Appendix 1

City of London Corporation

CHAMBERLAIN'S FINANCIAL APPRAISALS

Procedure Guide and Manual

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SECTION 1: INTRODUCTION

1.1 ABOUT THIS PROCEDURE GUIDE

This procedure guide has been written to replace several existing documents within Corporate Treasury in order to present a consistent approach to financial appraisals regardless of the source of the request e.g. commercial lettings, City property developments, procurement projects, and ad hoc background checks. The guide seeks to incorporate best practice and officers' experience and knowledge developed over several years. The main changes to previous practice brought about by the Public Contract Regulations 2015 [PCR 2015] are that only 2 years' full signed accounts can be requested for appraisal in respect of procurement projects and the Pre-Qualification Questionnaire now discloses financial criteria to potential tenderers to facilitate self-assessment. All other appraisals remain outside of these changes. In every respect however – analytical techniques, quality of evidence, and interpretation of results - all financial appraisals are undertaken in a standard manner and this guide should be read accordingly.

1.2 WHAT IS A FINANCIAL APPRAISAL?

1. A financial appraisal of a company [or other entity which produces accounts – e.g. charity, limited liability partnership, sole trader] in the context of the Research and Technical team [R&T] is a desk top evaluation of publically available financial information, usually in the form of published accounts or summaries thereof. Constituent members of consortia are treated as standalone individual entities for the purposes of financial appraisals; the format of a consortium will determine the impact of the appraisal results.

2. A financial appraisal undertaken on a set of accounts is valid and relevant solely to that set of accounts <u>at the time of the appraisal.</u>

3. A financial appraisal is <u>not</u>:

    a. An exercise in due diligence [which is a phrase with a very specific meaning in law];
    b. A guarantee of future performance, whether good or bad;
    c. An opinion which applies forever afterwards;
    d. Fool proof, as it can only be as good as the available information;

4. All appraisals are undertaken to common standards of analysis and presentation and also require the same standard of information to be provided to the R&T team. City Procurement requests are based on 2 years' full signed accounts. Other departments' requests are based on 3 years' full signed accounts.

1.3 WHY UNDERTAKE A FINANCIAL APPRAISAL?

5. The City of London Corporation [CoL] has a diverse range of commercial and business interests. This means that its financial resources are exposed to risk, either by loss of income or by incurring excessive expenditure, when engaging with other entities. Financial appraisals are a means of mitigating that risk in some part.

6. The main areas of risk are retail and commercial leases, property developments, contracts for the supply of goods or services and the Approved List of Caterers for Guildhall functions.

1.4 WHAT SOURCES OF INFORMATION ARE USED?

7. The principal sources of information are company accounts, management accounts and business plans with financial information.

8. Credit reference agency reports are used for accounts information, company structure, shareholdings and directorship histories <u>and not</u> for the credit rating/procurement limits suggested by the agency. There are several reasons for this – credit ratings utilise information to which the CoL is not privy, the information is analysed by methodologies which are not disclosed and the ratings themselves are not directly applicable for the purposes of a Chamberlain's financial appraisal.

9. Companies [or other entities] which are recently incorporated or still in inception will not have accounts as such to be appraised. In such instances business plans and supporting financial information are acceptable.

10. Accounts provided for appraisal should be:

    a. The accounts of the entity in question
    b. The latest available set;
    c. Fully signed where required;
    d. Full and not abbreviated accounts.

11. In the case of contract tenders, if at the date of the tender the last accounts were for a period ended more than ten months previously, interim management accounts and/or turnover statements for the current period should be provided.

SECTION 2: TECHNICAL

2.1 QUALITY OF THE INFORMATION REQUIRED

1. Where accounts are requested R&T requires full signed accounts which should meet the criteria in paragraph 10 above. The only exception allowable to this is where an entity has not been in existence long enough to file or produce this information. Prior year comparatives are not an acceptable substitute as they are usually lacking detailed notes.

2. Where a business entity is yet to be incorporated or has not yet filed any accounts it is the usual practice to request business plan type information and other ancillary information as follows:

    a. An opening balance sheet;
    b. Management accounts for the initial trading period to latest period [including detailed income/expenditure or profit & loss and latest balance sheet];
    c. A medium term trading/cash flow forecast [preferably first year analysed month by month] or medium term business plan;
    d. Information concerning the owners/partners/directors [names, dates of birth and addresses with postcodes];
    e. Information about parent and ultimate parent companies [names and registrations numbers] if applicable.

    This information should be produced and signed by a person in a senior position within the business.

3. Not every entity is obliged to produce accounts for filing or external scrutiny e.g. Limited Partnerships [N.B. these are distinct from Limited Liability Partnerships which are regulated in a similar manner to companies], sole traders. In such cases the certification or otherwise of the accounts can vary widely but as far as is practicable the same standard of verification should be applied. In all cases the standards of appraisal remain the same – the status of an entity does not influence the final opinion.

4. Business entities may be registered with regulatory bodies other than Companies House e.g. The Charity Commission, Financial Conduct Authority, and these can have different requirements for the filing of accounts. Companies registered in Crown dependencies or foreign countries are not necessarily governed by the same standards of certification and audit as mainland UK companies.

5. In such cases, if accounts are provided however they should still be checked for compliance with local statute/regulation as far as this can be ascertained. It is the general practice of R&T to accept such accounts as provided in good faith, subject to any additional source of information

available which can be cross checked to information in credit reference reports.

2.2 HOW FINANCIAL APPRAISALS ARE UNDERTAKEN

6. A financial appraisal is initiated by a request from another officer and should include all of the following information where applicable:

   a. The name of the contract;
   b. The total amount of contract [actual or estimated];
   c. The length of the contract in years;
   d. If the contract is more than 12 months in length - the specific phasing of contract amounts in each of the succeeding periods;
   e. The names of the tendering entities and company registration numbers [which should be sourced from PQQ/application form not financial accounts supplied];
   f. The reasons for particular concern if the contract cost is below any pre-determined de minimis level;
   g. Which OJEU procedures are applicable to the contract procurement;
   h. Whether or not the provision of financial statements was a mandatory condition under the OJEU procedure or similar.
   i. The name of the relevant contact officer; and
   j. The name of the Head of Finance who will financially review the associated Committee Report [if applicable].

7. The City Surveyor's department has a standard procedure to determine whether or not an appraisal is required and uses a request form which should include all of the relevant information for an appraisal if required.

8. The standard timescale applies to all appraisals but in cases where a short list exceeds 6 companies, an extension to this time should be agreed and confirmed with the requesting officer as soon as possible.

9. Once the information received for an appraisal is confirmed as being complete and correct the appraisal proper can commence.

2.3 HOW FINANCIAL APPRAISALS ARE UNDERTAKEN: ANALYSING THE FINANCIAL INFORMATION

10. Financial appraisals are conducted on a case-by-case basis and there is no set formula or threshold applied, provided the organisation has not failed in respect of any initial pass/fail criteria published on the PQQ. The results of the appraisal are down to the analysis of the information provided and the judgement of the individual R&T officers undertaking the appraisal.

11. In cases where the provision of financial information is a mandatory condition of a procurement exercise, R&T does not have freedom of action to obtain or utilise financial information unless it has been provided directly as part of the exercise. Once the information has been checked for quality

[see above section on quality] a standard working paper is completed. This applies regardless of whether a company files full accounts or not. Credit reference reports are to be obtained as near to simultaneous real time as possible to demonstrate equity of treatment.

12. Where an entity has not yet filed or published accounts then such business plan information as is supplied which also satisfies the quality requirements above may be used. This information rarely includes profit and loss accounts so it is not usually the case that a working paper can be completed. Credit reference agency reports should be obtained if available as these contain useful background information.

13. In general, the main items examined include, but are not limited to:

    a. Turnover;
    b. Profitability;
    c. Working capital;
    d. Net worth;
    e. Cash flow;
    f. Funding;
    g. Intercompany trading;
    h. Company ownership;
    i. Directors’ appointments;
    j. The auditor’s report;
    k. The directors’ report;

14. Standard accounting ratios and Altman’s Z-Score are used on PQQ as an initial check on financial suitability. Entities which fail to meet these criteria as published on the PQQ are not appraised. Entities which do meet these criteria will not necessarily be appraised as financially satisfactory.

15. In the case of charity accounts the proportion of restricted funds received and held should be noted. The charity’s general effectiveness is more properly assessed from its level of general reserves and unrestricted incoming resources. The reserves policy should also be noted, whether or not this has actually been achieved. The relevance of restricted funds is not solely financial e.g. a charity’s priorities may be dictated by the need to meet service delivery conditions attached to a restricted grant received.

16. The results of financial appraisals are reported to the requesting officer and the relevant departmental finance head if applicable.

SECTION 3: DEVELOPMENTS

3.1 CHALLENGES FACING FINANCIAL APPRAISALS

1. The financial and operational environment in which the City must function is changing, particularly with regard to contracts and tendering, procurement initiatives and accounting regulation. It is important that R&T keeps abreast of changes in order to maintain relevance and accuracy.

2. The main challenges identifiable in early 2015 include:

    a. Closer regulation of procurement and prescription of financial appraisal requirements under EU directives e.g. Directive 2014/24 was transposed into UK law as PCR 2015 with effect from 26 February 2015;
    b. Greater transparency of procedures required by City Procurement to meet challenges to tender evaluation results;
    c. The effects of using strict financial criteria on PQQ as an initial self-certifying assessment by prospective tenderers;
    d. How to monitor contractors' financial accounts over the life of contracts where the term extends past the next accounting date [as a minimum];
    e. How to deal with consortia/Joint Venture Companies and remain compliant with EU regulation where applicable;
    f. How to maintain a robust analysis in cases where usual appraisal practices are not ideally suited e.g. contracts tendered specifically with community interest companies/charities/social enterprises in mind;
    g. Incorporation of more factors into the appraisals themselves e.g. cash flow analysis, cost benefit analysis of rent free periods vs. empty rates costs, weighting of risk assessment of money vs. time period.
    h. Potential incorporation of more detailed financial appraisal information into committee reports which will raise the profile of R&T and emphasise the need for robust and defensible appraisal opinions in the face of member challenge.

3. How and when R&T meets these challenges will depend on the source – for example, forthcoming procurement regulation changes will be externally imposed and require immediate implementation whereas accounting standards will require internal review of working papers in the period after 2015.

SECTION 4: ANNEXES

ANNEXE 1: PQQ FINANCIAL CRITERIA

Appraisal Of Applicants' Financial And Economic Standing

1. Applicants are required to pass the City's appraisal of their financial and economic standing. The appraisal consists of three parts as described below:

PART A: Applicants are required to satisfy minimum standards with regards to their turnover requirement, standard accounting ratios and Altman's Z Score. Details of these standards and their calculation are set in para 2 to 5 below.

PART B: The Applicants' accounts will be examined following the process described in para 5 to 7 below to determine whether there is material evidence to show that they do not have the financial and economic standing to perform the contact.

PART C: Applicants with accounts that display any of the factors listed in para 8 below will automatically result in a failed appraisal. Applicants with accounts that display any of the factors listed in para 9 below will be failed unless there are strong mitigating circumstances.

Applicants Must Pass All Three Parts Of The Appraisal Process

PART A:

Turnover Ratio

2. Minimum Turnover Requirement:
The turnover requirement is calculated as the annual average of the last two reported financial years, divided by the estimated annual contract value. Applicants will be required to have a result of '**2.0**' or greater.

Standard Accounting Ratios

3. Applicants will be required to meet minimum standards with regards to the following accounting ratios calculated from their last reported set of financial accounts.

   a. Current Ratio: being total current assets divided by total current liabilities. Applicants will be required to have a result of '**Y.Y**' or greater.

b. Quick Ratio: being total current assets excluding stock and work in progress divided by total current liabilities. Applicants will be required to have a result of ‘**Z.Z**’ or greater.

c. Profits before interest and tax as a percentage of an entity’s turnover: Applicants are expected to be profitable and not to be loss making. No minimum profit percentage is prescribed as long as the applicant is profitable.

d. Profits before interest and tax as a percentage of total assets: Applicants are expected to be profitable and not to be loss making. No minimum profit percentage is prescribed as long as the applicant is profitable.

Altman’s Z Score

4. A definition and explanation of Altman’s Z score and its calculation can be found on: http://en.wikipedia.org/wiki/Altman_Z-score

5. Applicants are required to have an Altman’s Zones of Discrimination score of ‘**1.8**’ or greater calculated as follows from the latest reported set of financial accounts:

a. The sum of [Working Capital divided by Total Assets] multiplied by 1.2; plus
b. The sum of [Retained Earnings divided by Total Assets] multiplied by 1.4; plus
c. The sum of [Profits before interest and tax divided by Total Assets] multiplied by 3.3; plus
d. The sum of [Market Capital divided by Total Liabilities] multiplied by 0.6; plus
e. The sum of [Turnover divided by Total Assets] multiplied by 1.0.

f. The sum of factors (a)-(e) above is compared to Altman’s Zones of discrimination to reach a numerical score.

PART B:

Assessment of financial statements for evidence of financial and economic standing

5. In addition to the requirements set out in Part A above, the City will critically examine the following items in the accounts to determine whether the applicant has the financial and economic standing to perform the contract:

a. Turnover
b. Profitability
c. Working Capital
d. Net Worth
e. Cash Flow
f. Funding

g. Intercompany Trading
h. Company Ownership
i. Directors Appointments
j. Auditors Report
k. The director's report
l. Indices calculated on turnover, retained profit and working capital over three years.
m. Notes to the accounts

Where the applicant is a charity, the following items will also be considered:

a. The proportion of restricted funds received and held;
b. The level of general reserves;
c. The level of unrestricted incoming resources;
d. The reserves policy, and whether or not this has actually been achieved;

6. In relation to the items above, the City will examine year to year changes, the accuracy of the data, any unexplained large movements, any changes in ownership, unexplained restating of prior year comparative figures and any relevant narrative to establish whether the applicant has the financial and economic standing to perform the contract.

7. The applicant will be failed if in making the assessment above, there is material evidence to show that the applicant lacks the financial and economic standing to perform the contract.

PART C:

Factors which will lead to a failed appraisal of the applicant's economic and financial standing

8. The following factors **will** result in a failed appraisal of the applicant's financial and economic standing:

a. A qualified audit report on the latest set of accounts;
b. Loss making entities with negative working capital and negative net worth
c. Entities in administration;
d. A refusal to provide 2 years' full signed accounts where it is known that such information exists;
e. Signed accounts which are numerically inaccurate, incomplete or which contradict other versions of the same accounts;
f. Accounts with pages inserted belonging to other entities;

Factors which will lead to a failed appraisal of the applicant's economic and financial standing unless there are strong mitigating circumstances

9**.** Applicants with accounts displaying any of the factors listed below will result in a failed appraisal of their economic and financial standing unless there are strong mitigating circumstances shown in the accounts, or other financial documents that the applicant is able to provide to the satisfaction of the Chamberlain:

a. Accounts overdue for filing by more than one month;
b. Accounts disclosing a loss with negative working capital and whose net worth is negative if intangible assets are discounted.
c. Three or more late filings out of the last five of documentation required by Companies House eg the annual return or accounts;
d. Registrar's Motions to Strike Off from the register of Companies;
e. Entities operating under a Corporate Voluntary Arrangement or other such agreement with creditors;
f. An Emphasis of Matter raised by the Auditor eg on the validity or otherwise of a going concern statement;
g. Failure to disclose a conflict of interest revealed by examination of the accounts.