Section No. 3

Sourcing Toolkit

Selection and Award

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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 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 Procurement Policy Notes (PPNs), the PPNs will take precedence.

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 Public Contracts Regulations 2015 (PCR 2015);
- The Utilities Contracts Regulations 2016 (UCR 2016); and
- The Concession Contracts Regulations 2016 (CCR 2016).

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[2] sets out the Procurement Policy in relation to the commissioning and procurement of certain social, health and education services, also referred to as services falling under the 'Light Touch Regime' with a value greater than the relevant UK Procurement Threshold[3] (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, an economic operator's economic and financial standing,

[1] The tender evaluation stage is also known as the award stage
[2] PPN 02/21 Procurement of Social and Other Specific Services | Department of Finance (finance-ni.gov.uk)
[3] Information about procurement thresholds | Department of Finance (finance-ni.gov.uk)

technical capacity and professional ability to deliver a particular contract. 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 selection criteria and grounds for exclusion. Economic operators are 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 a number of experts in the relevant fields 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 (see the section on conflict of interest below).

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

The procurement regulations contain provisions in relation to Conflict of Interest. Regulation 24 of PCR 2015[4] requires contracting authorities to take appropriate measures to effectively prevent, identify and remedy conflicts of interest arising in the conduct of procurement procedures, so as to avoid any distortion of competition and to ensure equal treatment of all economic operators. 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

[4] Regulation 42 of the UCR 2016. Regulation 35 of the CCR 2016.

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 assessments for economic and financial standing 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[5] 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 Questions/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.

Eligibility

In order to be eligible to be awarded a public contract, it is important to determine if an economic operator has been excluded from the procurement process under one of the exclusion grounds. Some of grounds for exclusion are mandatory, some are discretionary. Details of the exclusions can be found in Regulation 57 of PCR 2015[6]. The process outlined in the regulations should be followed and legal advice sought before excluding an economic operator.

Process for considering the exclusion of economic operators

If a contracting authority becomes aware of relevant circumstances that indicate that a ground for the exclusion of an economic operator may exist, and therefore that the contracting authority may exercise its discretion to exclude the economic operator, the contracting authority should:

- gather any evidence available to it which may include, but is not limited to, findings from other contracting authorities;
- on the basis of the evidence, consider whether any of the possible exclusions may apply;
- if all of the elements of an exclusion ground are not met, the economic operator may not be excluded from the procurement procedure;

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

[6] The rules concerning the exclusion of economic operators from participation in utilities and concession procurements are contained in Regulation 80 of the UCR 2016 and Regulation 38 of the CCR 2016 respectively.

- in the event that all of the elements of the exclusion ground are met, the contracting authority must not exclude the economic operator if any of the following situations arise:
    - it would be disproportionate to exclude the economic operator;
    - the time limit for exclusion has expired (the maximum allowed is five years from the date of the conviction in the case of mandatory exclusion, or three years in the case of discretionary exclusions)[7];
    - there is evidence of adequate self-cleaning (see page 14).
- if the evidence suggests that a ground for exclusion has been met and none of the above situations arise, the economic operator should be given the opportunity to comment on and refute the information gathered by the contracting authority;
- the contracting authority should set out, in writing, the evidence before it and outline why it believes the information may give rise to a discretion to exclude the economic operator. The economic operator concerned must be provided with enough information to allow it to properly address the issues;
- in order for a contracting authority to fully consider the economic operator's position, it may wish to ask for information or views in relation to the following:
    - whether the contracting authority is incorrect in its understanding of the facts relating to the exclusion ground in question;
    - what the facts mean in terms of the statutory situation in question (for example; if the issue is grave professional misconduct, the first issue is what the operator says on whether the facts meet this standard and the second element will be whether it renders the economic operator's integrity questionable);

[7] The maximum exclusion period does not apply to mandatory and discretionary exclusions for the non-payment of taxes

    - whether the discretion for exclusion remains within the time limits outlined at Regulations 57(11) and (12). If the contracting authority has a view as to the starting point of the exclusion ground, it should set this out;
    - whether the economic operator wishes to rely on self-cleaning (see page 14);
    - whether it would be disproportionate to exclude the economic operator;
    - any other matters that the economic operator believes may be relevant to the exercise of a discretion to exclude.
- the economic operator must be allowed sufficient time to provide a proper response;
- depending on the facts of the case and any response, it may be necessary to seek further information or clarification from the economic operator;
- once a full response is received, the contracting authority should carefully consider all matters put forward by the economic operator and come to a decision. A detailed note of the reasons for the decision should be kept, including any reasons for agreeing or rejecting matters put forward by the economic operator;
- once a decision has been reached, the contracting authority should inform the economic operator of that decision and provide it with a statement of the reasons sufficient for it to understand the finding.

The above sets out the broad outlines of the Regulations. It is imperative that if a Department believes that an exclusion may be appropriate, it consults the PCR 2015 for the precise wording of the legal texts. Legal advice should be taken on any decision to exclude an economic operator. It is generally best that this is sought at an early stage.

Self-cleaning[8]

If the contracting authority considers the measures taken by an economic operator are sufficient to demonstrate its reliability despite the existence of a relevant ground for exclusion, then the economic operator shall not be excluded from the procurement procedure. For that purpose, the economic operator needs to prove that it has:

[8] Regulation 57(13) – (17) of the PCR 2015

- paid or undertaken to pay compensation in respect of any damage caused by the criminal offence or misconduct;
- clarified the facts and circumstances in a comprehensive manner by actively collaborating with the investigating authorities; and
- taken concrete technical, organisational and personal measures that are appropriate to prevent further criminal offences and misconduct.

The measures taken shall be evaluated taking into account the gravity and particular circumstances of the criminal offence or misconduct. Where the contracting authority considers such measures to be insufficient, it shall give the economic operator a statement of the reasons.

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, and any change of supplier may come at an increased price, particularly if urgent short-term or interim arrangements are required. Poor delivery or failure may also have consequential effects, for example delays to the continuity of critical public services.

Principles

All assessments of tenderers' EFS should be proportionate, flexible, contract specific and not overly risk averse while ensuring protection of taxpayer value and safety and compliance with relevant procurement law. Procurement law requires that requirements of tenderers to demonstrate EFS are related and proportionate to the subject matter of the contract and are limited to those that are appropriate to ensure that the tenderer has the financial capacity to perform the contract.

All tenderers, whatever their size and constitution, shall be treated equally and without discrimination during the assessment of their EFS. 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. This may be done by allowing all tenderers to propose relevant mitigations for particular risks, for example, those where a potential risk resulting from an organisation's size or structure is identified.

EFS should be utilised as a critical hurdle to assess tenderers' ability to deliver the contract at selection stage. The selection stage is also referred to as the PQQ stage.

Assessment of EFS must be transparent, objective and non-discriminatory. It can be based on a set of metrics and ratios appraised against pre-determined thresholds to provide a set of risk classifications for each tenderer. Tenderers should be able to see their risk classifications as they complete the financial assessment and, where relevant, 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.

Financial testing

Contract categorisation

In order to determine what constitutes a proportionate assessment of EFS it is important to categorise the contract based on its criticality. The categorisation should then drive the level of EFS required from tenderers and any associated requirement for financial assessment subject matter expertise.

One mechanism for categorising the criticality of a contract is by using a Contract Tiering Tool[9]. 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,

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

although these would need to be reviewed to ensure they are related, proportionate and appropriate.

	Description	Assessment
Bronze Contracts (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.	As a starting point, an 'off-the-shelf' financial analyses and risk assessments from a credit scoring agency can be used, such as Constructionline, Experian, Company Watch and Dun & Bradstreet, etc. The credit score thresholds should be set above which tenderers are deemed to have met minimum EFS criteria. As a minimum, this should be above the relevant warning of default level for the applicable credit scoring agencies: 25 for a Company Watch H score; 10 for a Dun & Bradstreet score. Where a tenderer falls below the thresholds set, a more detailed assessment, including ratio analysis, can be undertaken, with tenderer clarifications used to gain clarity. Credit agency scores **should not**, on their own, be

		used to exclude a tenderer, without further investigation.
Silver Contracts	Silver contracts are typically contracts for important but not critical works and services. In these cases a more detailed financial assessment may be appropriate and minimum thresholds should be set accordingly.	The assessment can use the standard financial metrics and ratios set out in: '***APPENDIX IV – Standard Financial Ratios***' and the minimum thresholds in: '***APPENDIX V – Interpreting standard financial metrics***'
Gold Contracts (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; minimum thresholds can be set at the same level as for Silver contracts or higher.	The assessment can include the standard financial metrics and ratios set out in: '***APPENDIX IV – Standard Financial Ratios***' and the minimum thresholds in: '***APPENDIX V – Interpreting standard financial metrics***'. Contracting authorities can also consider whether to carry out additional analysis, for example the use of additional financial metrics, ratios and/or trend analysis.

		Contracting authorities may also consider more demanding thresholds to be appropriate, taking into account the greater and/or more complex requirements of the contract.

Tailoring thresholds to specific sectors

In setting threshold targets contracting authorities can seek to reflect industry or sector specific trends. This may involve setting different thresholds than Standard Ratios as set out at ***APPENDIX IV.*** Analysis carried out in relation to the *Construction, Facilities Management*, *Business Process Outsourcing* and *IT and Telecoms* sectors has identified bespoke thresholds that may be utilised for procurements in these sectors as also detailed at ***APPENDIX V.***

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*'.**

Demonstrating economic and financial standing

The financial data utilised to evaluate a tenderer's EFS may be provided by one or more of the following:

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

Where the information set out above is not appropriate in a particular case the tenderer can be asked to provide other information to prove its EFS. Similarly, where the tenderer is unable to provide the information above (for any valid reason), the tenderer may provide evidence of its EFS by any other document which the contracting authority considers appropriate. Circumstances where it may be appropriate to require or permit alternative evidence are discussed further below.

Use of the information set out above to assess the EFS of the tenderer is subject to various shortcomings. For example, information on a tenderer's profitability, cash flow, liquidity and solvency (typically the most relevant criteria to assess EFS) is limited to historical and current information. Over time, however, a supplier's profitability, cash flow, liquidity and solvency and therefore its economic and financial capacity to deliver the contract can change. Note also that the majority of companies are only legally required to file accounts nine months after their year-end, resulting in a delay in available public information.

It is important that all available information is used in such a way as to provide as accurate a picture as possible of the tenderer's economic and financial capacity to deliver the contract.

When financial metrics and ratios are used, they should set out bands for each metric or ratio at which a tenderer would normally be classed high, medium or low risk. Thresholds at which a tenderer may be eliminated from a procurement should be specified in advance. Such thresholds may be linked to the risk rating on a single financial metric or ratio or to a combination of risk ratings across multiple financial metrics or ratios. Thresholds shall be transparent, objective and proportionate to the requirement under procurement.

Sector analysis can be used in advance of the procurement commencing to ensure any stipulated threshold tests provide a good reflection of the health of the sector and that a disproportionate level of good quality tenderers are not excluded from the process.

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. Examples of such explanations include but are not limited to:

- Improvements in a tenderer's EFS due to the sale of a business or raising of additional capital since the last accounting reference date (but prior to the tender submission date);

- Non-underlying charges or circumstances which are one-off in nature and not expected to repeat themselves, for example an expensive item of plant and equipment having to be replaced unexpectedly;
- Adoption of new accounting policies/standards; and
- One-off use of restricted reserves accumulated by a charity.

The validity of such explanations should be considered and taken into consideration in the assessment of a tenderer's EFS. It is important that where tenderers could fail to meet the required thresholds, the clarification stage is used to seek further information and explanation before elimination is considered[10].

Where there has been a public announcement of an event or other change in circumstances affecting a tenderer, the contracting authority may seek to calculate proforma ratios based on the event or change of circumstances. This should be considered in the light of circumstances at the time and would normally only be appropriate where updated figures are available from the tenderer or a reputable independent source or can be estimated with reasonable certainty[11].

An explanation of how the proforma ratios were derived should be provided and tenderer should be given the right to explain in writing why application of a different risk classification would be more appropriate before using the proforma ratios as a basis for its appraisal of EFS. Examples of changes in circumstances in which use of proforma 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.

[10] Review Step 3 and Step 4 from the APPENDIX IX: EFS Clarification Road Map
[11] If an exact figure cannot be estimated but it can reasonably be ascertained to be above (or below) a particular amount and use of any figure above (or below) that amount would produce a similar outcome in the appraisal of EFS, the Authority may use that amount as the basis for the proforma.

As above, where tenderers could fail to meet the required thresholds, they should be given the opportunity to provide further information and explanation before elimination is considered. A Tenderer may be permitted to proceed in the procurement competition despite being classified overall as medium or high risk subject to agreeing a set of risk mitigations. Such mitigations may include but should not be limited to:

- Enhanced contract management and financial monitoring procedures, which may include additional obligations or Financial Distress Events;
- Parent company guarantees (PCG) – Where the tenderer is part of a wider group its parent company can be asked to provide a PCG. If there are issues about the financial strength of the Parent Company, the Ultimate Parent Company or other group entity might be approached for this guarantee. – see *Section on application to groups and guarantors for further discussion*.
- Restrictions on the tenderer's business and/or its ability to make distributions or lend money to other group members if it wins the contract; or
- The provision of a collateralised cash deposit, guarantee or performance bond.

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, can generate potential risk bands by ratio for each tenderer 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 tenderer. Where there is a compelling rationale, the Contracting authority may tailor their Tool to be more suited to the assessment of EFS of potential tenderers.

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.

Proof of a tenderer's EFS should be in accordance with Public Contract Regulations, Regulations 60(6), (7) and (8). 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, in accordance with Regulation 60(7) 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[12] 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.

[12] 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.

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 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 framework agreements and call-off agreements

Where a Contracting authority is procuring a framework agreement, it should assess the EFS of tenderers in a similar manner to the procurement of a standard contract. The contracting authority procuring the framework agreement should also monitor the ongoing EFS of suppliers on the framework agreement.

Generally a contracting authority entering into a call off contract under a framework agreement[13] may be able to rely on the assessment of EFS already undertaken although it should always satisfy itself as to the validity of the EFS assessment in the light of any new information or change in circumstances since the assessment. This is not a new EFS assessment and should be a check that the original EFS requirements defined within the framework agreement are still being met based on more recent information.

Where a contracting authority runs a mini-competition under a multi-supplier framework agreement it shall invite to tender all tenderers capable of performing the contract.[14] The procurement documents establishing the framework agreement should define what "capable" means and how it is determined, and this should also be reflected in the framework agreement itself. Capability may relate to EFS[15] where appropriate[16] Careful consideration of EFS in the context of capability assessment at the time of the competition to establish the framework agreement should help enable appropriate and proportionate assessments for the assumed range of risk associated with the call-off contracts.

The framework agreement should require the supplier to warrant their financial position before a call-off contract is awarded

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.

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[13] Whether a single supplier framework agreement or a multi-supplier framework agreement (whichever of the methods of award under the multi-supplier framework agreement is used).

[14] Reg 33(11)(a) of the PCR 2015.

[15] For example: capability could mean different suppliers are identified as capable of delivering different values (or ranges of values) of contracts based on the EFS information submitted at the PQQ stage of the competition to establish the framework agreement; or where the values of call-off contracts may vary widely or are uncertain, a capability mechanism could be defined at the outset along with the EFS information provided at the PQQ stage that would be used to apply the mechanism.

[16] In addition to other potentially relevant areas such as technical ability.

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[17] 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), and hence the risk of their financial failure, can deteriorate after procurement, either gradually or suddenly (for example because of the loss of a major contract or flooding or fire incident). Where a supplier's EFS declines, there is often a heightened risk of a decline in performance under the contract. In the relatively rare case that a supplier becomes insolvent, there is a significant risk that services may be interrupted or cease completely, whether because of a lack of liquidity to maintain them, loss of key staff or other reasons.

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

[17] These arrangements normally attract charges/fees

Principles

Contracting authorities should identify their key suppliers and monitor their EFS on an ongoing basis. Its frequency should reflect the perceived risk of failure, the frequency of the supplier's own financial reporting regime and any contractual arrangement for data provision. Monitoring should be carried out at least 12 monthly and include a review of EFS metrics and wider business considerations using interim or full year results, public and/or reported information under the contract. More regular reviews (e.g. every 6 months or less) are particularly recommended for Public Sector Dependent Suppliers (unless these provide low risk Bronze contracts) and suppliers flagged by contracting authorities as critical for their services or which are perceived to have other than a low risk of financial failure.

Monitoring should also reflect the criticality of the contract and, where appropriate, should cover not just the contractual Financial Distress Events (or their equivalent) but take a wider view of the supplier's business[18], performance against the contract KPIs and wider commercial behaviour (e.g. prompt payment to the supply chain, regular requests for review of contractual mechanisms and recoverable costs). The focus should primarily be on liquidity and solvency.

Where no Financial Distress Event has been notified, boards of suppliers of critical (Gold) contracts and Public Sector Dependent Suppliers should provide formal annual confirmations that no Financial Distress Event or any matter which could cause a Financial Distress Event has occurred.

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 or enhanced monitoring is required.

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

[18] For example, the supplier's share price, public statements to the market (e.g. profit warnings), delays to results statements and accounts filings, or as to issues with debt service or negotiations with lenders

‘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 periodically.

EFS should be a standing item on the agenda of supplier relationship meetings. Reviews should normally take place following publication of the supplier’s statutory accounts and, in the case of Gold contracts, receipt of the annual statement of compliance. In the case of publicly quoted suppliers interim reviews may also be appropriate following publication of interim results. Where the contract provides for more frequent (e.g. quarterly) testing of Financial Distress Events, the monitoring frequency should adopt the same pattern. Any key supplier considered to be at heightened risk of failure should be monitored more frequently.

Monitoring teams should establish ‘alert’ systems under which they are immediately informed, in respect of key suppliers, of:

- any stock exchange announcements (where suppliers are quoted);
- press articles commenting on a supplier’s profitability or financial standing;
- any movements in suppliers’ credit ratings (where suppliers have formal credit ratings); and
- any drop in Dun & Bradstreet and/or Company Watch H scores below standard financial health levels (10 for D&B score and 25 for the H score).

> “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 questions include:

- Are its existing borrowing facilities committed or can they be withdrawn by the lender?
- When do the existing facilities mature and what plans does the supplier or its group have to repay or replace them (where maturing facilities need to be replaced, most companies start to do this at least 12 – 18 months prior to maturity)?
- What is the capital and interest repayment profile?
- How much borrowing headroom do the facilities provide against peak future borrowing requirements and how will the supplier manage any pinch points?
- Has the supplier or its group provided security to its lenders?
- How tightly drawn are the covenants in the facilities? How much covenant headroom is there?
- Are there any restrictions on how liquidity can be used, for example grants provided for specific activities?
- How much reliance is there on other group entities for liquidity?[19]
- What is the working capital profile of the supplier?

Not all of this information is readily available in the public domain; some suppliers (particularly quoted suppliers) may be reluctant to provide details of 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 position and prospects.

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

Set out in '***APPENDIX VIII – Potential indicators of future financial distress***' is a non-exhaustive list of potential indicators of future financial distress. Note that while the presence of an indicator may give rise to concern, it should not be assumed inevitably to lead to financial distress.

Access to forward looking information

The limitation of using published information 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 degree of shorting of a supplier's shares can also be useful; where this exceeds 5% of a supplier's issued share capital, it would suggest significant divergence in investors' views over the company's future profitability or financial position, possibly as a result of adverse information about its prospects leaking into the market.

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 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. Where a private supplier falls below key parameters (a Company Watch H score of 25 or a Dun and Bradstreet score of 10), reassurance should be sought from the supplier about its financial position and prospects.

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 economically advantageous tender (MEAT) submitted for a project. MEAT 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.

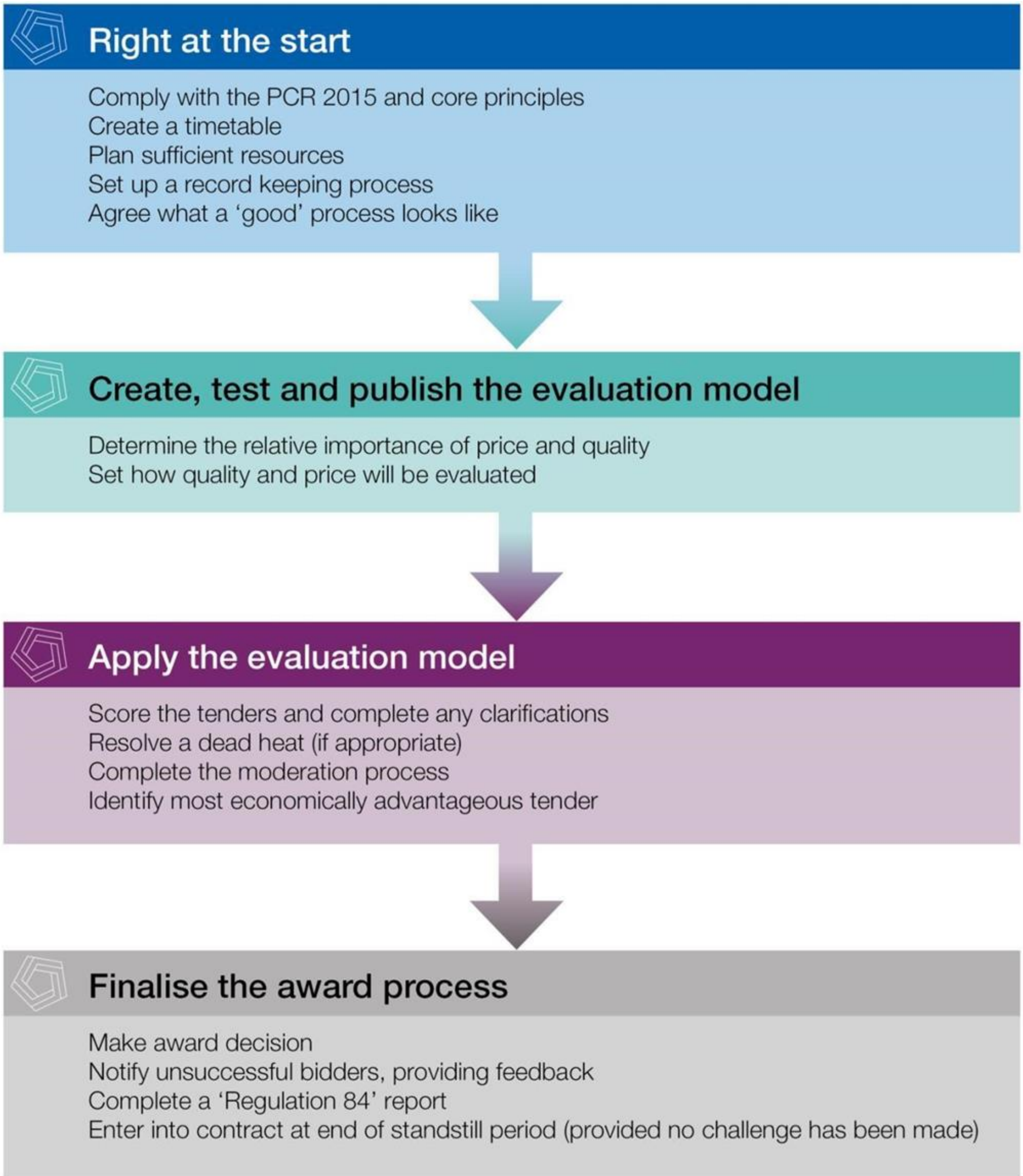
Create a timetable

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.

Figure 1: A high level overview of a tender evaluation process



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 may form part of a wider "Regulation 84" report as required under Regulation 84 of the Public Contracts Regulations 2015). The purpose of the evaluation report is 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[20]) will be balanced;
- How quality will be evaluated (including, where appropriate, how social value will be evaluated); and

[20] PPN 01/21 - Scoring Social Value | Department of Finance (finance-ni.gov.uk)

- 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 MEAT. The definition of MEAT 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[21] 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 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,

[21] Information about procurement thresholds | Department of Finance (finance-ni.gov.uk)

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 MEAT, 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[22].

Figure 2: key considerations to create an effective evaluation model

[22] 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)

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 further assessment of the professional/technical ability of the economic operator is prohibited at the tender evaluation stage. However, the regulations[23] make it clear that the organisation, qualification and experience of staff assigned to perform the contract can be taken into account as part of the award criteria where the quality of the staff assigned can have a significant impact on the level of performance of the contract.

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

[23] Regulation 67(3)(b) of the PCR 2015.Regulation 82(3)(b) of the UCR 2016

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 MEAT 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. The method used for the assessment of costs imputed to environmental externalities must meet the requirements set out in Regulation 68(3) of the PCR 2015[24], the aim of which is to make sure that this approach does not favour a particular tenderer.

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.

[24] Regulation 83(3) of the UCR 2016

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

[Regulation 69 of the Public Contracts Regulations 2015] places a duty on a contracting authority to investigate tenders it considers abnormally low. It also places a duty on the contracting authority to disregard tenders that are abnormally low because they are in breach of international environmental, social or labour laws.

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. Regulation 69(2) sets out a list of potential explanations for the ALT, however, 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.

In accordance with Regulation 84(1)(c) if a tender is found to be abnormally low and rejected the reasons for its rejection must be recorded in the evaluation report.

Test and publish evaluation model

Calculating MEAT

When calculating MEAT, 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: The PCR 2015[25] require 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.

Prior to the award, the contracting authority must notify the unsuccessful tenderers of the decision in writing. This notice is often referred to as the "standstill letter" and should contain certain prescribed information as required by the procurement regulations; this includes details of the winning tenderer, their own and winning tenderer's scores and the characteristics and relative advantages of the winning tender. Contracting authorities must ensure the standstill letters comply with the requirements set out in Regulation 86 of PCR 2015[26] and may need to send them to tenderers excluded at earlier stages in the procurement.

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:

[25] Regulation 84(8). (Regulation 99(5) of the UCR 2016
[26] Regulation 101 of the UCR 2016

- 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;

Complete an evaluation report

At the end of any evaluation process, contracting authorities are required to produce an evaluation report which may form part of a wider “Regulation 84” report as set out under Regulation 84 of the Public Contracts Regulations 2015. The purpose of the evaluation report is to demonstrate that the evaluation has been performed properly and to provide evidence supporting the scores given to each bid.

Good practice is to include store documentation of all discussions, meetings and decisions which are relevant to the evaluation. The reporting obligations apply to all forms of records including electronic, paper and all forms of notes - however informal. Hard copy notes should always be scanned. SMS or other methods of communication (e.g. WhatsApp or Google Hangouts) which are difficult to record should not be used.

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 MEAT.

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.

<u>MoSCoW prioritisation</u>

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.

<u>Weighting guidelines template</u>

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.

Terminology: The terms referred to in this paper are those used by UK companies in their financial statements and are mostly available on the face of the Balance Sheet, Income Statement and Statements of Cash Flow. Where the entity is not a UK company, the corresponding items should be used even if the terminology is slightly different (for example a charity would refer to a surplus or deficit rather than a profit or loss).

UK Company terminology	Charity Equivalent
Income Statement	Statement of Financial Activities (SoFA)
Operating Profit	Net Income / (Expenditure) after Charitable Activities Or Net Surplus / (Deficit) after Charitable Activities
Net Profit	Net Income (Expenditure) Or Net Surplus (Deficit)
Net Worth	Total Charity Funds

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

Foreign currency conversion: In a procurement situation the contracting authority should specify what exchange rate to use to convert amounts denoted in foreign currency to Sterling. In some tests, where both the numerator and denominator are expressed in the same foreign currency, no conversion may be required. Where conversion is required, amounts should generally be converted either at current exchange rates (e.g. the rate prevailing at the date of issue of the PQQ) or at the exchange rate in force at the relevant date for which the financial ratio or metric is being calculated.

Treatment of non-underlying items: Ratios should generally be based on IFRS (or appropriate accounting framework) figures in the audited 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.

Subject to reserving the right to do so, a contracting authority may also adjust for non-underlying items which are material and out of the ordinary course where this would move the categorisation to a higher risk banding. Where adopted, the Contract Authority shall:

- include explanation in the PQQ or other procurement document,
- disclose the proposed adjustments to the tenderer,
- allow the tenderer adequate time to respond and
- appropriately consider any representations the tenderer wishes to make.

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. Appropriate adjustments should be made where necessary. Contracting authorities should discuss the basis of the adjustments with their Finance Teams.

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 has been qualified (either due to not being able to obtain sufficient evidence or if the auditor concludes that the financial statements are not free from material misstatement) or if the Auditor's Report contains additional disclosures[27], contracting authorities should review the qualification or emphasis and decide how to proceed. Additional assurance may be required to confirm the entity's EFS. Particular care should be taken where the qualification, emphasis or material uncertainty relates to whether the entity is a going concern. See **Appendix VIII** for additional information

The methodology for assessing EFS should be clearly described and any minimum financial requirements clearly stated in the PQQ or other procurement document. Where tenderers 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 should always be performed on the winning tenderer. Where the procurement relates to a critical or important (Gold or Silver) contract, checks should be performed on all tenderers at the tenderer selection stage to avoid the risk of later damage and delay to the procurement.

The assessment should normally include as a minimum the standard financial metrics and ratios set out below. 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. Where a tenderer's ratio score results in a High Risk classification, there is an opportunity within the Financial Viability Rating Assessment template for the tenderer to provide explanations. If an alternative tool is used the same opportunities should be provided to tenderers.

All metrics included in the EFS guidance and the recommended thresholds for sectors will be reviewed at least annually by the Financial Analysis team in Markets and Suppliers (supplierfinanalysis@cabinetoffice.gov.uk)

Potential mitigations: In addition to those detailed under each metric, other mitigations should also be considered such as the use of PBAs, PCGs or Bonds, liquidity facilities

[27] 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.

available to a company (e.g. level of undrawn debt available) and access to capital (e.g. a PLC has access to equity markets, yet a private company will not).

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

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. Contracting authorities should use outputs from any **Should Cost Modelling** to arrive at this figure.

Benchmark

The Public Contract Regulations 2015 (Regulation 58.9) permit contracting authorities to require a minimum annual turnover of up to twice the estimated contract value (save where a higher figure can be justified by reference to the special risks attaching to the nature of the works, services or supplies). 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. Tenderers should normally not be eliminated on the basis of the Turnover Ratio alone.

The Turnover Ratio is not relevant to the procurement of multi-supplier frameworks.

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.

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*'.

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 tenderer 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 Red:Amber:Green Ratio result produced by the FVRA, even though there has been no actual commercial impact on reporting entity. See Appendix X for more information; or

- 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*'**.

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. See Appendix X for more information;
- 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 tenderer'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.

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'*.

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).

- **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 II – 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

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

Net Interest Paid = Interest paid – Interest received

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 received and interest paid should be shown on the face of the Cash Flow statement.

Where Net interest paid is negative (i.e. the entity has net interest received), the outcome of the test should be regarded as '*Low risk*'.

Interpretation

The Net 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 II – 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).

Section 3 Appendix V: Interpreting Standard Financial Metrics

The following table sets out how to interpret the results of standard financial assessments.

Guidance below provides a step-by-step guide to calculating ratios and then benchmarking these against the relevant Gold, Silver or Bronze thresholds. Alternately the Financial Viability Risk Assessment Tool can be used to carry out this calculation by:

Step 1 – Review the 'Authority RAG Thresholds' tab and update target thresholds as required. The table is already populated with the 'All Sectors' Silver and Gold thresholds. Authorities undertaking Business Process Outsourcing, Facilities Management, Construction or IT & Telecoms procurements, should use the bespoke sector thresholds as set out in the table below.

Step 2 – Input the anticipate Annual Contract Value – in £000s – at cell C15 on the 'Authority Rag Thresholds' tab.

Step 3 – Populate columns B-D on the tab '1.1 – Lead Financial Input' with relevant data from the tenderer's/suppliers accounts.

Step 4 – Scroll down to the bottom of '1.1 – Lead Financial Input' tab – Rows 117 – 125 – to review how the tenderer/supplier's ratios benchmark against the RAG thresholds.

How to use the table

Before you start:

1. Calculate the ratio based on the guidance in **APPENDIX IV.**
2. Identify the criticality (i.e. Gold, Silver or Bronze) of the contract under procurement using the Contract Tiering Tool.
3. Identify the most suitable sector (in the first column) into which the services to be delivered under the contract fall.

Consulting the table:

4. Identify the metric you have calculated in the 2nd column.

5. Identify the relevant set of thresholds based on the contract criticality (i.e. Gold, Silver or Bronze).

6. Identify the threshold into which the calculation carried out in step 1 falls.

7. The column header identifies the level of risk the supplier represents based on the metric assessed.

Interpreting standard financial metrics - Risk categories by Sector and Criticality of procurement

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

		Non-critical (Bronze) procurements			*Important (Silver) or Critical (Gold) procurements*		
Sector	**Metric**	**Low risk**	**Medium risk**	**High risk**	**Low risk**	**Medium risk**	**High risk**
All sectors (save where shown separately below)	Metric 1 - Turnover Ratio	>2.0x[1]	1.5 - 2.0x	<1.5	>2.0x[1]	1.5 - 2.0x	<1.5
	Metric 2 - Operating Margin	N/A	N/A	N/A	>10%	5 - 10%	< 5%
	Metric 3(A) - Free Cash Flow / Net Debt	N/A	N/A	N/A	> 15%	5 - 15%	< 5%
	Metric 3(B) - Net Debt / EBITDA	< 2.5x	2.5 - 3.5x	> 3.5x	< 2.5x	2.5 - 3.5x	> 3.5x
	Metric 4 - Net Debt + Net Pension Deficit / EBITDA	N/A	N/A	N/A	< 4.0x	4.0 - 5.0x	>5.0x

	Metric 5 - Net Interest Paid Cover	> 4.0x	2.5 - 4.0x	< 2.5x	> 4.5x	3.0 - 4.5x	< 3.0x
	Metric 6 - Acid Ratio	> 0.8x	0.7 - 0.8x	< 0.7x	> 1.0x	0.8 - 1.0x	< 0.8x
	Metric 7 - Net Assets	> Nil	> Nil	> Nil	> Nil	> Nil	> Nil
	Metric 8 - Group Exposure Ratio	N/A	N/A	N/A	<25%	25 - 50%	> 50%

Complex Outsourcing	Metric 2 - Operating Margin	> 8%	3 - 8%	<3%	> 10%	5 - 10%	< 5%
	Metric 3(A) - Free Cash Flow / Net Debt	N/A	N/A	N/A	N/A	N/A	N/A
	Metric 3(B) - Net Debt / EBITDA	< 2.5x	2.5 - 3.5x	> 3.5x	< 2.5x	2.5 - 3.5x	> 3.5x
	Metric 4 - Net Debt + Net Pension Deficit / EBITDA	N/A	N/A	N/A	< 4.0x	4.0 - 5.0x	>5.0x

Construction/Engineering/Facilities management	Metric 2 - Operating Margin	> 4%	2 - 4%	< 2%	> 4%	2 - 4%	< 2%
	Metric 3(A) - Free Cash Flow / Net Debt	N/A	N/A	N/A	N/A	N/A	N/A
	Metric 3(B) - Net Debt / EBITDA[28]	< 1.0x	1.0 - 2.0x	> 2.0x	< 1.0x	1.0 - 2.0x	> 2.0x
	Metric 4 - Net Debt + Net Pension Deficit / EBITDA	N/A	N/A	N/A	< 2.5x	2.5 - 3.5x	>3.5x

Information Technology and Telecoms	Metric 2 - Operating Margin	N/A	N/A	N/A	> 10%	5 - 10%	< 5%
	Metric 3(A) - Free Cash Flow / Net Debt	N/A	N/A	N/A	N/A	N/A	N/A
		< 3.0x	3.0 - 3.5x	> 3.5x	< 3.0x		

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

	Metric 3(B) - Net Debt / EBITDA					3.0 - 3.5x	>3.5x
	Metric 4 - Net Debt + Net Pension Deficit / EBITDA	N/A	N/A	N/A	<4.5x	4.5 - 5.0x	>5.0x

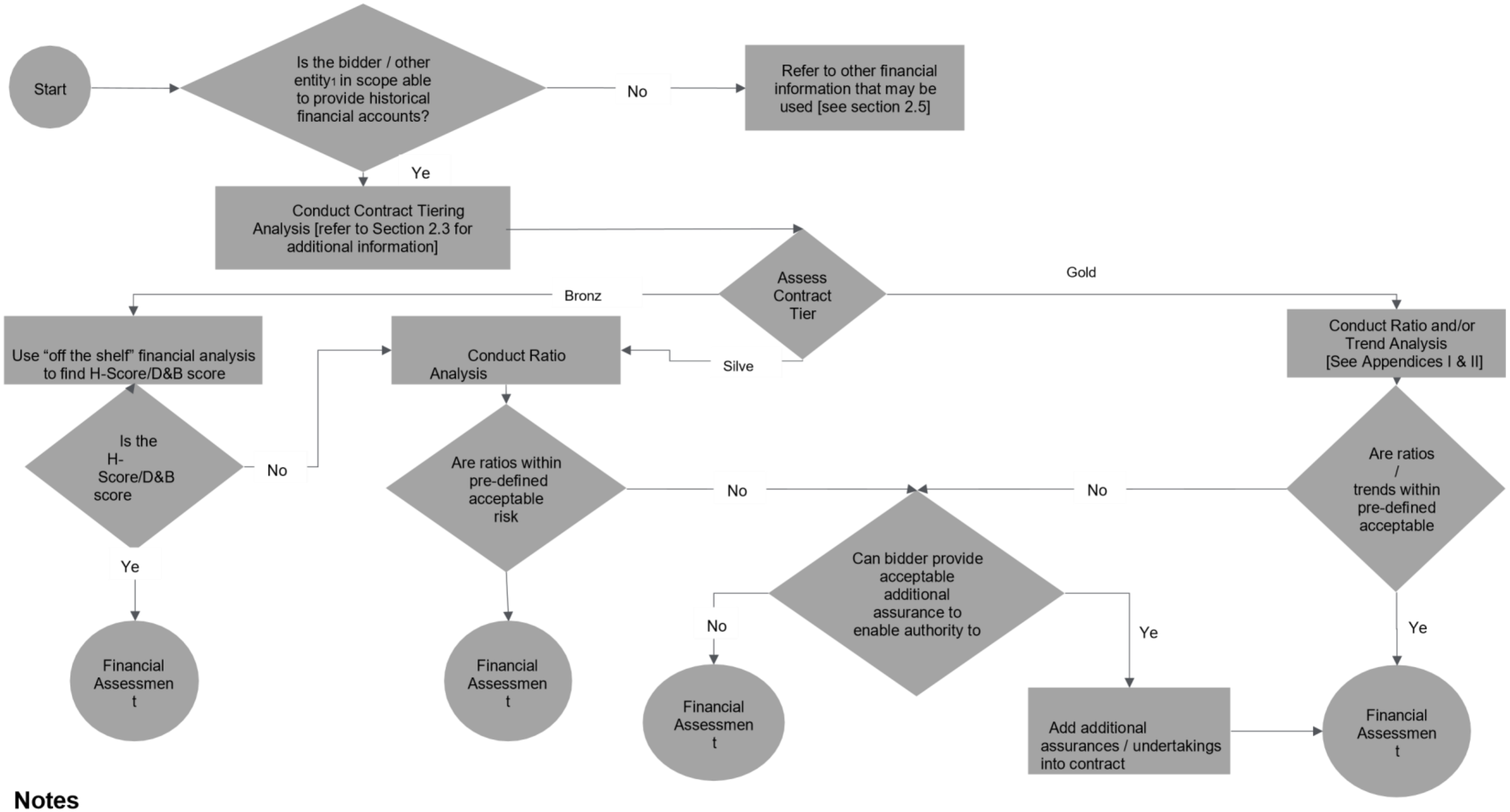
Notes:

(1) Maximum threshold at which exclusion is permitted by procurement law

(2) The selection of ratios and thresholds should be tailored to the circumstances of the particular procurement. For example, for very short bronze contracts it may not be appropriate to apply a Net Debt / EBITDA ratio. For potential Gold contracts, however, more demanding thresholds may be appropriate. Contracting authorities should consider what is appropriate to their particular procurement and adopt a ‘Comply or Explain’ approach.

Section 3 Appendix VI: Financial Assessment Flowcharts

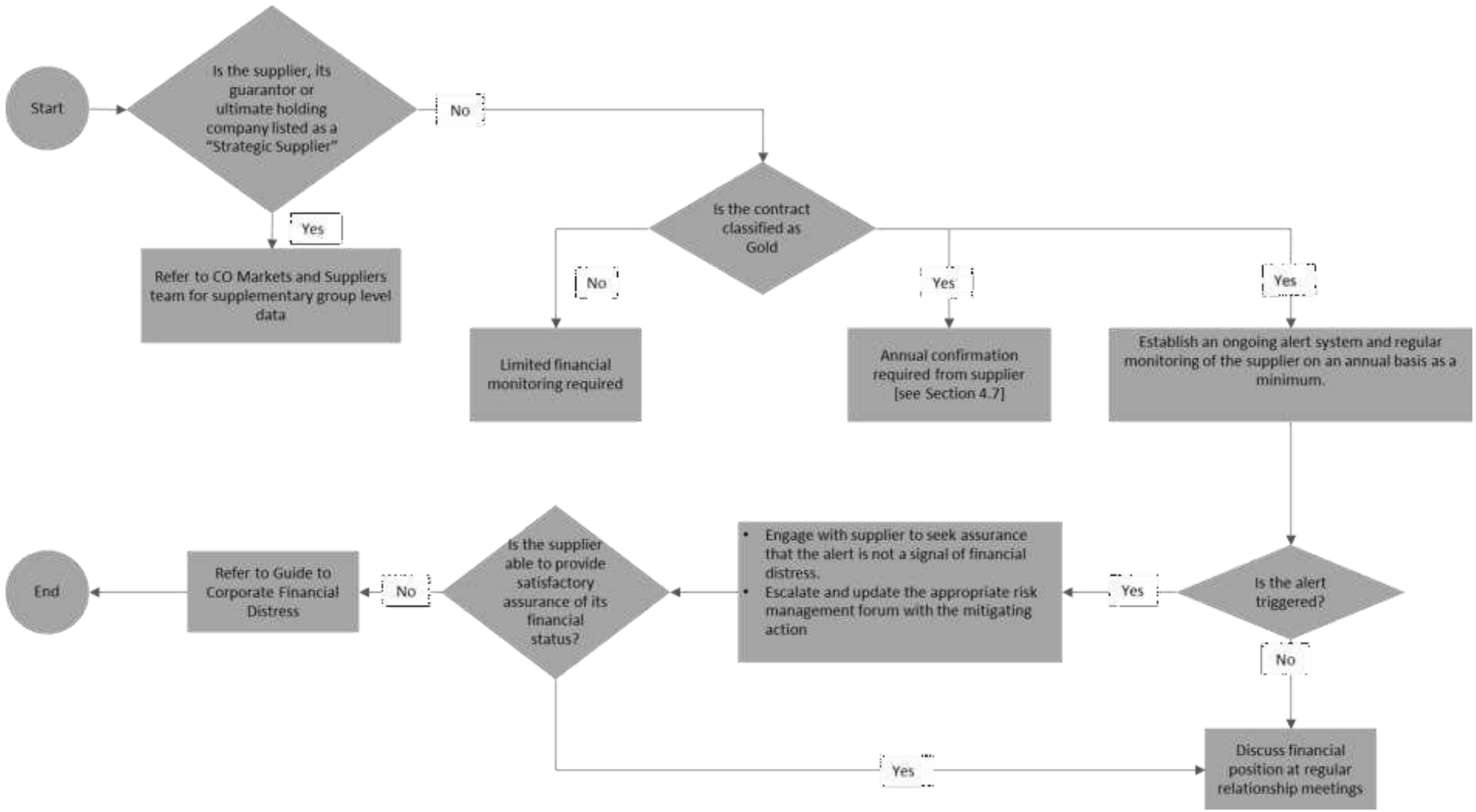
Financial Testing Tree Part 1 – Financial Assessment of Tenderers



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>Not Prime</td><td>BB+</td><td>B</td><td>BB+</td><td>B</td><td></td></tr>
</table>

Ba2		BB		BB		Non-investment grade speculative
Ba3		BB-		BB-		
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

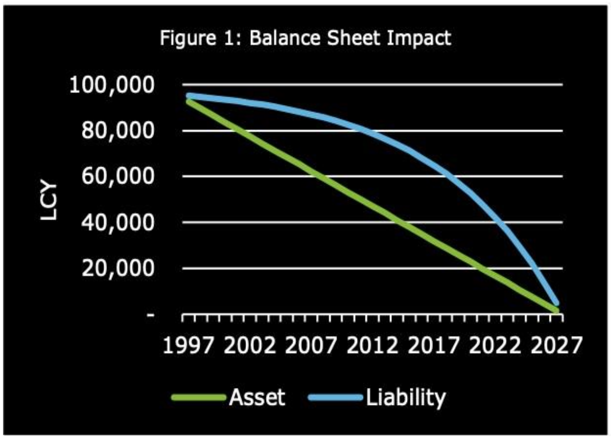
EBITDA is likely to increase as rental costs, which reduce earnings before interest and tax, are removed and replaced by interest costs and depreciation which are explicitly excluded from the accounting metric[29]. Initial work undertaken implies this could be as much as 10% across listed companies.

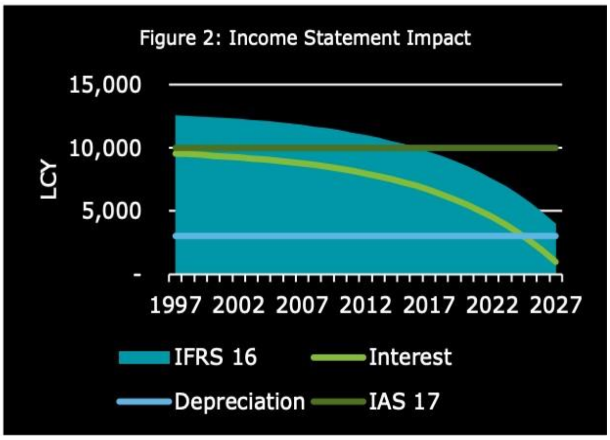
It is also expected that Net Debt will increase as a result of an additional lease liability being included in net debt and thus increasing leverage within an organisation. This is likely to be higher at an average of c.16%[30], leading to an overall increase in Net Debt to EBITDA ratios.

[29] Interest costs and depreciation are added back to the earnings before interest and tax to derive EBITDA.
[30] https://www2.deloitte.com/content/dam/Deloitte/za/Documents/finance/IFRS-1-brochure-V9.pdf

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 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.[31] Initial studies have seen as large as 147% increases in Net Debt: EBITDA for the transportation, construction & engineering services sector[32].

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.

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

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

Useful Links

IAS Plus IFRS 16 / Deloitte IFRS 16 e-learning

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.[33]

Key considerations for an increase in Net Debt[34]

- 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

[33] 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.

[34] To be considered as relevant alongside the potential mitigations identified in Metric 3A – Free Cash Flow to Net Debt Ratio.

before considering whether to assess the company’s health on a pre-IFRS 16 basis.

- 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.

<u>Key considerations for an increase in EBITDA</u>[35]

- 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.

<u>Key considerations for a worsening of Interest Cover Ratio</u>[36]

- 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).

[35] To be considered as relevant alongside the potential mitigations identified in Metric 3B – Net Debt to EBITDA Ratio.
[36] To be considered as relevant alongside the potential mitigations identified in Metric 5 – Net Interest Paid Cover.

- 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 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[37]

- 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

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

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. 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:

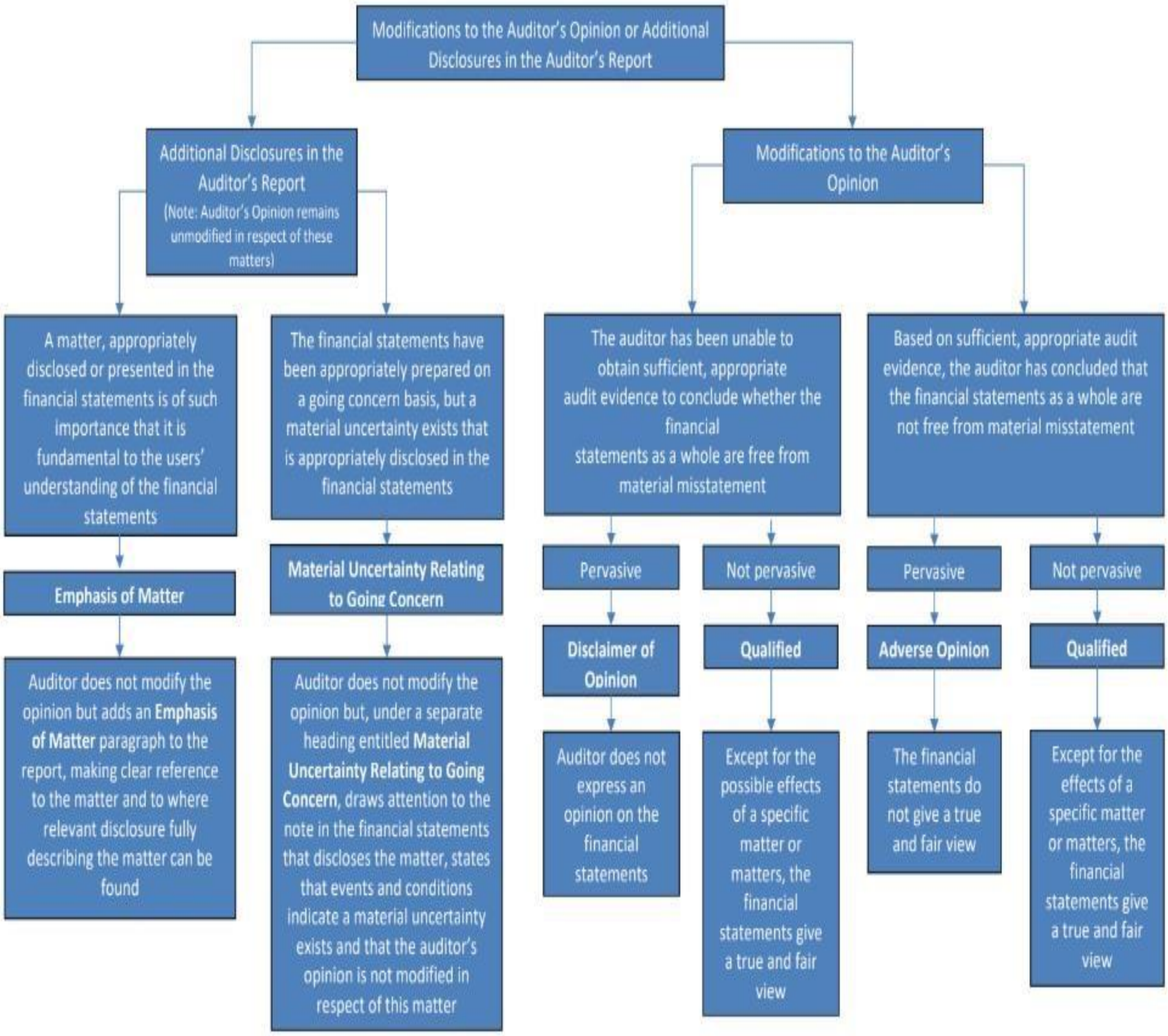
In the PQQ document potential questions could include:

- 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).[38]

[38] 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 Financial Viability Risk Assessment tool

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

Construction Playbook

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

Companies House

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

Contract Tiering Tool (KHub account required)

https://khub.net/group/gcf-community/cm-guide/-/knowledge_base/b-3-1-tiering-the-contract

Company Watch

https://www.companywatch.net/

Dun & Bradstreet
https://www.dnb.co.uk/

Model Services Contract

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

Experian

https://www.experian.co.uk

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

The role of the Chairperson is to:

- determine what training[39] 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 Regulation 24 of The PCR 2015[40] (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;

[39] For procurements above UK thresholds, tender evaluation panels must receive appropriate training in evaluation best practice.
[40] Regulation 42 of The UCR 2016. Regulation 35 of The CCR 2016.

- 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.