supported by a parent company guarantee;

- Assessment of the costs included in the annual expenses. For instance, to ascertain if significant one-off expenses - where information is available as to what they relate to - could be excluded, or whether any expenses could be supported through other sources e.g. National Portfolio funding;

- Consideration of financial controls, monitoring and reporting processes in place to ensure effective financial management of the organisation;

- Review of future cash flow forecasts and/or activity plans to ascertain future income, expenditure and any potential financial risk.

VCSE Metric 2 –Operating Reliance Ratio

Assesses how efficiently an organisation is using its funds to fulfil its mission

Operating Reliance Ratio = Unrestricted Income / Expenditure

Definition

Unrestricted Income: This refers to income/funds that are not restricted to a particular charitable purpose and can be spent as the charity sees fit, hence the term “unrestricted.” (The alternative is “restricted” income which can only be used for a specific charitable purpose). The split between unrestricted and restricted income can be found on the Statement of Financial Activities (SoFA).

Expenditure: This is the annual expenditure on charitable activities and raising funds. The value can be found on the Statement on Financial Activities (SoFA) directly below the income activities.

Interpretation

The Operating Reliance Ratio is used to assess: (a) financial sustainability - an indication to donors and stakeholders that the organisation can sustain itself through core activities and that restricted contributions will be used for intended key missions rather than basic operational needs; (b) expense management - how effectively the organisation is at controlling expenses in line with income; (c) resource allocation - how reliant the organisation is on restricted versus unrestricted funds. A high ratio would normally suggest, other things being equal, that it can more easily generate the required levels of income to meet its expenditure.

Benchmark

A VCSE should be aiming for a ratio of 1.0 or higher; this indicates that the organisation can sustain its operations through its unrestricted income (i.e. there is sufficient unrestricted income to cover its operating expenses); the higher the ratio (above 1.0), the more desirable, as it indicates greater financial independence. A ratio below 1.0 suggests that the organisation is struggling to meet its expenses with unrestricted income which could be an indication of poor expense management.

Potential mitigations

Where application of the test generates a ratio which would fall into the medium or higher risk band, potential mitigations could include:

- Extension of the test to the bidder's wider group where the bidder is part of a group and is supported by a parent company guarantee;
- Assessment of the organisation's funding options to ascertain whether there are any additional sources of income that have not previously been considered e.g. affordable lending, philanthropic income;
- Consideration of the financial controls, monitoring and reporting processes to review expense management efficacy, and notably whether restricted funds are being used for their designated purposes;
- Review of future cash flow forecasts and/or activity plans to ascertain future income, expenditure and any potential financial risk.

VCSE Metric 3 –Donations & Legacy Reliance Ratio

Assesses financial security, how well funded the organisation is and the stability / diversity of its income

Donations & Legacy Reliance Ratio = Donations and Legacy Income / Total Income

Definition

Donations & Legacy Income: A VCSE must classify its income by source or funding stream within its Statement of Financial Activities (SoFA). This splits income into one of five standard sources: donations and legacies, charitable activities, other trading activities, investments and other income. A further breakdown of income by specific activity will be included within the VCSE's accompanying statement notes. Within the SoFA, donations and legacies relate to income received by the charity as a gift made on a voluntary basis; it may be restricted (given for a specific purpose) or unrestricted. Total Donations & Legacy Income should be used for the calculation.

Total Income: This is the total of all income activities and funds, both restricted and unrestricted. The value can be found on the Statement of Financial Activities (SoFA).

Interpretation

The Donations & Legacy Income Reliance Ratio is used to assess an organisation's financial security, whether it receives sufficient and stable funding and its reliance on different income sources. It is important to understand a VCSE's different funding sources including grants, and particularly the proportion of unearned versus earned income. As donations and legacies are voluntary, they are a riskier and more unreliable source of income versus other income sources which are usually steadier by nature.

Grants fit under one of two funding categories:

- Grants and Legacies: grants that provide core funding or are of a general nature;
- Charitable activities: grants specifically for the provision of goods or services as part of charitable activities or services to beneficiaries (including performance-related grants). A low ratio would normally suggest, other things being equal, that the entity has a more diverse income stream, and would be better able to manage a reduction in donations of legacies.

Benchmark

While the ideal income mix depends on the organisation's size, mission and age, income earned through charitable activities, contracted services, trading and investments can be viewed as a less risky and steadier source of income which demonstrates a cost disciplined business model. There is no set criteria for donations and legacies versus other sources of income, however a possible benchmark could be no more than 30 percent derived from donations and legacies which can be viewed as a riskier and more unreliable source.

Potential mitigations

Where application of the test suggests over reliance on donations and legacies, potential mitigations could include:

- Extension of the test to the bidder's wider group where the bidder is part of a group and is supported by a parent company guarantee;
- Consider forecasts and future strategy for the organisation encompassing any new / additional income streams;
- Assessment of the organisation's funding options to ascertain whether there are any additional sources of income that have not previously been considered e.g. affordable lending, philanthropic income;

- Assessment of the income sources to ascertain the number of streams within each one. For instance, where there is a significant reliance on donations and legacies, a large number of different donors may be less risky than a reliance on a single donor. Similarly, where there is a significant reliance on charitable activities, a large number of charitable activities may be less risky than one core activity.

VCSE Metric 4 –Operating Cash Ratio

Assesses if the VCSE has sufficient cash flow to manage its core business activities and deliver throughout the lifetime of the contract.

Operating Cash Ratio = Net Cash Flow from Operations / Current Liabilities

Definition

Net Cash Flow from Operations: The net cash flow from operating activities can be found on the Statement of Cash Flow. It includes regular fundraising, grants and trading activities; it excludes cash inflow/outflow from investments and disposals which are listed separately in the Statement of Cash Flow.

Current Liabilities: Listed as 'creditors: amounts falling due within one year' on the Balance Sheet. This includes amounts owed to third parties but not yet paid (such as accruals for grants payable, trade creditors, bank loans and overdrafts, taxation and social security).

Interpretation

The Operating Cash Ratio is used to measure the number of times a VCSE can pay off current liabilities with net cash flow from operations calculated on a rolling 12-month basis. It helps assess how readily the VCSE can cover its short term liabilities using cash from day to day operations; it is in indication of its liquidity and therefore how easily it can fulfil contract deliverables.

A high ratio would normally suggest, other things being equal, that it can more easily meet its liabilities as they fall due.

Benchmark

A VCSE should be aiming for a ratio of 1.0 or higher; this implies that the organisation is able to manage its core business activities and maintain liquidity; an indication that it will have sufficient cash flow to fulfil contract deliverables based on current funding. A ratio below 1.0 suggests that the organisation is not managing its cash flow for day-to-day operations and contract deliverables over time could be at risk.

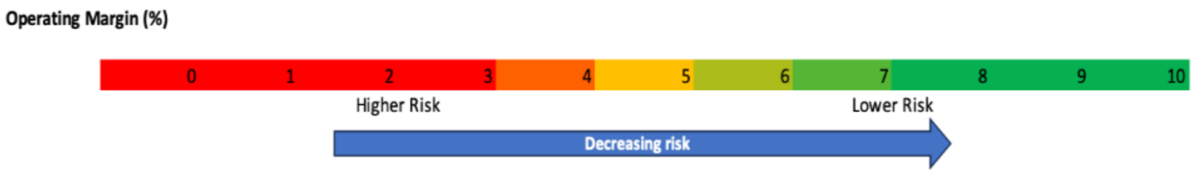
Potential mitigations

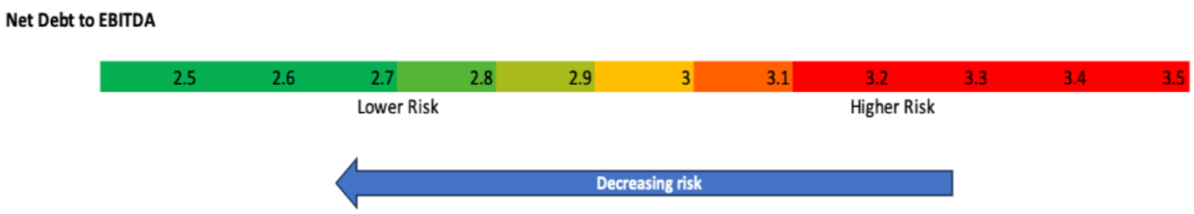
Where application of the test generates a ratio which would fall into the medium or higher risk band, potential mitigations could include:

- Extension of the test to the bidder’s wider group where the bidder is part of a group and is supported by a parent company guarantee;
- Consider payment mechanisms (eg, payment schedules, milestone payments) and if they can be changed to enhance cashflow;
- Consider cash in hand (in the ‘cash and cash equivalents’ section of the balance sheet) as an additional source to pay off the liabilities;
- Review of future cash flow forecasts and/or activity plans to ascertain future income, expenditure and any potential financial risk.

Section 3 Appendix V: Interpreting Standard Financial Metrics

Interpreting standard financial metrics - Risk categories by sector and criticality of procurement. These values represent a scale of risk rather than a prescribed threshold. For example, the table below should be interpreted as followed for the presented metrics:





Mitigations should be considered when a bidder’s EFS begins to move into the higher risk of the spectrum but should be proportional to the requirement and criticality of the contract.

The following tables should be used to determine the level of risk associated with a bidder/supplier following the application of standard financial assessments.

Sector	Metric	Lower risk	Decreasing risk	Medium risk	Increasing risk	Higher risk
All sectors (save where shown separately below)	Metric 1 - Turnover Ratio	>2.0x	>1.5x	<1.5x	<1.5x	<1.0x
	Metric 2 - Operating Margin	>10.0%	>7.5%	7.5%	<7.5%	<5.0%
	Metric 3(A) - Free Cash Flow / Net Debt	>15.0%	>10%	10.0%	<10.0%	<5.0%
	Metric 3(B) - Net Debt / EBITDA	<2.5x	<3.0x	3.0x	>3.0x	>3.5x
	Metric 4 - Net Debt + Net Pension Deficit / EBITDA	<4.0x	<4.5x	4.5x	<4.5x	>5.0x
	Metric 5 - Interest Paid Cover	>4.5x	>3.75x	3.75x	<3.75x	<3.00x

	Metric 6 - Acid Ratio	<1.00x	>0.9x	0.9x	<0.9x	<0.8x
	Metric 7 - Net Assets	>0	N/A	N.A	N/A	<0
	Metric 8 - Group Exposure Ratio	<25.0%	<37.5%	37.5%	>37.5%	>50.0%

Sector	Metric	Lower risk	Decreasing risk	Medium risk	Increasing risk	Higher risk
Construction, Engineering and Facilities management	Metric 2 - Operating Margin	>4.0%	>3.0%	3.0%	<3.0%	<2 .0%
	Metric 3(B) - Net Debt / EBITDA[11]	< 1.0x	<1.5x	1.5x	1.5x	>2.0x
	Metric 4 - Net Debt + Net Pension Deficit / EBITDA	<2.5x	<3.0x	3.0x	>3.0x	<3.5x

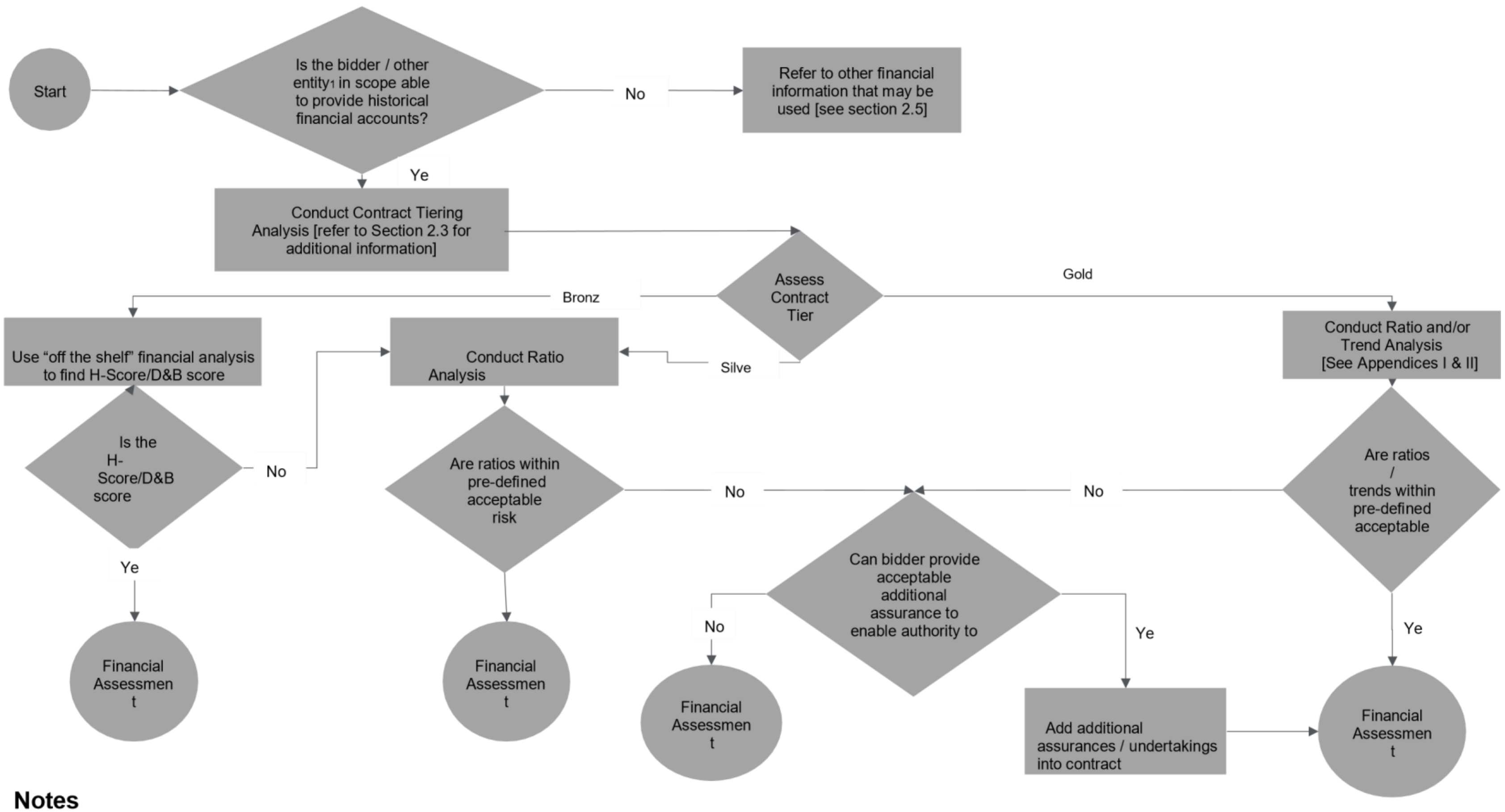
[11] Bidders are encouraged to submit an alternative metric in conjunction with the FVRA tool

Sector	Metric	Lower risk	Decreasing risk	Medium risk	Increasing risk	Higher risk
Information Technology and Telecoms	Metric 3(B) - Net Debt / EBITDA	<3.00x	<3.25x	3.25x	>3.25x	>3.50x
	Metric 4 - Net Debt + Net Pension Deficit / EBITDA	<4.50x	4.75x >	4.75x	>4.75x	>5.00x

Sector	Metric	Lower risk	Decreasing risk	Medium risk	Increasing risk	Higher risk
VCSE	VCSE Metric 1 - Operating Reserve Ratio	>4.0x	<3.0x	3.0x	<3.0x	<2.0x
	VCSE Metric 2 - Operating Reliance Ratio	<1.00x	>0.75x	0.75x	<0.75x	<0.50x
	VCSE Metric 3 - Donations & Legacy Reliance Ratio	<30.0%	<40.0%	40.0%	>40.0%	>50.0%
	VCSE Metric 4 - Operating Cash Ratio	>1.0x	>0.75x	<0.75x	<0.75x	<0.50X

Section 3 Appendix VI: Financial Assessment Flowcharts

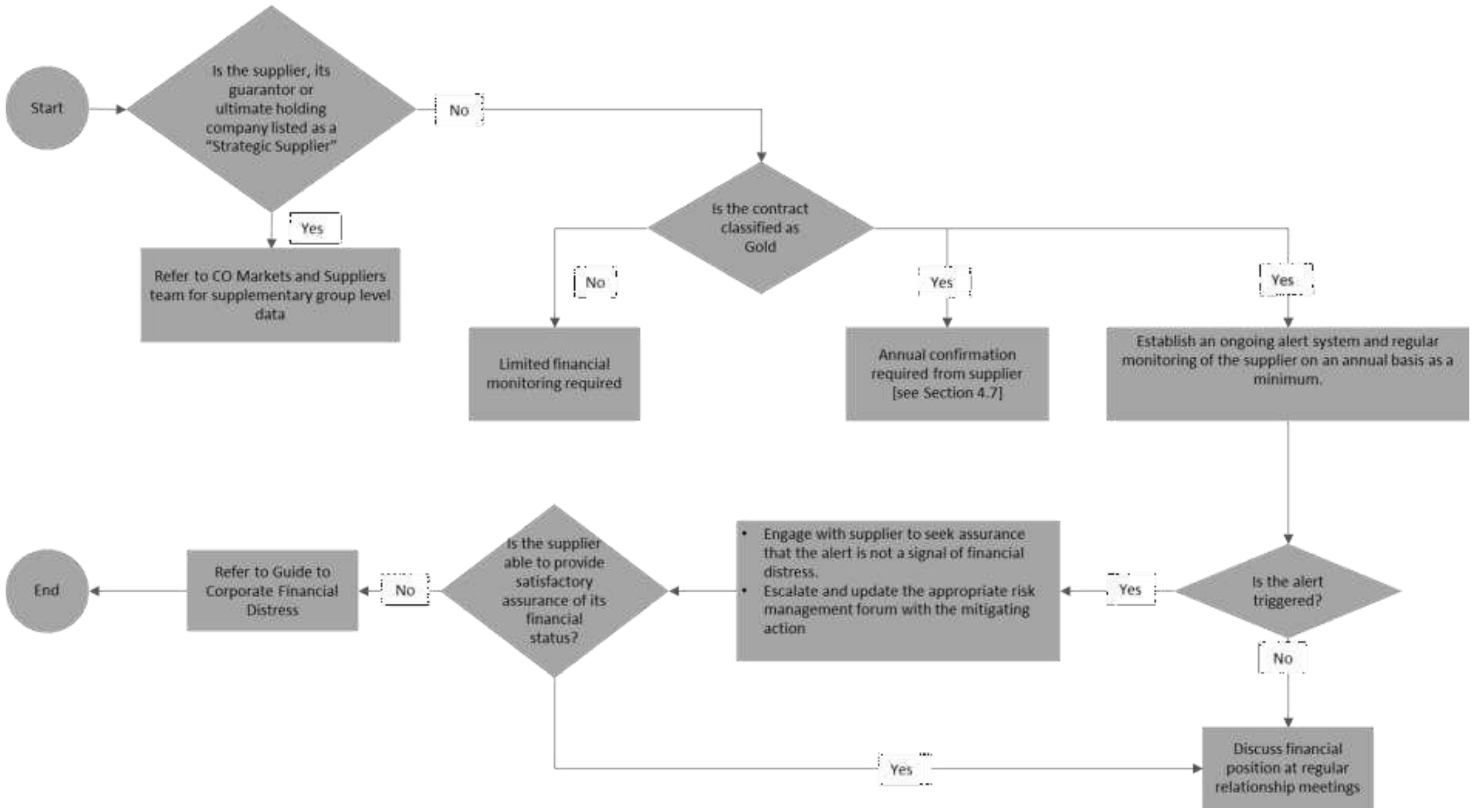
Financial Testing Tree Part 1 – Financial Assessment of Tenderers



Notes

(1) Other entities in scope may include the guarantor and any key sub-contractors

Financial Testing Tree Part 2 – In Contract Financial Modelling



Section 3 Appendix VII: Comparison of Credit Ratings issued by different Rating Agencies

<table>
<tr><th colspan="2">Moody’s</th><th colspan="2">Standard & Poor’s</th><th colspan="2">Fitch</th><th></th></tr>
<tr><th>Long-term</th><th>Shortterm</th><th>Long-term</th><th>Shortterm</th><th>Long-term</th><th>Shortterm</th><th></th></tr>
<tr><td>Aaa</td><td rowspan="6">P-1</td><td>AAA</td><td rowspan="4">A-1+</td><td>AAA</td><td rowspan="4">F1+</td><td>Prime</td></tr>
<tr><td>Aa1</td><td>AA+</td><td>AA+</td><td rowspan="3">High grade</td></tr>
<tr><td>Aa2</td><td>AA</td><td>AA</td></tr>
<tr><td>Aa3</td><td>AA-</td><td>AA-</td></tr>
<tr><td>A1</td><td>A+</td><td rowspan="2">A-1</td><td>A+</td><td rowspan="2">F1</td><td rowspan="3">Upper medium grade</td></tr>
<tr><td>A2</td><td>A</td><td>A</td></tr>
<tr><td>A3</td><td rowspan="2">P-2</td><td>A-</td><td rowspan="3">A-2</td><td>A-</td><td rowspan="2">F2</td></tr>
<tr><td>Baa1</td><td>BBB+</td><td>BBB+</td><td rowspan="3">Lower medium grade</td></tr>
<tr><td>Baa2</td><td rowspan="2">P-3</td><td>BBB</td><td>BBB</td><td rowspan="2">F3</td></tr>
<tr><td>Baa3</td><td>BBB-</td><td>A-3</td><td>BBB-</td></tr>
<tr><td>Ba1</td><td rowspan="2">Not Prime</td><td>BB+</td><td rowspan="2">B</td><td>BB+</td><td rowspan="2">B</td><td rowspan="2">Non-investment grade</td></tr>
<tr><td>Ba2</td><td>BB</td><td>BB</td></tr>
</table>

Ba3		BB-		BB-		speculative
B1		B+		B+		Highly speculative
B2		B		B		
B3		B-		B-		
Caa1		CCC+	C	CCC+	C	Substantial risks
Caa2		CCC		CCC		
Caa3		CCC-		CCC-		
Ca		CC		CC		Extremely speculative
		C		C		Default imminent
C		RD	D	DDD	D	In default

Section 3 Appendix VIII: 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 short- term 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 short-term 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

Section 3 Appendix IX: Clarification Road Map

Use of the FVRA tool, or other applicable assessment tools, can assist contracting authorities in capturing tenderers' financial results in a standard format and highlighting where the tenderer would initially be assessed as Medium (Amber) or High (Red) risk against tested the pre-determined risk thresholds.

FVRA outputs on their own, however, shall not be viewed as a decision tool to progress or automatically eliminate tenderers flagged from the procurement process. Rather, FVRA outputs should be used by contracting authorities to inform dialogue with tenderers in the clarification stage, helping to 'get behind' these results and assess whether and how these risks might be mitigated going forward.

While every situation will be different, there are checks the contracting authority should perform:

Step 1 – Arithmetic checks

Red or Amber ratio results could reflect incorrectly input financial information.

- **High level Balance Sheet check** by reviewing the 'Financial Input' sheets to confirm that the 'Assets less current liab.' total is the same as the 'Capital employed' total. For Private companies these are found on Rows 75 and 91, for Charities / Voluntary Sector Organisations on Rows 52 and 64. Where these totals do not agree a tenderer will have typically omitted or erroneously entered a balance sheet input.

- **Spot checks of individual FVRA cell inputs to source accounts.** Select c10-15 individual FVRA cell inputs across the three financial years and tick back to source accounts. Follow up noted variances with tenderers.

Arithmetic checking will frequently highlight obvious inputting errors – figure input in £s rather than £000s etc. Tenderers shall always be asked to confirm the error and resubmit FVRA however, to provide a robust procurement audit trail.

Step 2 – Review FVRA Assessment Tabs – identify trends

Having completed arithmetic checks, a sensible first step is to review the black

'Assessment' tabs with prefix 3 in the FVRA. Look to see this as a one-off or a trend across the three financial years. A trend, especially downwards, will be of greater concern.

The Assessment tabs also contain yellow fields where tenderers are asked to provide comments on FVRA results. Authorities should exercise critical judgement in reviewing these and use clarification questions to confirm understanding. Where tenderer explanations are felt to be confusing or jargon-heavy further clarification should be sought.

Step 3 – Ask targeted clarification questions that provide tenderers with the opportunity to provide mitigating explanations or evidence

A good clarification question will:

- Clearly specify the source of the concern
- Ask why this is the case
- Probe how the tenderer is seeking to address the issue raised
- Invite additional evidence to be provided as required. Where a significant period of time has passed since the tenderer last published financial accounts (as in the example below) Authorities might consider asking tenderers for latest Management Accounting data to confirm that these are consistent with narrative explanations provided. For example:

"We note that XYZ's Interest Paid Cover Ratio has declined across the 3 year period from Green in 2017 to Amber in 2018 and now Red in the year to March 2019. Please explain key reasons for this movement and how XYZ has / is seeking to address. Please support your response with Management Accounting or other applicable evidence."

In defining clarification questions Authorities should always be mindful of not suggesting answers to the question they are asking.

Tenderers can be asked to provide wider ratio analysis to supplement core FVRA outputs.

- Average month-end Net cash or average month-end Net Debt to EBITDA alongside Net Debt to EBITDA (this is relevant for Construction, see **Appendix I**)

- Current Ratio alongside Quick Ratio

Step 4 – Review initial clarification responses and ask further clarification questions as required, ahead of final decision

Procurement timetables will inevitably limit time available for clarifications, but as a minimum Authorities should allow for two rounds of clarifications to ensure that an informed decision can be reached.

In reviewing tenderer clarification responses, Authorities should ask themselves the 'So What?' question. Specifically, has the response provided a sufficient level of comfort that the tenderer has sufficient mitigations in place in relation to the Red or Amber ratio output. In making this assessment, Authorities may find useful guidance in the 'Potential Mitigations' section for each of the eight standard FVRA ratios as set out at **Appendix I** to this document.

Where tenderers are not yet felt to have addressed concerns raised satisfactorily, Authorities should now consider whether they should be asked to commit to relevant mitigations as a condition of being taken forward. This could, for example, involve asking tenderer to agree to an enhanced or more regular financial monitoring if they were awarded the contract / placed on the framework. Authorities should be mindful that tenderers may more willingly agree to these additional commitments whilst still in a competitive procurement, than when appointed preferred tenderer.

Authorities should ensure that any such additional commitments agreed to by the tenderer in the procurement appear in any contract awarded to the tenderer, should the tenderer be successful.

Section 3 Appendix X: Impact of IFRS on Assessing Financial Standing of Suppliers

Introduction:

IFRS 16 has been introduced in order to increase the visibility of off-balance sheet arrangements and to increase the transparency in financial reporting of leases, replacing IAS 17.

Although the introduction of new accounting policies should not affect the fundamental valuation of a company, as there is no change to the underlying cash flows generated by the business, IFRS 16 will have an impact on key valuation and financial health metrics.

With reference to the guidance in **Appendix III** about using appropriate in-house/external expertise when assessing EFS, it is recommended that contracting authorities, in conjunction with such experts (who should have appropriate knowledge of financial reporting standards), consider this Note and information referred to in it at appropriate points in a procurement process, including when:

- Preparing EFS questions;
- Assessing tenderer EFS responses and supporting information;
- Responding to EFS clarification questions raised by tenderers: *Tenderers should be able to see their risk classification as they complete their financial assessment so they can provide further information to the authority if required to explain why application of a different risk classification would be more appropriate. The impact of the change in accounting standards, such as IFRS 16), can be a reason for a different risk classification.*
- Raising EFS clarification questions of tenderers.
- Making a decision regarding a tenderer's EFS at any stage in the procurement process, whether at selection stage or any later stage in the process, (e.g. if concerns about a tenderer's EFS arise subsequently).

Key Principles:

The new accounting standard sees the introduction of an amortising lease liability (equal to the present value of lease payments) with a corresponding *Right of Use (RoU) Asset* for nearly all leases. As a result, operating lease rent is removed from EBITDA and replaced with depreciation of the RoU Asset and finance interest costs with the lease liability.

The accounting standard is effective for financial periods beginning on or after 1 January 2019, replacing the previous leases standard, IAS 17. There are 3 transition options available on adoption, these are:

1) Retrospective: restatement of all comparatives as if IFRS 16 had always applied; and

2a) Cumulative Catch-up: leave comparatives as previously reported and calculate the outstanding liability with the incremental borrowing rate at date of transition; and

2b) Cumulative Catch-up: leave comparatives as previously reported and measure the asset at an amount equal to the liability.

As a result of the transition arrangements under 2a and 2b, there will not be comparative years from which financial metrics can be analysed for trends and due to the difference in transition approach there may be challenges in ensuring fair treatment of tenderers during the tendering process where the risk classification of tenderers' financial results are materially affected by the change in the accounting standard. There may also be challenges with comparability between companies within the same industries when benchmarking a company's EFS as a result of the differences in transition arrangements.

It shall also be noted that many lending covenants have been established, and will continue to apply in many cases, on a pre-IFRS 16 basis. As a result, it is paramount to understand the basis upon which financial analysis should be performed and to acknowledge that the impact of IFRS 16 will vary as a result of not only companies' lease portfolios but also their lending agreements and transition approach. One shall also note that IFRS 16 may not be applicable for all companies due to their accounting frameworks (i.e. FRS 102 exemptions) and jurisdictions. IFRS 16 applies to all companies applying IFRS but those under UK GAAP may, but are not required to, apply the change in accounting standards.

Under US GAAP, companies will report both operating and finance leases on balance sheet, in line with IFRS 16, but maintaining separate classification which can enable comparability of results with previous years. However, ASC 842 continues to treat lease payments as an operating expense and therefore there is no change in how the income statement is reported.

Impacts to Consider:

The IFRS 16 is likely to affect materially 6 of the financial ratios used in the FVRA

- Operating margin
- Net debt/ EBITDA
- Free cash flow/ Net debt
- (Net debt + net pension deficit) /EBITDA
- Net interest paid cover
- Net assets

EBITDA is likely to increase as rental costs, which reduce earnings before interest and tax, are removed and replaced by interest costs and depreciation which are explicitly excluded from the accounting metric[12]. Initial work undertaken implies this could be as much as 10% across listed companies.

It is also expected that Net Debt will increase as a result of an additional lease liability being included in net debt and thus increasing leverage within an organisation. This is likely to be higher at an average of c.16%[13], leading to an overall increase in Net Debt to EBITDA ratios.

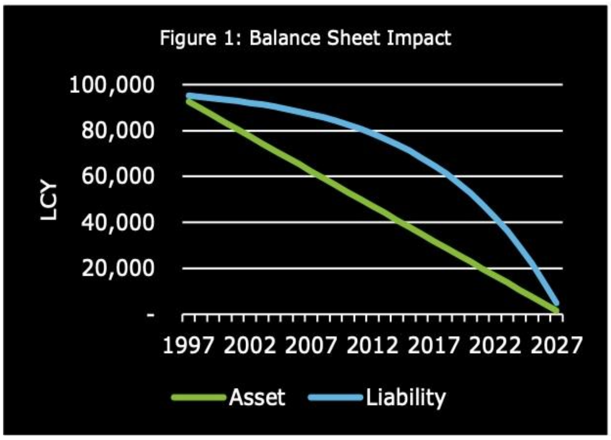
There will be volatility introduced into profit before tax (PBT) due to financing arrangements, as seen in *Figure 2*. This is proportional to the discount rate applied to the liability and has the potential to vary over the lease of the asset, dependent on the

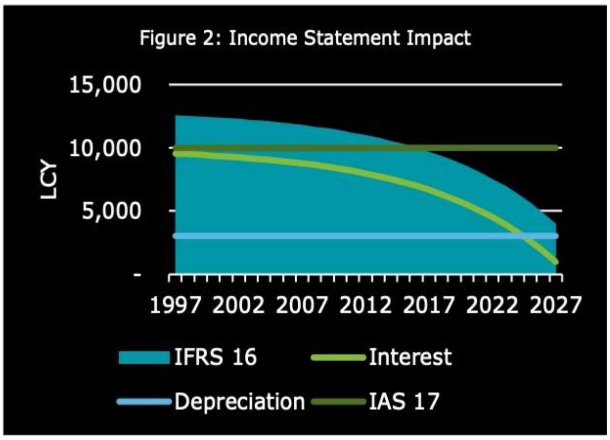
[12] Interest costs and depreciation are added back to the earnings before interest and tax to derive EBITDA.

[13] https://www2.deloitte.com/content/dam/Deloitte/za/Documents/finance/IFRS-1-brochure-V9.pdf

inception and maturity of leases. The impact on Net Debt/EBITDA will generally be higher at the start of the lease term, gradually reducing to zero at its maturity.

With an increase in interest payments, interest cover ratio (defined as net finance costs/EBIT) will fluctuate as a function of the lease population and the associated discount rates. This is likely to decrease interest cover, with it increasing back to pre-IFRS 16 levels at maturity of the loan as the discount rate unwinds.





Key Reasons for Differences:

The most significant difference will be for sectors such as retail, construction, communication services and transportation who traditionally have many operating leases.[14] Initial studies have seen as large as 147% increases in Net Debt: EBITDA for the transportation, construction & engineering services sector[15].

Where IFRS 16 is the cause for abnormal or skewed metrics with future trends, this may imply a change in lease term and the organisation's leases may be new or have been renewed with increased term length.

Useful Links

IAS Plus IFRS 16 / Deloitte IFRS 16 e-learning

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[14] Such sectoral differences should be borne in mind in order to ensure that threshold targets are tailored to the relevant sector

[15] https://www2.deloitte.com/content/dam/Deloitte/nl/Documents/mergers-acquisitions/deloitte-nl-ma-ifrs16-impactonbusinessvaluation1.pdf

Mitigations and key considerations:

In order to understand the IFRS 16 impact on a company's results, it is recommended that the company's first time adoption disclosures are reviewed as part of the assessment of economic and financial standing. Such disclosures would be expected to be included in the notes to the company's audited accounts which would be included as part of a tenderer's EFS PQQ submission. It is also recommended to discuss the underlying nature of leases and potential impacts of lease termination directly with the tenderer where their results are impacted by the adoption of IFRS 16.[16]

Key considerations for an increase in Net Debt[17]

- A company with longer lease periods and lower discount rates will give a higher lease liability.
- A significant increase year on year may be caused by a renegotiation of leases or a change in the underlying discount rate applied to the lease portfolio.
- Where lease obligations are intrinsically linked to performance obligations of specific Government contracts, the contracting authority may want to confirm that the lease obligations are either immaterial or easily serviceable and can be terminated at no or immaterial fee. Therefore, the Contacting Authority can determine if these may be seen as a mitigating circumstance when these leases have caused an increase in Net Debt.
- Where a company's Net Debt has significantly increased year on year and there is no comparative period presented, a detailed understanding of the material lease obligations and ability to finance these obligations is required before considering whether to assess the company's health on a pre-IFRS 16 basis.

[16] Such discussion may form part of the discussions that may be necessary as highlighted in Economic and Financial Standing of Suppliers (Appendix III,) in relation to the treatment of non-underlying items.
[17] To be considered as relevant alongside the potential mitigations identified in Metric 3A – Free Cash Flow to Net Debt Ratio.

- The contracting authority should be aware of any previous ‘onerous lease provisions’ and ensure these have been appropriately reflected with any past or expected impairments of the Right of Use Asset.

- Where a tenderer has a covenant test linked to Net Debt to EBITDA, the contracting authority may request clarifications about how leases are reflected in the underlying test and the overall covenant result on the latest test before considering whether to assess the company's health on a pre-IFRS 16 basis.

Key considerations for an increase in EBITDA[18]

- Under IFRS 16 there is no clear recognition of rent free periods as they are included in the liability representing the whole course of the loan. Detailed understanding of the payment profile and any such rent free periods is recommended to understand the profile of future obligations.

- Where a company’s lease obligations have previously been finance lease obligations, an immaterial change to EBITDA would be expected and as such there should not be a significant change in EBITDA year on year, irrespective of transition approach.

- A company may still record ‘rental costs’ if the leases are less than 12 months or low in value. These are likely to be immaterial and thus should not distort the adoption of IFRS 16 for the majority of the lease portfolio.

Key considerations for a worsening of Interest Cover Ratio[19]

- Total expense recognised will be weighted towards the start of the lease term (due to higher interest cost arising when a larger balance is outstanding).

- If an entity has an increase in finance costs associated with leases, the contracting authority should be aware that this may represent other sources of financing arrangements being entered into. This may be seen as a positive in

[18] To be considered as relevant alongside the potential mitigations identified in Metric 3B – Net Debt to EBITDA Ratio.

[19] To be considered as relevant alongside the potential mitigations identified in Metric 5 – Net Interest Paid Cover.

increasing liquidity or alternatively a sign of reliance upon alternative financing arrangements.

- Given the IFRS 16 changes and impacts, contracting authorities should request further clarification to understand the underlying nature of the lease and the level of risk and materiality associated with the underlying contract.

Key considerations for worsening Net Assets[20]

- Adoption of IFRS 16 may result in a material increase in assets and liabilities, with a net increase in liabilities. In extreme examples, this may result in a move from an overall net asset position to a net liability position. It may be useful to review the company's first time adoption disclosures and understand the underlying nature of the leases and their corresponding liabilities.

- Comparison to a pre-IFRS 16 position where available and analysis of the composition of assets and liabilities can be helpful in understanding the underlying risks of the balance sheet.

- An increase in discount rate or overall lease portfolio length would see a relatively greater increase in the lease liability than in the RoU asset - whereas a short term portfolio would see a lower differential between the asset and liability and thus a decreased impact on net assets (shareholder equity).

- **Please note, tenderers should normally not be eliminated on the basis of the Net Asset Value test alone.**

What is the solution?

In the long run it is unknown whether the market will perform valuations and covenant analysis on a post-IFRS 16 basis. The current lack of consistent implementation (as a result of the different transition options) and comparability (identically performing companies with different lease terms will show volatility in their metrics) mean that it may be simpler and easier to complete the assessment of financial health of a tenderer on a pre-IFRS 16 basis.

[20] To be considered as relevant alongside the potential mitigations identified in Metric 7 – Net Asset Value.

This appears to be a preferred approach by credit rating agencies and lenders at the moment. Although there are some covenants on a post-IFRS 16 basis, they are rare for now.

Once the full extent of the impact is known, it may be appropriate to adjust the risk classification thresholds or calculation methods in relation to the affected ratios used in the EFS. Market sentiment should continue to be monitored for best practice by the contracting authorities as we note current ratios are on a pre-IFRS 16 basis.

Acknowledging difficulties in obtaining comparable financial data other than published accounts, it is important to continue to assess suppliers and potential suppliers in a fair and equitable manner. Whilst the impacts are being understood, contracting authorities should ensure they are aware of, and factoring in, the impacts of IFRS 16 upon key financial metrics when assessing the Economic and Financial Standing of Suppliers. This may include requesting financial evaluation questionnaires on an IAS 17 and IFRS 16 basis to aid comparability between suppliers, undertaking more detailed competitor and market analysis or increased scepticism applied to metrics impacted by the change in standards.

Practical considerations for contracting authorities when preparing their PQQ/selection process

When adopting any of the key considerations above, the contracting authority should ensure transparency of the process and that suppliers are treated fairly (e.g. recognising impact of IFRS 16 which may lead to adjustments in risk metrics). Even if it should be clear from audited accounts that IFRS 16 is being adopted, a contracting authority may consider adjusting its PQQ document to make its approach to dealing with IFRS 16 in its process clear. For example:

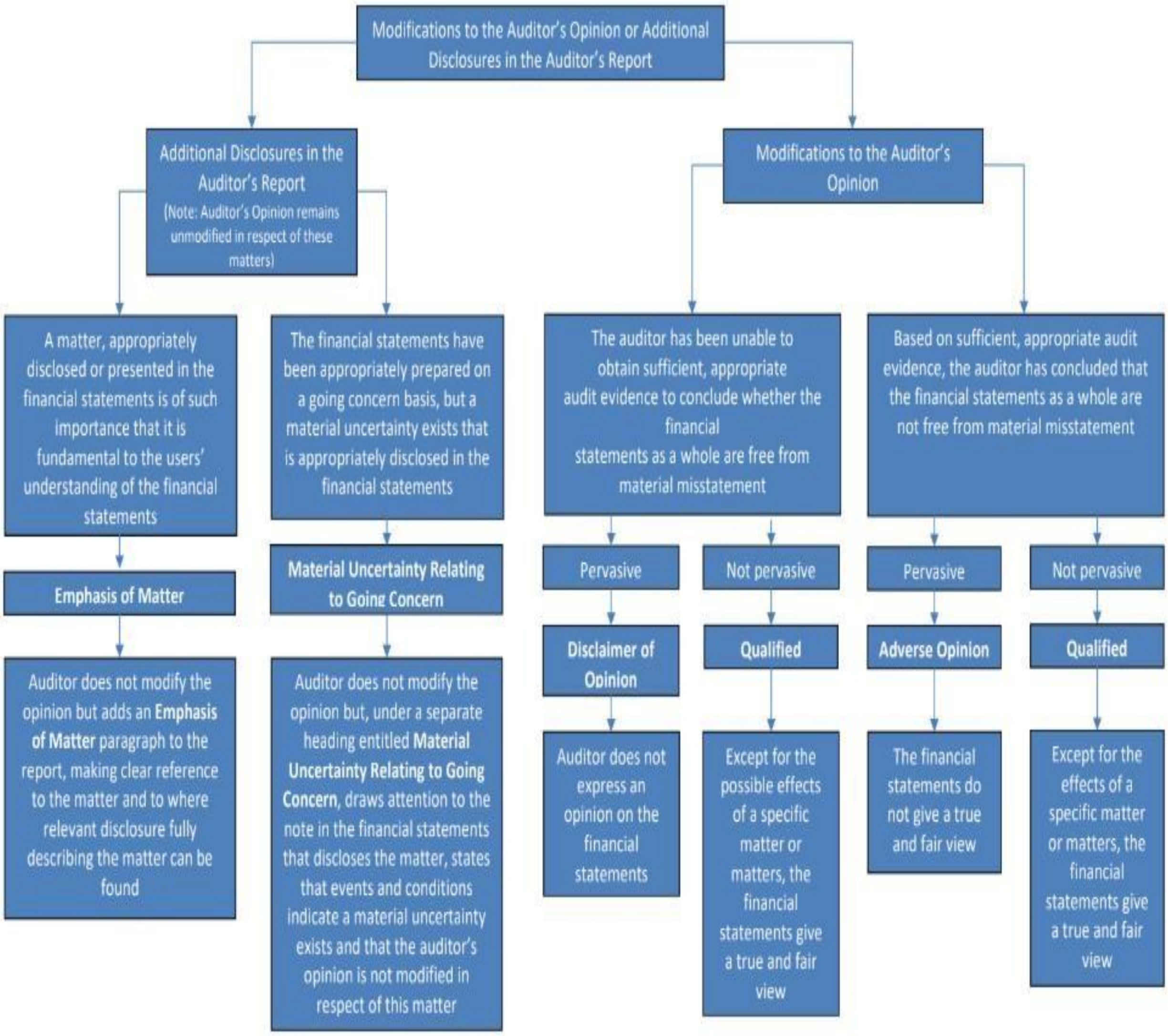
In the PQQ document potential questions could include:

- Are your accounts prepared on an IFRS 16 basis or pre-IFRS 16 basis?
- If not IFRS 16, please explain why?

If IFRS 16, please provide explanations as appropriate to explain any impacts on your EFS submission (e.g. Net Debt, etc.), particularly where there are significant differences in financial information post IFRS 16 (in order that tenderers may pre-empt clarification questions).[21]

[21] This is consistent with the Economic and Financial Standing of Suppliers (see 'Financial information required from tenderers' on page 24) in which it is noted that bidders are encouraged to provide narrative with their audited accounts/equivalent financial information to minimise the need for clarification questions.

Section 3 Appendix XI: Modifications to the Auditor's Opinion or Additional Disclosures in the Internal Auditor's Report



Section 3 Appendix XII: Tools and Information Sources

Sourcing Playbook and Guidance Notes

https://www.gov.uk/government/publications/the-sourcing-and-consultancy-playbooks

Construction Playbook

https://www.gov.uk/government/publications/the-construction-playbook

Digital, Data and Technology Playbook

https://www.gov.uk/government/publications/the-digital-data-and-technology-playbook

Public Contract Regulations

https://www.legislation.gov.uk/uksi/2015/102/contents/made

Find a Tender Service

https://www.find-tender.service.gov.uk

Companies House

https://www.gov.uk/government/organisations/companies-house

Contract Tiering Tool (KHub account required)

https://khub.net/group/gcf-community/group-library/-/document_library

Model Services Contract

https://www.gov.uk/government/publications/model-services-contract

Mid-Tier Contract

https://www.gov.uk/government/collections/the-mid-tier-contract

Public Sector Contract

https://www.gov.uk/government/collections/the-public-sector-contract

Charities SORP (FRS 102)

https://www.gov.uk/government/publications/charities-sorp-2005

Section 3 Appendix XIII: Roles and Responsibilities of the Chairperson and Panel Members

The role of the Chairperson is to:

- determine what training[22] or guidance the panels need to conduct the selection and tender evaluation processes;
- ensure all panel members appointed, have received the necessary training, have the necessary knowledge, skills and competency, and are available to carry out the selection and tender evaluation process;
- ensure that the selection and award criteria, and their weightings, are agreed and published in the contract notice or procurement documents;
- ensure panel members have no conflict of interest at any stage of the competition and that they complete the appropriate conflict of interest declarations/confidentiality agreements. The Chairperson must place particular emphasis upon Sections 81, 82 and 83 of the Procurement Act 2023 (see section on conflict of interest on page 9);
- ensure all requests to participate and tenders are in the requested format, and have been received by the stated deadline. This should be treated with a degree of caution and the principles of equal treatment, transparency and proportionality adhered to. The panel may wish to seek clarification regarding an expression of interest or tender. Where this is the case, care should be taken to ensure the information received is clarification and not additional information. Legal advice should be taken in every instance where an economic operator wishes to submit documents or information, or the panel requests it after the deadline;
- determine, if appropriate, which members of the panel will be responsible for evaluating the various aspects of the requests to participate and tenders;

[22] For procurements above UK thresholds, tender evaluation panels should receive appropriate training in evaluation best practice.

- ensure panel members individually evaluate each economic operator and/or tender before the consensus meeting/s;
- ensure all documents used in the evaluation of economic operators and tenders (including all comments, justifications, marks and any amendments) are recorded and signed off, and dated, by both the panel members and the Chairperson as appropriate;
- ensure selection and tender evaluation panel membership is, where possible, consistent and members are available for the duration of the process;
- seek and ensure due cognisance is taken of professional procurement advice provided by the CoPE;
- be available, if requested, to provide support with the debriefing process for unsuccessful economic operators;
- act as Moderator during the consensus meeting; and
- sign off all relevant documentation.