

CRITERIA USED FOR FINANCIAL EVALUATION OF CANDIDATES IN THE PROCUREMENT PROCESS

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

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

In most cases, a range of factors need to be considered. The financial appraisal, forms part of a broader, holistic assessment of the candidate to determine capacity (the ability to deliver) capability (to a required standard) and the degree of dependency on a single contract or customer.

North Hertfordshire carry out their financial appraisals using the following tests as appropriate depending on the number of years the organisation in question has traded.

Turnover and Contract Limit

A contract limit is the size of contract that is considered “safe” to award to a supplier, based on a simple comparison of the annual contract value to the annual (or average annual) turnover.

E.g., Ideally, we require the contract value to be only 10% of the candidates overall annual turnover.

We use this indicator to highlight the following issues

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

This notional calculation of contract limit is only used as **part of** the assessment to confirm the Authority’s opinion of whether a candidate is substantial enough to provide the appropriate capacity.

Candidates will only be eliminated on the strength of the contract limit alone if they **clearly** have insufficient capacity to deliver the requirement and there is no appropriate support available from a parent organisation or other third party.

Credit Checks

An independent credit status checks is carried out with

- ICSM - www.icsmcredit.com

These are subscription based credit check companies. The information they provide tells us the credit limit for the candidate and the current assessment concerning it's level of credit worthiness. The results from each, are compared across all the other candidates being assessed.

Assessment of Company Accounts

Figures from the accounts provided by the candidate are used to calculate the movement on turnover, gross profit/loss and operating profit between the past three years or for however many years the organisation in question has been trading. The information is used to help provide assurance as to the financial stability of the company and will help to show whether trade volumes are stable. In order to provide this assurance, ratio analysis is carried out on the figures provided in the accounts.

Where no accounts are available due to length of trading, the Council will need to be satisfied that the organisation's credit and cash position is sufficient to perform the contract and the Council reserves the right to request additional guarantees or indemnities it considers appropriate..

Ratio Analysis

Accounting ratios are an aid for analysing and interpreting relationships existing between different items in a candidates financial statements. They help to highlight areas and items that should be subjected to more detailed examination and questioning. Few figures in the financial statements are significant in themselves. Ratios help to show relationships to other quantities or the direction and amount of change over a period.

Two main areas are tested

- Financial structure – assessment of whether a candidate is likely to experience cash flow problems, whether the business is adequately financed and from what sources. The main areas tested are liquidity and gearing (or leverage)
- Operating Performance – assessment of the financial performance of the company.

Financial Structure Ratios

Acid Test

This is carried out in order to test liquidity. The calculation is:

(Current Assets - Stock)

Current Liabilities

A ratio of 1:1 is generally considered appropriate.

Gearing

This helps to identify the level of long term debt in the capital structure.

The calculation is:

$$\frac{\text{Long Term Debt}}{\text{Net Worth}} \times 100 = \%$$

Generally, the lower the gearing percentage the better, however, when considering the level of long term debt, the level of interest payments are also taken into account. A company may have high levels of long term debt, but the interest payments could mean it is a manageable debt.

Operating Performance Ratios

Return on Capital Employed (ROCE)

A calculation is done to identify the return on invested capital.

$$\frac{\text{Operating Profit}}{\text{Capital Employed}} \times 100 = \%$$

This is the most important measure of the overall efficiency of the management of the business as it relates the result of operations to the total funds being used in the business. It helps to show the operating performance of the company. When compared to the acid test, it gives an idea as to the candidates vulnerability to take-over and bankruptcy. The higher the ROCE percentage the better, however ROCE does vary by industry sector and this must be taken into account.

Information Obtained from the Supplier

In order to carry out the financial appraisal NHDC requires various information from the supplier. Generally, this information takes the form of the most recent set of audited accounts which show figures for the past three years of trading. These should include

- Profit and Loss Statements
- Cash Flow Statements
- Balance Sheet Information
- Parent Company Accounts (where applicable)