<table>
<thead>
<tr>
<th>Annex B</th>
<th>Key Ratios for Analysis ............................................................... 40</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annex C</td>
<td>Financial Glossary ............................................................................... 46</td>
</tr>
</tbody>
</table>
1 Introduction

Purpose of Guidance

1.1 This guidance provides advice on how to conduct the financial appraisal of candidate suppliers bidding for significant public sector contracts. Although it is particularly relevant to the procurement of strategic services, the principles apply to all government purchasing. The scope and effort of financial appraisal should be proportionate to the size and risk of the contract. The guidance endorses a broad business approach so that risk is assessed relative to the particular factors of the requirement and the supplier.

1.2 Although this guidance is primarily intended for staff responsible for public sector procurements, it should also be helpful to potential suppliers by giving them an understanding of the scope and rigour of Authorities’ appraisal processes. Its use is not mandatory but it is strongly recommended by OGC and represents current good commercial practice.

1.3 This guidance updates the first edition that was published in October 2001.

Practitioners

1.4 Only suitably experienced staff should conduct supplier financial appraisals, calling on specialist expertise as necessary. In terms of formal training, the National School of Government’s Certificate of Competence in Purchasing & Supply, and the ACCA Diploma in Financial Management are desirable qualifications.

EU Procurement Rules

1.5 References to the EU procurement rules include the EU Procurement Directives as implemented in UK legislation\(^1\), related rulings of the European Court of Justice and other relevant EU law.

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\(^1\) in terms of value, duration, strategic importance or complexity

\(^2\) The Public Contracts Regulations 2006 (SI 2006 No. 5) [http://www.opsi.gov.uk/si/si2006/20060005.htm](http://www.opsi.gov.uk/si/si2006/20060005.htm)

See also OGC’s EU procurement guidance [http://www.ogc.gov.uk/documents/Intro_to_EU.pdf](http://www.ogc.gov.uk/documents/Intro_to_EU.pdf)
Acknowledgement

1.6 Prepared by OGC, this guidance has been developed after extensive consultation in both the public and private sectors, drawing on feedback from many contributors. These contributions are acknowledged with thanks.

April 2008
2 Overview

Key Messages

2.1 The assessment of risk should be based on sound business judgement rather than just the mechanistic application of financial formulae (see section 2.11).

2.2 All candidates, whatever their size, should be treated fairly and with equal diligence during the financial appraisal process. Small and Medium-sized Enterprises (SMEs) should not be inadvertently disadvantaged (see 3.7 et seq.).

2.3 Candidates are requested to provide accounts for the past two years of trading rather than for the previous three years, (which has been a traditional requirement of contracting authorities but not required by the EU procurement rules). In the absence of audited statements, other information should be requested that is considered sufficient for assessment purposes (see 3.9 et seq.).

2.4 Financial standing should only be considered as part of the risk assessment. It may not, on its own, reflect candidates’ ability to deliver (see 3.12).

2.5 As a questionnaire pro-forma, suggested information requirements from candidates regarding their economic and financial standing are listed (see 3.17).

2.6 Although a contract limit based on turnover can be a useful indicator of financial capacity and dependency, candidates should only be eliminated on the strength of contract limit alone if they clearly have insufficient capacity to deliver the requirement (see 3.26 et seq.).

2.7 The Profit & Loss (P & L) account (income statement for accounts prepared under International Financial Reporting Standards) and Balance Sheet alone do not provide sufficient information for a thorough financial assessment of a supplier. Cash is the immediate requirement for working
capital needs; a candidate’s cash generating ability should be assessed where possible (see 3.32 et seq.).

2.8 Although it is desirable to reduce a large response to a more manageable number, suppliers should only be excluded from further consideration if they are clearly unrealistic candidates having inadequate resources to undertake the work (see 3.39).

2.9 Financial data and credit ratings from specialist on-line providers are useful snapshot indicators but should not be used as a substitute for detailed examination of a candidate’s financial statements (see 4.4).

2.10 As part of the detailed appraisal process, the Authority should, for a major award, check whether a candidate is rated by one of the leading debt rating agencies. Their rating reports take account of a company’s corporate strategy, operating position, financial management and general prospects, and should be noted by the Authority (see 4.5). A candidate should not be penalised if it does not have a debt rating.

Recommended Approach

2.11 The key objective of financial appraisal in the procurement process is to analyse a supplier’s 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 should be based on sound business judgement rather than just the mechanistic application of financial formulae.3

2.12 Most significant procurements will be over the EU thresholds, and therefore the EU procurement rules will apply. In addition, the OGC Gateway Process5 examines programmes and projects at key decision points in their lifecycle. It looks ahead to provide assurance that they can

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3 see also Green Book, Appraisal and Evaluation in Central Government at http://greenbook.treasury.gov.uk/


5 http://www.ogc.gov.uk/what_is_ogc_gateway_review.asp
progress successfully to the next stage; the process is best practice in central civil government, the health sector, local government and Defence. The selection and evaluation stage of the procurement lifecycle proceeds after the Gate 2 Review of Delivery Strategy and before the Gate 3 Review of the Investment Decision.

2.13 In the context of the EU rules, 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 can be grounds for selecting a candidate to tender or negotiate.

2.14 In most cases, a range of factors needs to be considered as part of the financial appraisal and various financial statistics, ratios\(^6\) and figures analysed. The financial appraisal also needs to form part of a broader, holistic assessment of the candidate, which looks at capacity (the ability to deliver), capability (to a required standard) and the degree of dependency on a single contract or customer.

2.15 Once the appropriate data have been obtained, the Authority must apply commercial judgement to the issues. There are some occasions when the numbers will suggest a clear-cut decision. A supplier that is consistently trading unprofitably, with a net deficit and no apparent working capital may be a simple case for non-selection. But often the situation will not be clear-cut, and here judgement must be applied.

2.16 The following sections give more detail about the various aspects of financial appraisal and how to use them, but the underlying principle remains that the Authority must apply a broad, commercial perspective and assess the risk relative to the particular circumstances of the supplier and the contract rather than placing an over-reliance on numerical formulae to reject or accept a candidate.

\(^6\) see Annex B Key Ratios for Analysis
3 Financial Appraisal of Candidates

Objective

3.1 The objective of financial appraisal is the selection of candidates to minimum standards for the particular procurement. In practice, this can be a time consuming and costly process. So suppliers that clearly fall short of the minimum standards should be identified before going on to assess the remaining candidates in more detail.

Use of Third Parties for Appraisal

3.2 As stated at 1.4, only suitably experienced staff should conduct supplier financial appraisal, calling on specialist expertise as necessary. Where there is a lack of in-house expertise, an Authority can use a third party to undertake financial evaluation, monitoring and risk assessment, if it has the necessary skills and experience.

3.3 The Authority is responsible for ensuring that the third party service provider undertakes the assessment process diligently and professionally and that its online databases are not used as a substitute for detailed examination of candidates’ financial statements (see 4.4). The Authority is also ultimately responsible for selection decisions after considering recommendations from the third party financial appraisal process.

Information Used

3.4 Under the EU procurement rules, proof of the supplier’s financial and economic standing may be provided by one or more of the following:

- appropriate statements from the candidate’s bankers or where appropriate, evidence of relevant professional risk indemnity insurance;
- statements of accounts or extracts from them relating to the business of the candidate where publication of the statement is required under the law of the relevant State in which the candidate is established;
• a statement of the overall turnover of the business of the candidate and the turnover in respect of services of a similar type to those to be provided under the proposed contract in the three previous financial years of the candidate. [Statements covering three years may be taken into account, but this is not a requirement]

3.5 The most recent audited accounts should be provided (that show figures for the past two years of trading – if applicable); however, where the information is not appropriate or is unavailable in a particular case, the Authority may, under the EU rules, require a candidate to provide other adequate information to demonstrate the candidate’s economic and financial standing (see 3.10). Also, where the candidate is unable for a valid reason to provide the information that is required, the Authority may accept such other information provided by the candidate as is considered appropriate to ensure equal treatment. The Authority may also require the candidate to provide supplementary information. This flexibility is particularly relevant for achieving a level playing field during the appraisal process.

OJEU Advertisement

3.6 The Authority should specify in the OJEU (Official Journal of the European Union) advertisement (Contract Notice) the information required to undertake the supplier appraisal. Having reviewed expressions of interest from potential suppliers in response to the advert, it may be necessary to obtain further information on their economic and financial standing in order to select which suppliers should participate in the procurement. For example, this further information could be obtained via a Pre-Qualification Questionnaire (PQQ, see 3.17) or a follow-up letter subject to the limitations imposed by Regulation 24 of the Public Contracts Regulations 2006.

Equal Treatment

3.7 Care must be taken to ensure that respondents are treated equally (one of the main principles of the European Treaty). A key Government strategy is to achieve effective competition for government business by simplifying access to the government market place for suppliers. In particular, Small and Medium-sized Enterprises (SMEs) can be inadvertently disadvantaged and there is also a need to attract innovative suppliers where they can provide better value.
3.8 SMEs may have sometimes been inadvertently excluded from further consideration because:

- they were recently formed and could not provide financial information for the previous three years (which has been the traditional requirement, but is not recommended in this guidance – see 3.11), or provide any filed accounts at all; and / or
- they did not have a parent company that could provide a deed of guarantee as security.

3.9 Authorities are therefore urged to exercise flexibility within the bounds of equality in specifying their financial information requirements in the Contract Notice or follow-up questionnaire. Given that audited accounts including a cash flow statement, may not be available, the drafting of the advertisement or the subsequent questionnaire should be sufficiently flexible to allow SMEs, or any other candidates, to provide other appropriate information e.g. draft accounts that will demonstrate the supplier’s economic and financial standing.

3.10 Examples of other information that may be appropriate to enable an assessment to be undertaken include:

- parent company accounts (if applicable);
- bankers statements and references;
- accountants’ references;
- management accounts;
- financial projections, including cash flow forecasts;
- details of previous contracts, including contract values; and
- capital availability.

3.11 A suggested pro-forma for questions regarding financial and economic standing is outlined at 3.17. Audited accounts are requested, if available, that include figures for the past two years of trading rather than for the previous three years. Over-emphasis on historical accounts is not a helpful guide to a candidate’s current suitability. The financial position of a candidate may have significantly strengthened (or weakened) in the period between the last published accounts
and the start of the new contract – a period that can be as long as two years. Many suppliers are also operating on a global basis and there is increasing restructuring and consolidation activity in some markets making historical data beyond two years less relevant for current financial appraisal purposes. In the absence of more recent audited statements, other information should be requested that is considered sufficient for a current assessment of a candidate’s financial standing.

3.12 Although a major supplier may present less financial risk than an SME for the same contract, the level of risk presented by an SME may still be acceptable and manageable and may be offset by increased value for money. For example, in the fast moving information technology market place, well-established suppliers may not necessarily offer the most innovative or cost effective solutions. Candidates’ financial standing should only be considered as part of the risk management exercise. It may not, on its own, reflect their ability to deliver. The financial risk should be carefully considered before a decision is made on whether to select the candidate.

Information from Partnerships

3.13 Some projects attract expressions of interest from partnerships. Partnership accounts, except for Limited Liability Partnerships (LLPs), see below, are not subject to a statutory audit and these firms usually confine their disclosures to statements of turnover. This presents a problem for contracting authorities because:

- without further details, the financial status of the firm is unknown; and,
- compared to candidates that are companies or LLPs, such firms appear to enjoy a privileged position in the bidding process by virtue of being a partnership entity and therefore not having to disclose the same financial information as corporate competitors.

3.14 The EU procurement rules make provision for contracting authorities to take into account statements of accounts or extracts from them where publication of the statements is required under the law. They also permit that where the information is not appropriate in a particular case (partnerships, with the exception of LLPs, are not required under the law to publish a statement of accounts), a contracting authority may require a supplier to provide other information to demonstrate
economic and financial standing provided that the required information is specified in the contract notice. The Authority cannot reject an application from a partnership that is not an LLP on the grounds of non-disclosure, but it is entitled to reject a candidate that is not able or willing to prove it has the necessary financial standing. In practice, a partnership is likely to release its accounts if the firm really wants the business. Partnerships may legitimately expect the contracting authority to treat this information as commercially confidential.

3.15 Following the Limited Liability Partnership Act 2000 and the LLP Regulations 2001 (and their Scottish equivalent) the legal entity of Limited Liability Partnership is available. Although legally a distinct type of entity compared to a limited liability or public limited company, certain provisions of the Companies Acts 1985 and 2006 and of other Acts regulating limited companies, also apply to LLPs. Of particular relevance to this guidance, provisions concerning accounts and audit requirements affecting limited companies also apply to LLPs. Therefore, for the purposes of analysing economic and financial standing using audited accounts, LLPs can practically be treated in the same manner as limited companies.

3.16 Since the LLP status has been available, a number of major accountancy, consultancy and other professional firms, previously partnerships, have registered as LLPs. Therefore the number of cases where Authorities have to seek alternative financial information as suggested above has been reduced.

**Questionnaire Pro-forma**

3.17 Candidates may be invited by the Authority to complete a questionnaire that can be used as the basis to measure them against the Authority’s minimum standards. The suggested information requirements relating to economic and financial standing are listed below:

(a) A copy of the most recent audited accounts that cover the last two years of trading or for the period that is available if trading for less than two years.

(b) A statement of the candidate’s turnover, profit & loss and cash flow position for the most recent full year of trading (or part year if full year not applicable) and an end period Balance Sheet, where this information is not available in an audited form at (a).
(c) Where (b) cannot be provided, a statement of the candidate’s cash flow forecast for the current year and a bank letter outlining the current cash and credit facility position.

(d) If the candidate is a subsidiary of a group, (a) to (c) are required for both the subsidiary and the ultimate parent. Where a consortium or association is proposed, the information is requested for each member company or firm.

(e) A separate statement of the candidate’s turnover that relates directly to the supply of this service for the past two years, or for the period the candidate has been trading (if less than two years).

(f) Parent company and/or other guarantees of performance and financial standing may be required if considered appropriate. Also, confirmation of the candidate’s willingness to arrange for a guarantee or a performance bond (see 4.32 et seq).

(g) Details of the candidate’s insurance protection in respect of public and professional liabilities (see 4.42).

For further information on pre-qualification questions, go to the OGC website.  

Initial Analysis

Basic Checks

3.18 Basic checks should be made on a UK-based candidate company’s title and its registered number at Companies House, whether the company is trading or dormant and whether it is owned by another company or supported by a venture capital organisation. The status of the company’s accounts should also be determined, that is the last accounting period for which statements have been filed and whether there are later accounts that are overdue.

3.19 A free-of-charge searchable Company Names and Address Index called WebCheck is available from the Companies House website. A chargeable

7 http://www.ogc.gov.uk/social_issues_in_purchasing_pre-qualification_questionnaire.asp
8 http://www.companies-house.gov.uk
Companies House Direct service is also accessible from the same site, providing UK Company annual reports and accounts, annual returns, details of company directors, dissolved companies, disqualified directors and insolvency details. Companies that are in receivership, administration or liquidation can be identified from other specialist subscription based websites.

3.20 The Public Contracts Regulations 2006 include a mandatory requirement for contracting authorities to exclude economic operators (suppliers, contractors and service providers) from public contracts where they have been convicted of certain offences.\(^9\)

3.21 See also 4.4 ‘Credit Agencies & On-line Databases’ and 4.6 ‘Filings in the US’.

**Scope of Financial Analysis**

3.22 The scope of analysis should cover each candidate responding to the advertisement and, if applicable, their ultimate parent(s). It should draw attention to any significant items in the accounts, including turnover and trading results and their trends, cash movements, and Balance Sheet strengths and weaknesses. However, when addressing these items, procurement staff are encouraged to think in a broad, commercially focused manner by reviewing financial criteria in the context of the key characteristics and requirements of the contract.

**International Financial Reporting Standards (IFRS)**

3.23 Authorities should be aware that IFRS must be adopted by all listed companies in the EU for their consolidated accounts. Other, non-listed firms, including those that are subsidiaries of listed companies, have the option to adopt IFRS, but under current UK rules are not obliged to do so; however, if they choose to adopt IFRS they cannot later retract from that decision.

3.24 The specific changes to accounts arising from the adoption of IFRS are complex and Authorities should ensure that their analysts have sufficient training to interpret these accounts and to understand the potential differences between accounts prepared under IFRS and those prepared under pre-existing accounting standards. It is possible that Authorities will have some candidates whose

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accounts are prepared in accordance with IFRS, whilst other candidates’ accounts will not. Where applicable, Authorities should take these differences into consideration when comparing the financial standing of different candidates.

3.25 It will not be possible to clearly ascertain any generic trends in reported financial performance arising from the introduction of IRFS until these standards have been widely implemented over a number of years. In some cases it could lead to more year-on-year volatility in reported figures. It is intended that UK accounting standards (UK GAAP) will converge towards commonality with IFRS.

**Turnover and Contract Limit**

3.26 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. Authorities using this concept have tended to apply a maximum threshold of 25% (annual contract value to turnover). The concept of contract limit could be used as a guide in terms of:

- 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?
- or a dependency issue – will the candidate become over-dependent on this contract or contracting authority?

Generally, the greater the proportion of a candidate’s turnover represented by a contract, the more likely that one or more of these issues will be pertinent and any decision about the suitability of a candidate should be undertaken with that in mind.

3.27 While turnover can be a useful indicator for any of these questions, the more rounded, commercial approach that is recommended here means that the contract limit as a clear cut ‘yes or no’ factor should not be used as a matter of course. It is too simplistic a concept to carry such weight.

3.28 Turnover may be a useful indicator as to capacity, but it is far from the only factor. A supplier may have recently invested in productive capacity and be able to show
very clearly that it can manage a contract that is a high proportion of previous turnover. The contract limit also looks backwards; young or rapidly growing companies can easily double in size between the period relating to the accounts under consideration, and the actual period of the new contract, although consideration should also be given to whether a rapidly growing company could be overstretcing itself.

3.29 Issues of financial position, capacity, capability and dependency should all be considered as part of the appraisal process. If a candidate is not selected, there must be clear and demonstrable evidence of financial risks, capacity or capability issues over and above a simple turnover or ratio measure. If a candidate meets the minimum standards, it may still be unsuccessful if other suppliers score better on the key selection criteria.

3.30 A notional calculation of contract limit should therefore only be 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 should only be eliminated on the strength of 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.

Profit & Loss

3.31 Data from the P & L account (Income Statement under IFRS) should be noted and considered for both the candidate and the ultimate parent company (if applicable). If the candidate’s P & L account is showing losses, this does not per se justify its elimination from the competition. For example, start-up companies often return losses during their early years but the Balance Sheet may, nevertheless, show adequate financial resources. Moreover, financially sound companies sometimes make losses for a short period if undergoing a restructuring or rationalisation exercise.

Cash Flow

3.32 The cash flow of the candidate and its parent (if there is one) should be analysed where the information is available. The P & L account and Balance Sheet alone do not provide sufficient information to enable a thorough financial assessment of a candidate. The P & L account may be distorted by items not directly related to
the current trading performance of the company, and the Balance Sheet may contain substantial assets, which cannot easily be turned into cash. Cash is the immediate requirement for working capital needs.

3.33 Under financial reporting standards, reporting entities must include a Cash Flow Statement within their financial statements (there are some exceptions to this). Cash flow information should be requested from a candidate (see 3.17).

3.34 The Cash Flow Statement shows the inflows and outflows of cash for the relevant past period, classified under the following headings:

- operating activities;
- dividends from joint ventures and associates;
- returns on investments and servicing of finance;
- taxation;
- capital expenditure and financial investments;
- acquisitions and disposals;
- equity dividends paid;
- management of liquid resources; and
- financing.

3.35 For accounts prepared under IFRS, the headings cover:

- operating activities;
- investing activities;
- financing activities;
- net increase (decrease) in cash and cash equivalents;
- cash and cash equivalents at beginning of period; and
- cash and cash equivalents at end of period.

3.36 The Cash Flow Statement therefore shows cash generation and cash absorption of the business for the period. This arises not only from operating activities but also, for example, from investment in new equipment. The statement also eliminates non-cash accounting items (such as depreciation and the effects of accruals accounting) to reveal the underlying cash performance of the business. This should be carefully assessed to establish whether there is sufficient cash flow to cover working capital requirements, capital repayments and interest. The
candidate’s cash generating ability is a major influence on investment capacity and the level of debt that can be carried. As with all financial statements, the Cash Flow Statement should be considered in the light of the background knowledge the Authority has on the candidate.

**Balance Sheet**

3.37 The analysis should, where possible, include:

- the calculation of the key ratios for liquidity and gearing (see Annex B). Loans to the supplier should be identified (short and long-term borrowing) so that the overall stability of the candidate can be quantified. A consistent annual overdraft (that is, of a similar sum each year, or non-diminishing) should be treated as long-term borrowing in terms of gearing and operating performance, as well as the acid test;
- consider whether interest-bearing debt is inter-company or provided from an external source. Inter-company borrowings are less likely to pose the same level of risk as external borrowings;
- the debtors element of current assets: any due ‘after one year’ component should be excluded for the acid test of liquidity;
- the value of any goodwill, intellectual property and other intangibles as capitalised on the Balance Sheet; and
- the determination of net worth and that element that can be mobilised in a financial crisis.

3.38 This will assist in identifying (a) whether there are working capital or ‘overtrading’ issues (b) the risk of supplier bankruptcy and (c) investment capacity. The candidate’s capital structure should reflect a reasonable balance between business and financial risk.

**Assessment**

3.39 The assessment is undertaken to produce a summary profile of the candidate’s financial condition and that of its ultimate parent (if applicable). On a case-by-case basis, and taking into account the information derived above, a recommendation has to be made on whether a candidate meets the minimum standard. Although it is desirable to reduce a large response to a more manageable number, suppliers should only be excluded from further
consideration if they are clearly unrealistic candidates, having inadequate resources to undertake the work. If there are doubts about the company's financial status or unresolved questions such as whether a deed of guarantee is available (from whatever source), the supplier should be retained for further consideration. The 'bottom line' is that general formulae should not be applied mechanistically without also considering the specific situation of each supplier in the context of the requirement as well.

3.40 The assessment can be used to identify the level of risk presented by each candidate: e.g. Low Risk (proceed), Medium Risk (proceed with caution) and High Risk (consider elimination). This can be a qualitative assessment based on the interpretation of all the relevant information.
4 Detailed Appraisal

Objectives

4.1 The aim of the detailed financial appraisal will be:

- to focus appraisal effort on a thorough examination;
- to use this analysis to establish the number of candidates to be invited to negotiate or to tender.

Information Used

4.2 After the assessment of each candidate and their ultimate parents (if applicable), further financial appraisal of candidates should include a detailed analysis of their latest available audited and interim accounts (if applicable) and cash flow information. This appraisal should also cover consortium members and major subcontractors (if applicable/known).

4.3 Other information provided by commercial service providers or otherwise in the Authority's possession, that may have a bearing on a candidate’s financial position or ownership (such as credit facilities, debt ratings, current take-over activity, restructuring, new capital investment, or relevant contractual / commercial information from other departments etc) can also be assessed. Authorities should ensure that the material relates to the types of information and criteria detailed in the EU procurement rules.

Credit Agencies & On-line Financial Databases

4.4 Financial data and credit ratings from specialist on-line database providers are useful indicators for getting a snapshot view of a supplier, but for major procurements should not be used as a substitute for detailed examination of the candidate’s financial statements by the contracting authority. Such databases tend to hold only a summary of the financial information that has been filed at Companies House. They may not hold information on recent results or foreign parents and their data may lack qualitative interpretation. These databases do not therefore provide a complete picture, but they can usefully complement a detailed
analysis of the original accounts\textsuperscript{10}. The candidate should, where applicable, supply its accounts to the Authority, including the statements of any ultimate parent (including overseas-based parents).

**Debt Ratings**

4.5 Debt ratings of the various rating agencies reflect each agency’s opinion of the financial strength and ability of the issuer to repay obligations punctually. Lower ratings generally result in higher borrowing costs. As part of the detailed appraisal process, the Authority should, for a major award, check whether a candidate supplier is rated by one of the major agencies such as Moody’s or Standard & Poor’s. Their rating reports take account of a company’s corporate strategy, operating position, financial management and general prospects, and should be noted by the Authority.

**Filings in the US**

4.6 Some candidates may either be based in the US or have a US parent. Public companies with more than $10 million in assets whose securities are held by more than 500 owners must file annual and other periodic reports with the Securities and Exchange Commission, the SEC, and have to publish more detailed information than suppliers provide in the UK\textsuperscript{11}. This includes revolving credit arrangements and risk factors such as litigation details, the company’s assessment of competitive pressures and other factors that may affect future results and business prospects. Conversely, privately held US companies have very limited requirements to make public their financial information.

**Further Analysis**

4.7 The scope and depth of analysis will reflect the size of the contract and the scope and criticality of the requirement. Particular care should be taken if doubts exist about a supplier’s financial standing, particularly when a large value, long duration contract is being let. The contracting authority must be confident of a supplier’s ability to deliver.

\textsuperscript{10} OGC has established a framework agreement enabling public sector organisations to purchase financial reports on potential suppliers: [http://www.ogc.gov.uk/procurement_resources_financial_reports_framework.asp](http://www.ogc.gov.uk/procurement_resources_financial_reports_framework.asp)

\textsuperscript{11} [http://www.sec.gov](http://www.sec.gov) These reports are available to the public through the SEC’s EDGAR database.
4.8 Although administration, receivership or creditors’ voluntary liquidation
demonstrably constitute the outright failure of the business, the early symptoms of
financial distress are more difficult to identify. The checklist below will assist the
compilation, for each candidate, of a financial profile of strengths and
weaknesses, and a risk assessment.

Warning Signals

4.9 Financial warning signals may include:
- falling cash levels
- falling profit margins
- increasing overdraft with static turnover
- major reductions in staffing
- increasing employment with static turnover
- increasing debtor and creditor days
- larger increases in creditors than debtors
- increasing stocks, slower stock turnover
- deteriorating liquidity
- over-reliance on short term debt
- high gearing
- increasing pension liabilities (FRS17 / IFRS19)
- heavy write-offs of foreign or subsidiary holdings
- late filing of accounts
- qualified accounts
- profit warnings
- County Court Judgements (CCJs)
- poor credit ratings
- unusual accounting policies
- changing auditors and bankers
- debt rating downgrades/alerts
- investment bank prospect reports
- adverse press reports.
Accounts Review

4.10 Suppliers’ audited annual reports and accounts should be reviewed. In addition to the core financial statements (P & L account or Income Statement, cash flow and Balance Sheet – if these are all published), the explanatory notes should also be scrutinised. They may include a detailed breakdown of turnover by specific activity, revenue recognition policies, pension accounting policies, changes in management staff, contingent liabilities, financial commitments and post Balance Sheet events. Analysis of turnover may identify or confirm a candidate’s core business and whether it is over-dependent on a particular customer. The Auditor’s Report should also be reviewed for details of any audit qualifications.

4.11 The status of the candidate’s accounts should be reviewed. The Companies Act 1989 requires that accounts are filed with Companies House within 10 months after the end of the relevant accounting period for a private company, or seven months in the case of a public company. From 6 April 2008, under the Companies Act 2006, the time limit for filing accounts is reduced to nine months for private companies and six months for public companies. Small companies can file abbreviated accounts – but under the Companies Acts are still required to prepare full accounts for their shareholders. For the purposes of the financial appraisal, the full shareholder accounts should be provided in all cases where these are available. The contracting authority should determine when the last accounts were filed and the date of signature on the directors’ and auditor’s reports. The Authority should also establish if more up-to-date information is available or should be available. If the latter, establish why it is not – for example, have later accounts been audited but not filed and would the candidate be prepared to release draft or management accounts? Also, have interim financial statements been published (where applicable)?

Review of Cash Flow

4.12 Where possible, cash flow should be reviewed to determine the operating and liquidity position of the candidate.

4.13 Projections: Companies are not required to produce cash flow forecasts as part of their accounts, but usually produce them for internal management information and control. If such a forecast is available, it will provide useful information but it should be borne in mind that it need not have been produced in accordance with
approved accounting practices and standards, nor will it have been the subject of an independent audit. If projections are significantly more favourable than past data, there should be convincing evidence to support the optimism.

4.14 Any available forecast will usually cover a year and the length of individual periods to be forecast is usually a month. It is compiled by entering the opening cash balance, forecasting for each period the cash receipts (noting that cash may not be received until some months after the date of sale) and the cash outgoings. Total payments are deducted from total receipts and adding (cash increase) or deducting (cash decrease) from the opening balance gives the closing cash balance. If this is a minus, the company will need to arrange an overdraft or reduce expenditure.

4.15 A review of each month’s closing balance enables the cash needs of the business to be estimated. Often there is provision to include the actual amounts received and paid alongside the budgeted figures to aid the monitoring of results.

4.16 The estimation of cash flows relating to a proposal will involve consideration of several factors including capital costs, the timing of expenditures, the estimated life of the project, future receipts, savings and costs.

Financial Support

4.17 Details of overdrafts, short-term loans and revolving credit arrangements should be reviewed and considered as part of the overall financial assessment. In particular, this should include the ability of the candidate to meet its short-term debt obligations in the context of its cash flow and Balance Sheet strength.

Parental Strength

4.18 A strong parent can often support a weak bidder and, for example, a Parent Company Guarantee may be appropriate (see 4.33). However, it is possible that a weak parent could drain a bidder’s resources.

4.19 Whether a bidder’s financially weak parent could materially prejudice the bidder’s financial strength is a matter that should be considered on a case-by-case basis. This may need to take into account any liabilities or dependencies between the bidder and its parent, which could create financial issues for the bidder in the
event that the parent has financial problems. For example, sums due from the parent to the bidder might not be repaid.

**Ratio Analysis**

4.20 The more detailed financial assessment should, where possible, include the calculation of a wider set of key accounting ratios so that the performance, efficiency and overall stability of the candidate can be quantitatively determined and compared with previous years and industry averages. However, ratios should not be considered solely at face value; all the other relevant factors referred to above must be taken into account. Annex B outlines key ratios for analysis.

**PFI**

4.21 Private Finance Initiative (PFI) deals and other Public Private Partnerships (PPP) tend to be intricate, particularly for large projects. For long-term, capital intensive contracts the private sector partners often form a separate company, a Special Purpose Vehicle (SPV), as the contractual party (‘Contractor’) responsible for delivering the required service.

4.22 The Contractor will often obtain the bulk of the capital required to undertake the project from external funding providers such as banks or other financial institutions which will undertake their own ‘due diligence’ investigations. Where the funding requirements are less, a single company Contractor may fund the project on its own Balance Sheet.

4.23 In all deals, whether funded through project or corporate finance, the financial arrangements are likely to be complex. A project cannot proceed until the required financing is in place, including, where appropriate, the direct agreement between the external funding provider and the Authority.

4.24 In a PFI deal the Contractor will not normally receive any payment until service delivery to the contracted standard commences. This could cause funding difficulties for single suppliers that may be used to receiving staged payments to support the pre-service delivery, development phase of projects.

4.25 In addition to an assessment of the ability of bidders (whether SPVs or single companies) to provide the service required, a detailed appraisal of their financial and economic standing should be undertaken as part of the pre-qualification
procedures. This will establish the viability of a bidder at the outset. This applies
irrespective of their size, and whether or not they will be seeking external funding.
If the bidder is an SPV it will need to demonstrate fully that it is a cohesive entity
rather than a disparate collection of constructors and service providers.

4.26 Having short listed bidders, the Authority will need to examine in detail the
deliverability of the Contractor’s proposed funding structures (reviewing and
checking the accuracy of their financial models, and assessing whether their
assumptions are likely to be realised without seeking further price variations).

4.27 It is likely the Authority will need suitably qualified and experienced external
financial advice from investment banks or specialist accountancy firms, which
should be procured competitively, not least to ensure the adequacy and
availability of funding. The Authority will need to ensure that there is no conflict of
interest between its provider of advice and the provider of funding to the
Contractor.

4.28 Both the relationship between members of the SPV and proposals for funding the
project may develop during the procurement process and subsequently. The
Authority should keep such aspects under review.

4.29 If the project is financed using corporate finance rather than through specific
project finance, the Authority should nevertheless examine in detail how the
Contractor intends to fund the project, using external advice if appropriate.

4.30 Further information on PFI can be found on the Treasury and Partnerships UK
websites12.

**Pre-Award Monitoring**

4.31 A monitoring and review process should be undertaken solely to take into account
any significant new financial and commercial information that may become
available from discussions with the candidate, from its customers, or from
searches of general commercial intelligence sources. Where new information
relating to a candidate’s standing comes to light, it may, under the EU
procurement rules, still be taken into account (i.e. after the selection process).

Deed of Guarantee / Indemnity

Parent

4.32 A deed of guarantee may be required for complex and/or high value projects where there are concerns regarding the financial standing of the candidate or if the potential value of a strategic service award exceeds a contract limit for a candidate (see 3.26 et seq.). It can take the form of a performance guarantee, under which a third party, the guarantor, often the parent company, undertakes to fulfil the terms of the contract and/or a financial guarantee that ensures the Authority receives financial compensation if the contract is not fulfilled.

4.33 A Parent Company Guarantee (PCG) may be appropriate where a candidate’s financial position is less robust than that of its immediate or ultimate parent. The decision on whether to seek a PCG comes down to a balance of risk and cost / benefits. The Authority should take into account all relevant factors including financial strength and technical ability of the bidder and its parent, length and value of contract and the criticality of the required service. A PCG will be a contingent liability for the company and legal costs and other overheads could ultimately be passed on to the Authority.

4.34 Candidates may be required to indicate in their responses to an OJEU advertisement or follow-up questionnaire whether they would be willing to arrange a guarantee if this was subsequently required. The Authority should notify candidates as soon as possible during the selection stage if a guarantee would be sought. Candidates that are not willing to provide a guarantee can be excluded from selection.

4.35 The requirement for a guarantee should be assessed and a standard form guarantee circulated to bidders early in the procurement process. As stated at 2.13, bidders’ financial standing and technical capacity may only be evaluated at the pre-qualification stage as criteria for short-listing the bidders. The Authority must satisfy itself that it has carried out sufficient due diligence in respect of the financial standing of each of the candidates to determine whether it will be necessary to obtain a guarantee from each if it were to succeed in the competition. If the Authority subsequently decides to proceed, it should request a suitable guarantor and draw up the guarantee documentation following
negotiations between the three parties and their legal representatives. It should only be ultimately requested where the requirement is proven.

4.36 The deed of guarantee is not always sought from the parent company. A PCG is only as good as the financial standing of the parent itself. Sometimes, the parent is a mere ‘shell’ and another group or associate company, with the most assets, should be the guarantor. Although a guarantee can usually be obtained from a parent based in other member states of the EU, or in the US, it is more difficult to obtain payment of a debt or to seek specific performance of the contract from a company not based in the UK. Legal opinion should be obtained on whether a PCG is enforceable where a parent is not registered in the UK.

Bank

4.37 A deed of guarantee can also be provided by a bank or insurance company. This can be a financial guarantee where the guarantor agrees to indemnify the Authority against losses, liabilities and expenses incurred if the supplier defaults on its contractual obligations. This may be less advantageous than a PCG if the guarantor is obliged to complete the contract.

4.38 There is a variety of alternative financial guarantees (bonds) that can be provided by the financial market. An advance payment bond, rarely used in Government, is an acceptable safeguard, particularly as the security is issued through a bank. The bond provider (supplier) usually bears the cost. Such instruments may be financially onerous on the candidate and are likely to be appropriate only in the absence of other credible guarantees.

4.39 Contracting authorities are advised to seek professional advice on the best choice, use and drafting of guarantees and bonds.

JVCs & SPVs

4.40 In cases where the Authority is considering a contract with a Joint Venture Company (JVC) or a Special Purpose Vehicle (SPV) company, which may have two or more parent companies and which may not be adequately capitalised or have sufficient strength of covenant on its own to support the risk and obligations it has under the contract, the Authority can seek ‘joint and several’ guarantees /
indemnities from each parent of the JVC or SPV. This could be based on a deed of guarantee / indemnity given by joint parent companies of a subsidiary from each of the parent companies. The objective is to avoid a situation in which identified risks that the Authority has placed with the contractor, being passed back to the Authority by virtue of the JVC or SPV not having sufficient strength of covenant on its own to support those risks.

4.41 The parent companies of the JVC or SPV are unlikely to allow the JVC or SPV to fail. However, one of the possible consequences of not seeking ‘joint and several’ guarantees / indemnities is the risk that the Authority may not achieve full recovery if the JVC or SPV and one or more of the parent companies were to fail. If the Authority has accepted only proportionate liability (that is ‘several’ guarantees / indemnities) from the parent companies, it risks a shortfall.

**Self-Insurance**

4.42 The adequacy of self-insurance coverage proposed by the contractor should be assessed during the bidder selection process i.e. at the pre-qualification stage. In the event that project specific insurances are required, the Authority should only request those that are absolutely necessary or appropriate.

**Insolvency**

4.43 According to the Insolvency Act 1986, a company is deemed insolvent if it is proved to the satisfaction of the court that:

- the company is unable to pay its debts as they fall due; or
- the value of its assets is less than its liabilities, taking into account its contingent and prospective liabilities.

4.44 There are three basic areas of risk for the contracting authority in dealing with insolvent companies:

- the risk of involvement in fraudulent trading with a supplier that is being wound-up under provisions in the Companies Acts 1985 and 2006 and the Insolvency Act 1986, regarding criminal and civil liability respectively;
- the risk of involvement in wrongful trading; and
- the risk of non-performance of contracts.
Placing a contract with an insolvent supplier should be avoided.

4.45 If the latest audited accounts show net liabilities, that is, a negative net worth or net deficit, the company can be regarded as technically insolvent as at the date of the referenced Balance Sheet. This means that it is potentially insolvent but not deemed to be incapable of debt repayments under the Insolvency Act. If the supplier is found to be technically insolvent, the relevant data should be carefully interpreted before deciding whether the financial risk is unacceptable.

4.46 The nature of the contingent liabilities should first be determined and then a judgement made about the likelihood of them becoming payable. Many suppliers continue to trade, some profitably, and develop successfully despite having net liabilities. Moreover, start-up costs often give new companies a net deficit position in the early years of trading. Where data are available, recent trends and the supplier’s cash position should be determined. In addition, a review of cash flow and trading forecasts, if provided, would identify whether a candidate could realistically trade out of technical insolvency. The supplier should be asked what its plans are to improve the financial outlook.

4.47 Where a candidate appears technically insolvent and is a member of a group that is solvent overall, there may be the following options for mitigating the financial risks:

- obtaining a suitable parent company indemnity from the ultimate holding company (see Deed of Guarantee / Indemnity at 4.32); or
- placing the contract with the ultimate holding or parent company. However, this option should only be pursued with legal advice, as in some circumstances it may contravene procurement rules to award a contract to a legal entity other than that which submitted a response to an OJEU advertisement, even if it is a parent company of the original bidder.

4.48 It should be emphasised that it is not illegal to trade with a technically insolvent supplier; it might after all trade its way successfully back to financial health. The business and financial risks involved should be carefully calculated and weighted against the benefits.
5 Post-award Monitoring

5.1 As an essential on-going activity after a major award, the Authority should continue to monitor the supplier's financial and commercial standing, and whether it continues to have the necessary resources to manage the contract. The market in which it operates should also be reviewed. This will enable the Authority to recognise and respond quickly and appropriately to significant external events, pressures, or new information affecting the supplier's viability or operations. Effort should of course be appropriate to the size and importance of the contract.

Financial Distress Schedule

5.2 As well as general monitoring of the financial and commercial standing of the supplier, Authorities may wish to include a specific contract clause to provide contractually-agreed rights and requirements on the parties in the event of certain particular events that may indicate risk of the supplier's potential financial distress. The OGC Model Agreement for ICT Services contains a Financial Distress schedule that may be used for large or critical contracts. This schedule and guidance on its use can be found on the Partnerships UK website\textsuperscript{13}. It suggests escalating through a number of levels of financial distress, as evidenced by various 'trigger' factors, varying from a supplier's profits warning to commencement of litigation against the supplier in respect of financial debt. At each level, specific contractual provisions may be invoked to help safeguard the Authority's position. Although this schedule is designed in particular for ICT services contracts, Authorities may consider a similar approach for other important contracts.

\textsuperscript{13} \url{http://www.partnershipsuk.org.uk/ictguidance/}
6 Using Framework Agreements

6.1 If the Authority is procuring through a framework agreement, such as those let by OGCbuying.solutions (OGCbs)\(^{14}\), it can do so without a lengthy procurement process and in compliance with the EU rules. Under a framework agreement selection procedure, the financial standing of suppliers on the framework has already been thoroughly assessed. Furthermore, OGCbs regularly monitors the financial condition of suppliers on its catalogues, and the terms and conditions of its framework contracts allow for adverse changes in financials to trigger, where necessary, the potential suspension of a supplier from the framework.

6.2 For major call-offs, it would nevertheless be prudent for the customer to check with the framework authority on the financial robustness of potential suppliers. However, a customer cannot subject a supplier to another formal financial appraisal process. As stated at 2.13, under the EU rules financial appraisal is a selection not an award criterion.

\(^{14}\) [http://online.ogcbuyingsolutions.gov.uk/news/](http://online.ogcbuyingsolutions.gov.uk/news/)
Annex A  Audit & Filing Dates and Exemptions

The detailed rules concerning the preparation and filing of accounts in the UK are published on the Companies House website\(^1\). These rules are summarised below.

**Legislation**

The regulations regarding the preparation of accounts and their filing at Companies House are legislated for under the Companies Act 2006 and the Limited Liability Partnerships Act 2000. The Companies Act 2006 is a modernisation and consolidation of previous company legislation (including the Companies Act 1985). New provisions include limitation of liability for auditors and a statutory statement of directors’ duties.

**Accounting Records**

All limited and unlimited companies and Limited Liability Partnerships (LLPs), whether or not they are trading, must keep accounting records. Generally, accounts must include:

- a P & L account (or Income Statement if prepared under IFRS);
- a Balance Sheet signed by a director (by a ‘designated member’ for an LLP);
- an auditors’ report signed by the auditor (if appropriate);
- a directors’ report signed by a director or the secretary of the company (not applicable to LLPs);
- notes to the accounts; and
- group accounts (if appropriate).

Since 1\(^{st}\) January 2005, the accounts may be prepared in accordance with International Financial Reporting Standards (IFRS). IFRS-prepared accounts generally contain the same content as above, with some exceptions as follows:

- the Profit & Loss account is referred to as the Income Statement;
- a Cash Flow statement must be included; and

\(^{1}\) [http://www.companieshouse.gov.uk/](http://www.companieshouse.gov.uk/)
a Statement of Changes in Equity or a Statement of Recognised Income & Expense must be included.

Accounting Reference Date

The Accounting Reference Date (ARD) is the financial year-end and the date that determines when accounts are due for delivery to Companies House.

A company’s or LLP’s first accounts cover the period starting on the date of incorporation, not the first day of trading.

An accounting period cannot be extended so that it lasts more than 18 months. It also cannot be extended more than once in 5 years unless:

- the company or LLP is subject to an administration order, or
- the Secretary of State for Trade & Industry has directed this, or
- the company or LLP is aligning its accounting reference date with that of a subsidiary or parent undertaking established within the European Economic Area.

A company incorporated overseas which has registered a branch in Great Britain, and which does not have to publish audited accounts in its country of incorporation, or has registered a place of business in Great Britain, is subject to the same ARD rules except that it is not restricted as to how often it may extend accounting periods.

A company incorporated overseas which has registered a branch in Great Britain, and which has to publish accounts in its country of incorporation is subject to different rules.

Filing of Accounts

All limited and public limited companies and LLPs must send their accounts to the Registrar at Companies House. If they are eligible and wish to, medium-sized, small and dormant companies and LLPs may prepare and file abbreviated accounts (see SMEs section below for further details).
Companies

Unlimited companies need only deliver accounts to the Registrar if, during the period covered by the accounts, the company was:

- a subsidiary or a parent of a limited undertaking; or
- a banking or insurance company (or the parent company of a banking or insurance company); or
- a qualifying company within the meaning of the Partnerships and Unlimited Companies (Accounts) Regulations 1993; or
- operating a trading stamp scheme.

Filing Dates

The time normally allowed for delivering accounts is:

- for a private company and an LLP, 10 months from the ARD;
- for a public company, seven months from the ARD.

The Companies Act 2006 reduces the time limit for filing accounts to nine months from the ARD (for private companies) and six months from the ARD (for public companies). Under this legislation, quoted companies must also publish their accounts on the Internet.

The period allowed for sending a company’s or an LLP’s first accounts are calculated differently.

If a limited company or LLP carries on business or has interests overseas, a three-month extension to the normal filing period can be claimed by the company completing Form 244 and filing it with Companies House. This form must be delivered before the normal filing deadline and this must be done for every year that the limited company or LLP wishes to claim the extension.

There are penalties for late filing (e.g. £5,000 if a public company delays by more than 12 months; £1,000 if a private company or LLP delays by more than 12 months). Failing to deliver accounts on time is also a criminal offence for which company directors or LLP designated members may be prosecuted.
SMEs  Certain small or medium-sized companies and LLPs (often referred to as Small to Medium sized Enterprises or SMEs) may prepare and deliver abbreviated accounts to Companies House (see Table 1 below). If the company or LLP ceases to be small or medium-sized, the exemption continues for the first year that the firm does not fulfil the conditions. Quoted companies and certain companies and LLPs in the regulated sectors cannot qualify as small or medium-sized companies or LLPs.

Table 1 Qualification as SMEs and content of abbreviated accounts

<table>
<thead>
<tr>
<th>Qualification as an SME</th>
<th>Small company or LLP</th>
<th>Medium-sized company or LLP</th>
</tr>
</thead>
<tbody>
<tr>
<td>To qualify as a small company or LLP, or a medium-sized company or LLP, at least two of the following conditions must be met:</td>
<td>• Annual turnover must be £5.6 million or less; • The Balance Sheet total assets must be £2.8 million or less; • The average number of employees must be 50 or less.</td>
<td>• Annual turnover must be £22.8 million or less; • The Balance Sheet total assets must be £11.4 million or less; • The average number of employees must be 250 or less.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Content of abbreviated accounts</th>
<th>Small company or LLP</th>
<th>Medium-sized company or LLP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abbreviated accounts of a small company or LLP, or a medium-sized company or LLP, must include:</td>
<td>• An abbreviated Balance Sheet and Notes; and • A special auditor’s report (unless the company is also claiming audit exemption).</td>
<td>• An abbreviated Profit &amp; Loss account; • A full Balance Sheet; • A Special Auditor’s Report; • The Directors’ Report; and • Notes to the accounts.</td>
</tr>
</tbody>
</table>

The special auditor’s report should state that in the auditor’s opinion the company is entitled to deliver abbreviated accounts and that they have been properly prepared in accordance with the Companies Act.

The Balance Sheet (and if appropriate, the directors’ report) must contain a statement that the accounts are prepared in accordance with the special provisions of the Companies Act relating to small or medium-sized companies, as the case may be.

SME Groups  A parent company or parent LLP need not prepare group accounts or send them to Companies House if the group is small
or medium-sized and none of its member companies or members is a public company or carries on regulated activities under the Financial Services and Markets Act 2000 or insurance market activity (see Table 2 below).

Table 2 Qualification as an SME Group

<table>
<thead>
<tr>
<th>To Qualify as small, a Group of companies or LLP Group must meet at least two of the conditions below</th>
<th>To qualify as medium-sized, a Group must satisfy at least two of the conditions below</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Aggregate turnover must be £5.6 million net (£6.72 million gross) or less;</td>
<td>• Aggregate turnover must be £22.8 million net (£27.36) or less;</td>
</tr>
<tr>
<td>• The aggregate Balance Sheet total assets must be £2.8 million net (£3.36 million gross) or less;</td>
<td>• The aggregate Balance Sheet total assets must be £11.4 million (£13.68 million gross) or less;</td>
</tr>
<tr>
<td>• The aggregate average number of employees must be 50 or less.</td>
<td>• The aggregate average number of employees must be 250 or less.</td>
</tr>
</tbody>
</table>

Audit of Small Companies And LLPs

Small companies and LLPs with a turnover of not more than £5.6 million and total Balance Sheet assets of not more than £2.8 million can claim exemption from audit. However, audited accounts must be delivered to Companies House if the small company or LLP falls into any of the following categories:

(a) A parent company or parent LLP, or subsidiary undertaking (unless dormant for the period during which it was a subsidiary) except where the:
- group qualifies as a small group;
- turnover for the whole group is not more than £5.6 million net or £6.72 million gross; and
- group’s combined Balance Sheet total is not more than £2.8 million net (£3.36 million gross).

(b) A member of a group of companies in which any member is a public company, or carries on regulated activities under the Financial Services and Markets Act 2000, or insurance market activity.
(c) A company where an audit is required by a member or members holding at least 10% of the nominal value of the issued share capital, or holding 10% of any class of shares.

(d) A public limited company unless the company is dormant.

An audit-exempt company or LLP needs to send unaudited accounts to Companies House in the form of an abbreviated Balance Sheet and notes. Unaudited accounts do not of course provide the reassurance of accounts that have been independently audited.

Dormant Companies and LLPs

A company or LLP is dormant if it has had no ‘significant accounting transactions’ during the accounting period. Dormant companies and LLPs can claim exemption from audit and need only prepare and deliver accounts to Companies House containing an abbreviated Balance Sheet and notes.

Partnerships

The Partnerships and Unlimited Companies (Accounts) Regulations 1993 require companies which are members of ‘qualifying partnerships’ to prepare and attach accounts of the partnership to their own accounts.

A qualifying partnership is a partnership that is governed by the laws of any part of Great Britain if each of the members is:

- A limited company; or
- An unlimited company or a Scottish firm, each of whose members is a limited company.
Annex B  Key Ratios for Analysis

Accounting ratios are an aid for analysing and interpreting relationships existing between different items in a candidate’s financial statements. Ratio analysis helps to highlight areas and items that should be subjected to more detailed examination and questioning.

Few figures in financial statements are highly significant in and of themselves. Rather it is their relationship to other quantities or the direction and amount of change over a period that is important. It should be noted that accounts prepared under International Financial Reporting Standards (IFRS) can produce very different ratios to those prepared under UK GAAP. Comparison should be undertaken with caution.

Ratios can be logically divided into three main groups (a summary table for reference is shown at the end of this annex).

**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 are liquidity and gearing (or leverage). The following principal ratios would assist this analysis:

**Acid Test Ratio** - also known as the Liquidity or Quick Ratio  
\[
\text{current assets – stock) / current liabilities}
\]

This test of liquidity excludes the least liquid portion of current assets, stocks. Its ‘defect’ is that it does not define the liquidity of the individual components of liquid assets and current liabilities. These individual liquidities could be crucial to the overall liquidity of the business. Debtor amounts beyond one year, where shown, should be excluded. While a ratio of 1:1 is generally considered appropriate, many companies can survive and trade with ratios considerably less than that and others have liquidity problems with ratios well in excess of it. It should be noted that industry average liquidity tends to vary by market sector.
**Long-term Leverage Ratio**

\[
\text{long-term debt} \div \text{net worth} \times 100 = \%
\]

This gearing ratio is sometimes calculated in relation to total capital employed rather than to net worth. It highlights the relative importance of long-term debt in the capital structure and can therefore provide useful additional information for assessing the acceptability of the overall leverage position of the business. The leverage ratio should be considered in conjunction with Interest Cover (see below). A business could have a high leverage ratio but also high interest cover, whereby its interest payments are manageable in relation to operating profit levels. In this situation, high leverage would not give undue cause for concern. Consideration should also be given as to whether debt is external or inter-company, as the latter usually has a lower level of risk associated with it.

There are various gearing ratios and comparisons should be made using consistent measures. For example an alternative gearing calculation:

\[
\text{long-term debt} \div (\text{long-term debt} + \text{net worth}) \times 100 = \%
\]

**Bank Leverage Ratio**

\[
\text{bank debt} \div \text{net worth} \times 100 = \%
\]

This is important in terms of the financial viability of the business because of the relatively strong position in which banks usually put themselves relative to other providers of funds. Bank debt is usually secured and entails comprehensive powers for the bank to take action if the ratio gets out of line or some other financial deterioration in the position of the business occurs. The ratio should be kept at a level acceptable to the lending bankers.

**Interest Cover**

\[
\text{operating profit} \div \text{interest charges}
\]

This shows the number of times available profit covers interest charges and measures the extent to which operating profit can
fall without being insufficient to cover the interest charges and thereby create a pre-tax loss. The higher the ratio the better. Consideration should also be given as to whether interest payments are external or inter-company, as the latter usually have a lower level of risk associated with them.

The principal ratios for assessing operating performance are listed below and combined with the ratios above would assist the detailed financial appraisal process.

**Return on Capital Employed (ROCE)** - also known as the Primary Ratio

\[
\text{ROCE} = \left( \frac{\text{operating profit}}{\text{capital employed}} \right) \times 100 = \%
\]

ROCE is the most important measure of the overall efficiency of the management of the business because it relates the result of operations to the total funds being used in the business. It avoids the distortions that might arise from different capital and financing structures and therefore gives a measure of the efficiency with which the resources of the business have been utilised irrespective of how they have been financed. It sheds more light on the criticality of gearing and, when compared with the acid test, gives an idea as to the candidate’s vulnerability to take-over and bankruptcy. Capital employed is the total of shareholders’ funds and long-term debt or expressed in terms of assets as total assets less current liabilities. Operating profit is used because loans are included in the capital employed and therefore the return on them must be calculated before charging the interest on them. The higher the ROCE ratio the better. It should be noted that ROCE will vary by industry sector.

**Return on Total Assets**

\[
\text{Return on Total Assets} = \left( \frac{\text{operating profit}}{\text{total assets}} \right) \times 100 = \%
\]

This ratio measures the overall efficiency with which assets are being utilised.
Gross Profit Ratio – also known as the Gross Margin
(sales less cost of sales / turnover) × 100 = %

This ratio is an indicator of the efficiency of the production operations of the business as distinct from the selling and general management areas. A gross loss would usually indicate that the company was selling its products below cost.

Operating Profit Ratio – also known as the Operating Margin
(profit before interest and tax / turnover) × 100 = %

This ratio is one of the best measures of the efficiency of the operating management of the business and indicates management’s ability to generate profits from the business before deducting costs that have nothing to do with operating efficiency. The Operating Margin will tend to vary by industry sector and can be skewed by large contracts.

Collection Period or Debtor Days Ratio
(average debtors × no. of days in period) / turnover

This gives an estimate of the number of days between the dates of credit sales and when payment has been received for them. It is a good indicator of the credit trends within the business and of the liquidity of debtors, and will vary by industry sector.

Payments Period or Creditor Days Ratio
(average creditors × no. of days in period) / cost of sales

This ratio gives an estimate of the number of days credit being taken from the candidate’s suppliers. It will vary by industry sector. An increase in this period could be an indication of cash flow problems causing the candidate to delay the payment of its creditors. As with the Collection Period, it should first be compared with the period of credit given to ascertain whether the
creditors are being stretched and thus likely to put pressure on the business’s liquidity.

**Inventory Period & Stock Turnover**

\[
\text{Inventory Period & Stock Turnover} = \frac{\text{stock} \times \text{no. of days in period}}{\text{cost of sales}}
\]

This gives an estimate of the number of days’ stock in terms of cost of sales, being held in the business. It effectively determines the number of days it takes to convert stock, in all its forms, into cash or debtors. It therefore can give a good indication of the liquidity of the inventory element in current assets. Stock turnover is derived by dividing cost of sales by the average stock of finished goods. If the rate of stock turnover declines, it takes longer for stock to be converted into debtors or cash.

**Investment Ratios**

Investment ratios can also be used to assist with the detailed financial appraisal analysis. They are an indicator for assessing future prospects but are usually only applicable to public companies whose shares are traded on the stock market(s). The principal ratios calculated are:

**P/E Ratio**

\[
\text{P/E Ratio} = \frac{\text{market price of share}}{\text{earnings per share}}
\]

This is the most important ratio used by the market generally to assess the relative rating of a share and the candidate's prospects. The higher the P/E ratio the higher the market’s rating of the share. It identifies the number of years’ earnings needed to cover the current market price of the share. It should not be used to compare suppliers in differing industries.

**Earnings Yield** (inverse of P/E ratio)

A ratio calculated by dividing a company’s earnings per share by its current share price.

**Dividend Yield**

\[
\text{Dividend Yield} = \frac{\text{dividend per share}}{\text{market price of share}}
\]
This is the actual yield currently available on investment in the share at the current market price.

**Principal Ratios: Reference Table**

The following summary table shows the grouping of the principal ratios and how they should be calculated:

<table>
<thead>
<tr>
<th>Ratio Group</th>
<th>Ratio</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial Structure:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liquidity</td>
<td>Acid Test or Quick Ratio</td>
<td>((\text{current assets} - \text{stock}) / \text{current liabilities})</td>
</tr>
<tr>
<td>Gearing</td>
<td>Long-term Leverage Ratio</td>
<td>((\text{long-term debt} / \text{net worth}) \times 100 = %)</td>
</tr>
<tr>
<td></td>
<td>Bank Leverage Ratio</td>
<td>((\text{bank debt} / \text{net worth}) \times 100 = %)</td>
</tr>
<tr>
<td>Interest payments</td>
<td>Interest Cover</td>
<td>operating profit / interest charges</td>
</tr>
<tr>
<td><strong>Operating Performance:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Efficiency</td>
<td>ROCE or Primary Ratio</td>
<td>((\text{operating profit} / \text{capital employed}) \times 100 = %)</td>
</tr>
<tr>
<td></td>
<td>Return on Total Assets</td>
<td>((\text{operating profit} / \text{total assets}) \times 100 = %)</td>
</tr>
<tr>
<td>Profit Margins</td>
<td>Gross Profit Ratio or Gross Margin</td>
<td>((\text{sales less cost of sales} / \text{turnover}) \times 100 = %)</td>
</tr>
<tr>
<td></td>
<td>Operating Profit Ratio or Operating Margin</td>
<td>((\text{profit before interest and tax} / \text{turnover}) \times 100 = %)</td>
</tr>
<tr>
<td>Debtors</td>
<td>Collection Period or Debtor Days Ratio</td>
<td>((\text{average debtors} \times \text{no. of days in period}) / \text{turnover})</td>
</tr>
<tr>
<td>Creditors</td>
<td>Payments Period or Creditor Days Ratio</td>
<td>((\text{average creditors} \times \text{no. of days in period}) / \text{cost of sales})</td>
</tr>
<tr>
<td>Stock</td>
<td>Inventory Period &amp; Stock Turnover</td>
<td>((\text{stock} \times \text{no. of days in period}) / \text{cost of sales})</td>
</tr>
</tbody>
</table>

**Investment:**

| Future prospects     | P/E Ratio                          | Market price of share / earnings per share |
| Earnings Yield       | Inverse of P/E Ratio               |                                           |
| Dividend Yield       | Dividend per share / market price of share |                                           |
| Asset backing per share | Net assets per share              |                                           |
### Annex C  Financial Glossary

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Abbreviated Accounts</strong></td>
<td>See Modified Accounts.</td>
</tr>
<tr>
<td><strong>Acquisition</strong></td>
<td>The members of the acquired company relinquish ownership because the company cannot compete, or raise sufficient capital, or because the shareholders are offered an attractive price for their shares. The acquired company may be merged with the acquiring company, or it may continue to trade as a separate legal entity as a subsidiary of the acquiring company.</td>
</tr>
<tr>
<td><strong>Adjusting Events</strong></td>
<td>Events that provide additional evidence relating to conditions existing at the Balance Sheet date. For example, if a debtor has become insolvent after the Balance Sheet date, the valuation of debtors in the financial statements will be revised.</td>
</tr>
<tr>
<td><strong>Amortisation</strong></td>
<td>Another term for depreciation of intangible assets.</td>
</tr>
<tr>
<td><strong>ARD</strong></td>
<td>Accounting Reference Date.</td>
</tr>
<tr>
<td><strong>ASB</strong></td>
<td>Accounting Standards Board (an operating body of the Financial Reporting Council), which issues accounting standards and is recognised for that purpose under the Companies Act 1985. These standards apply to all companies and other entities that prepare accounts that are intended to provide a true and fair view. <a href="http://www.frc.org.uk">http://www.frc.org.uk</a></td>
</tr>
<tr>
<td><strong>Associated Company</strong></td>
<td>A company is an associated company to another if it acts as a partner to the other in a joint venture, or has significant equity voting rights in the other (i.e. not less than 20%).</td>
</tr>
<tr>
<td><strong>Authority</strong></td>
<td>Contract awarding authority.</td>
</tr>
<tr>
<td><strong>Balance Sheet</strong></td>
<td>A Balance Sheet is a statement that shows the financial position of an organisation at a point in time. It is a snapshot picture of assets and liabilities (usually) in terms of historical cost.</td>
</tr>
<tr>
<td>Term</td>
<td>Description</td>
</tr>
<tr>
<td>----------------------</td>
<td>-----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Bonus Share Issues</td>
<td>A company’s Share Premium account is used to finance the issue of bonus shares to existing shareholders. The issue of bonus shares may be a sign that prospects for the company are good. Conversely, the issue of bonus shares may be considered to be an alternative method of maintaining shareholder confidence than the payment of dividends during periods of adverse cash flow.</td>
</tr>
<tr>
<td>Book Value</td>
<td>See Net Book Value.</td>
</tr>
<tr>
<td>Capital Employed</td>
<td>The aggregate of Shareholders Funds and Long Term Debt.</td>
</tr>
<tr>
<td>Capital Expenditure</td>
<td>Fixed Assets such as land and buildings, motor vehicles and office equipment not bought for resale, and intended for continuing use in a business.</td>
</tr>
<tr>
<td>Capitalised</td>
<td>This is when costs are treated as an asset in the Balance Sheet and written off over a number of accounting periods, instead of treated as expenditure in the period in which the cost is incurred. Such costs will be written off by either depreciation (tangible assets) or amortisation (intangible assets).</td>
</tr>
<tr>
<td>CCJs</td>
<td>County Court Judgements</td>
</tr>
<tr>
<td>Chairman’s Report</td>
<td>A statement of company policy and future prospects from the chairman that is presented with the published accounts. It also helps to build a picture of how the directors feel about the period under review. The statement tends to be a personal and subjective view of the company.</td>
</tr>
<tr>
<td>Consolidated Accounts</td>
<td>Where a parent or holding company owns over 50% of the shares of others, or is in a position to exert control, the annual report and accounts of the ultimate parent company will include two levels of Balance Sheets. These will be the Balance Sheet of the parent company itself, and a consolidated Balance Sheet showing the combined totals of all the subsidiaries plus the</td>
</tr>
</tbody>
</table>
The only figure that is certain to be the same on both the parent and consolidated Balance Sheets, will be the issued capital. The Profit and Loss account in consolidated accounts also summarises the results of the parent company and its subsidiaries, as does the Cash Flow Statement.

**Contract Award Notice**
The formal OJEU Notice posted within 48 days of award of contract.

**Contract Notice**
The formal OJEU Notice that sets out the scope of the requirement and invites parties to express an interest and become candidates for selection.

**Convertible Loan Stock**
An unsecured debt instrument convertible into equity at the option of the holder under specific terms and conditions. It is used for strengthening the capital structure of the business.

**Creditors**
Suppliers and others to whom money is owed.

**Credit Rating**
A rating used by financial institutions to assess an individual or company’s credit worthiness.

**Current Assets**
Assets that the company intends to consume, turn into cash, or sell in the normal cause of business, usually within twelve months of the date of the Balance Sheet. They usually include stocks and work in progress, cash in hand and at bank, and debtors.

**Current Liabilities**
Liabilities which fall due for payment within a year from the date of the Balance Sheet and include bank overdraft, trade creditors, taxation, and dividends which have not yet been paid.

**Debenture**
A debenture is a long-term loan taken out by a company, which is usually secured on the company’s assets and repayable at some future date. The company usually pays a fixed rate of interest to debenture holders each year until maturity.
Debtors
Third parties that owe sums for services rendered or goods received.

Debt Ratings
Ratings for creditworthiness of a borrower as measured in the US by debt rating agencies such as Moody's Investors Services and Standard and Poor's. A triple A rating means that there is almost no likelihood of the borrower failing to pay.

Deferred Liability
Certain income, e.g. from grants, is set up as a deferred liability in the Balance Sheet, rather than passing through the Profit and Loss in the year of receipt. A proportion can then be passed through the Profit and Loss account each year over the expected useful life of the asset to which the income relates.

Dividends
Public limited companies, plcs, can only pay a dividend if, after payment, net assets are equal to or greater than the total of issued share capital plus undistributable reserves.

Draft Accounts
Accounts that are generally unaudited and may appear at any stage before they are made final. It may be some months before the draft becomes final because of delays in agreeing items such as tax adjustments and directors remunerations. However, final accounts usually vary only marginally from the draft figures.

EBITDA
Earnings Before Interest, Tax, Depreciation and Amortisation.

EEA
European Economic Area.

Equity Capital
Equity (or share) capital provides the basis of the company’s capital structure. It should be sufficient to absorb any normal trading loss. The cost of financing equity capital is the dividend yield necessary to induce investment in the company. See Share Capital.

Equity Finance, Types
There are four types of equity finance: ordinary shares, preference shares, redeemable shares and reserves. Ordinary shares carry full rights to participate in controlling the business.
through voting at general meetings and sharing in profits. Preference shares carry no voting rights but holders receive dividends at a specified rate before the ordinary shareholder. Redeemable fully paid ordinary and preference shares can be issued and redeemed at a premium out of distributed profits or new issue proceeds. Reserves consist of retained earnings or profit not distributed to shareholders.

EU

The European Union.

Exceptional Items

Items which, whilst deriving from transactions or events that fall within the ordinary activities of the company need to be disclosed separately by virtue of their size or incidence, if the financial statements are to give a true and fair view. For example, rationalisation costs relating to continuing activities. These items pass through the profit and loss account above the line i.e. they are deducted in arriving at net profit before tax and taken to reserves.

Final (or certified) Accounts

These are the final figures, presented as the report and accounts, signed by the principal directors. Their purpose is for issue to the shareholders 14 days before the Annual General Meeting. They consolidate the most reliable of all the variations of Balance Sheet, though the reader should always look at the auditors report to see if there are any reservations or qualifications about the way the directors have presented the figures.

Financial Reporting Standards

Developed and issued by the Accounting Standards Board. Soon after it started its activities, the ASB adopted the standards issued by the Accounting Standards Committee so that they also fall within the legal definition of accounting standards. These are designated ‘Statements of Standard Accounting Practice’ (SSAPs). Whilst some of the SSAPs have been superseded by FRSs, others remain in force.
<p>| <strong>Fixed Assets</strong> | Fixed assets are used in the conduct of business and not with the intention of reselling in the normal course of business. Fixed assets are valued, in the majority of Balance Sheets, at cost less aggregate depreciation to date. |
| <strong>FRC</strong> | Financial Reporting Council |
| <strong>FRSs</strong> | See Financial Reporting Standards. |
| <strong>GAAP</strong> | Generally Accepted Accounting Principles. See UK GAAP and US GAAP. |
| <strong>Gearing</strong> | The same as leverage and refers to the extent to which costs have been financed by borrowing. A company is said to be highly geared when it has a high ratio of borrowing to shareholders funds. |
| <strong>Goodwill</strong> | The difference between the value of the business as a whole and the fair value of its separable net assets. Purchased goodwill must be capitalised and amortised over time. Only purchased goodwill can be shown on the Balance Sheet. The treatment of goodwill is slightly different under IFRS. Whilst only purchased goodwill can be shown on the Balance Sheet, IFRS prohibits the amortisation of goodwill, which should instead be tested for impairment at least annually. |
| <strong>Holding Company</strong> | A holding company usually has a number of operating subsidiaries. It owns either all or the majority of shares of the subsidiaries. In some cases the parent or holding company is a non-trading entity and simply holds the investments in the subsidiaries, many of which can be trading in different countries with their own subsidiaries. The parent / holding company of a vast group could comprise merely an office with a few legal and financial staff and may also incur expenses on behalf of the rest of the group. The shareholders of the holding company must receive ‘group accounts’ which includes a single set of consolidated accounts for the group. |
| <strong>IASB</strong> | International Accounting Standards Board, which is responsible for developing and promulgating IFRS. |
| <strong>IFRS</strong> | International Financial Reporting Standards (as published by the International Accounting Standards Board). In the interests of European harmonisation, the EU has legislated that all EU companies with publicly listed equity or debt must comply with IFRS. |
| <strong>JVC</strong> | A Joint Venture Company established to provide a specific service. |
| <strong>Leverage</strong> | See Gearing. |
| <strong>Liabilities, Current</strong> | Liabilities that fall due for payment within a year from the date of the Balance Sheet and include bank overdraft, trade creditors, taxation, and dividends that have not yet been paid. |
| <strong>LLP</strong> | Limited Liability Partnership. |
| <strong>Liabilities, Long-Term</strong> | Financial obligations which must be paid by the company beyond the next accounting period and typically include long-term loans and debentures. |
| <strong>Liquidation</strong> | Where a company, unable to pay off debts as and when they become due, is forced to stop operations and be wound up. Creditors may apply for an order from the Courts which may grant a liquidation order or one for administration / receivership. Also, the directors may seek a voluntary liquidation of a company, whilst the DTI also has powers to seek a winding up of a company. |
| <strong>Liquidity</strong> | The ability of a company to pay amounts owing as they fall due for payment; a measure of the degree to which current assets can be used to pay off current debt. Refer also to the definition of Solvency. |</p>
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Listed Companies</td>
<td>Companies whose securities are traded on a regulated market.</td>
</tr>
<tr>
<td>Long Term Debt</td>
<td>See Liabilities, Long-Term.</td>
</tr>
<tr>
<td>Long-Term Loan Capital</td>
<td>Long term loans that must be paid 12 months or more after the date of the Balance Sheet.</td>
</tr>
<tr>
<td>Merger</td>
<td>Where the total operations and assets of two companies are merged by placing them under the control of a new company under one management but jointly owned by the shareholders of the original companies.</td>
</tr>
<tr>
<td>Modified Accounts</td>
<td>Produced by ‘small’ or ‘medium’ size companies. All companies must file their accounts with Companies House. However, companies defined as small or medium size need only send abbreviated information.</td>
</tr>
<tr>
<td>Net Assets</td>
<td>Total assets less total liabilities. Some accountants refer to a company as being solvent if total assets exceed total liabilities. If total liabilities exceed total assets, the excess is referred to as net liabilities. This is equivalent to net worth (below).</td>
</tr>
<tr>
<td>Net Book Value</td>
<td>The value of fixed assets in the books found by deducting all the depreciation charged to date from the original cost of the asset.</td>
</tr>
<tr>
<td>Net Current Assets</td>
<td>See Working Capital.</td>
</tr>
<tr>
<td>Net Income</td>
<td>See Net Profit.</td>
</tr>
<tr>
<td>Net Margin</td>
<td>Net profit as a percentage of sales. The net margin indicates the profitability of sales after taking account of normal operating expenses.</td>
</tr>
<tr>
<td>Net Profit (or Loss)</td>
<td>The residual after expenses have been deducted from gross profit over a period of time.</td>
</tr>
<tr>
<td>Net Worth</td>
<td>The realistic true net asset value of a company after all adjustments have been allowed for. It is equivalent to the sum of</td>
</tr>
</tbody>
</table>
original capital subscribed, and accumulated retained earnings. This is not usually the value the company would realise if sold as a going concern. If a negative value, it is referred to as a net deficit.

Non-Adjusting Events
An event, relevant to the accounts, that had not taken place before or at the Balance Sheet date. It does not result in changes to the amounts in the financial statements. However, the event may need to be disclosed in the accounts. Examples of this type of event are a government announcement or an act of God. See adjusting events.

Notes to the Accounts
A supplementary set of statements providing further details of items in the Profit & Loss account and Balance Sheet. This is a requirement of the Companies Act. The notes will also disclose the major accounting policies adopted by the company (e.g. whether rentals under operating leases are charged to the profit & loss account on a straight line basis) and any significant changes in accounting policies.

OJEU
Official Journal of the European Union.

Operating Profit
Profit net of selling and administration expenses, but before interest and tax.

Overtrading
Overtrading arises when a company expands to such an extent that its capital base is insufficient to support the additional activity either directly or through increased borrowing. Hence it is important that a company has an appropriate capital structure; the correct mix of debt, equity and liquid funds.

PCG
Parent Company Guarantee.

P & L
Profit and Loss account.
Preference Shares

A preference share, under the terms of issue normally laid down in the company’s Articles of Association, is a claim to an annual dividend at a specified rate out of the profits before anything is paid to the ordinary shareholders. The shares also carry preference for the return of capital if the company is wound up, but only to the extent of the par value of the shares.

Private Limited Company

A registered company with limited liability that cannot offer its shares to the public. Ownership is usually confined to a small circle of investors. The transfer of shares only occurs with the consent of existing shareholders.

Profit and Loss Account

Shows the results of operations in terms of profitability over a period of time, usually the company’s accounting year. It is also referred to as the Income Statement and basically includes details of sales revenue less the cost of sales and the components of that cost, gross profit, expenses, profit before tax, and net profit.

Provisions

Provisions are charges for known liabilities of an unknown amount made before arriving at profit.

PUK

Partnerships UK.

Public Limited Company

A public limited company (plc) may offer shares to the public. It must be a company limited by shares or guarantee, with a minimum issued share capital and have a Memorandum which states that it is a registered plc.

Qualified Audit Report

If an auditor has reservations in relation to matters concerning the accounts then he/she should qualify his/her report. All the reasons for the qualification should be given, together with a quantification of its effect, if possible. Audit reports are qualified where there is uncertainty which prevents the auditor from forming an opinion on a matter, or where the auditor’s view...
conflicts with the view given in the financial statements. Auditors are in a fairly strong position to get their point of view accepted by the directors.

**Ratio Analysis**

Ratios are useful for analysing the adequacy or otherwise of a company’s efficiency over a period and its financial stability at the end of that period. However, they cannot be used in isolation; they should be regarded as comparative tools. The comparisons which should be made are:

- with other years for the same company to show any trend;
- with other businesses of a similar type.

All relevant factors must be considered before any conclusions are arrived at. These factors will include the effects of inflation and the social / economic conditions prevailing.

**Report of the Auditors**

The Companies Act requires that auditors report to shareholders, as distinct from directors, on whether the financial statements show a true and fair view and whether they comply with the provisions of the Act. They must also form an opinion on whether proper books have been kept and that the accounts are in agreement with the books. The auditors are appointed by the shareholders at the AGM on the recommendation of the directors. See also Qualified Audit Report.

**Report of the Directors**

Included in the company’s annual report and provides a review of the development and prospects of the business and also information concerning important events occurring after the financial year end. It also includes information on acquisition of the company’s own shares and R&D activity (if relevant).

**Reserves**

An element of shareholders funds. Reserves can be either capital reserves or revenue reserves and are profits or surpluses which have not been distributed as dividend. Capital reserves are not available for distribution as dividend and may include the
increase resulting from a revaluation of fixed assets and a share premium account (which shows the amount by which the issue price of shares exceeded their face value).

Retained Profit
Profits retained in the business (not distributed), forming part of the company’s reserves. Accumulated retained profits are shown as a capital component in the Balance Sheet.

Retained profit can be transferred back to the Profit and Loss account and made available for distribution as dividends. Some companies do this to maintain a dividend during a bad trading year.

Revenue
Usually refers to the sales income of the business.

Rights Issue
The most common way for companies with existing public issues to raise new equity capital. Rights issues are new shares offered to existing shareholders. It is normally required that any new issue of shares should first be offered to the existing shareholders unless there is specific permission granted by the shareholders to allow up to 10% of share capital to be offered to outsiders. The rights issue enables existing shareholders to subscribe for shares in proportion to their existing holdings.

SEC
Securities and Exchange Commission (USA).

Share Capital
The main types are nominal, issued and called-up capital. Nominal (or authorised) capital is set out in the company’s Memorandum that states the division of the authorised capital into fixed amounts. Issued capital is that part of authorised capital issued by the company. Called-up capital applies where shares are partly paid and represents that part of issued capital which has been called-up for payment.

Share Capital, Classes
A company’s Memorandum of Association may divide the share capital into classes and the rights attaching to each class is recorded in the Articles of Association.
See Equity Finance, Types.

**Share Premium Account**

When a company issues shares at incorporation it will normally do so at their par or nominal value that represents the legal liability attaching to the share. If the company’s prospects are good, then the directors may wish to issue additional shares at a premium particularly where the share market price exceeds the par value. A company usually raises further capital with a Rights Issue to existing shareholders. The issue price will be set at a price below the current market value. The premium received is taken to a share premium account and classified under capital reserves in subsequent Balance Sheets. The share premium represents the difference between the face value of the shares and the sums actually raised when they were sold to the shareholders.

**Shareholders’ Funds**

Shareholders funds consist of the company’s share capital and reserves.

**SMEs**

Small and Medium-sized Enterprises.

**Solvency**

Solvency is the ability of the firm (a) to pay off its current debt i.e. current liabilities as and when they become due; and (b) to maintain total assets in excess of total liabilities. A company is technically insolvent when its liabilities exceed its assets. The only justification for a company to continue to trade in this situation is when the management knows that the position is temporary and is certain to be retrieved.

**SPV**

Special Purpose Vehicle. A company established (often by a consortium) as the contractor to deliver a project.

**Subsidiary Company**

Where all or the majority of a company’s shares are owned by a holding or parent company.
Take-over Where one company takes control over another by acquiring a majority interest in its voting share capital. This is usually deemed to be anything over 50%.

UK GAAP UK Generally Accepted Accounting Principles. These are the accounting and disclosure requirements of the Companies Act 2006 and pronouncements by the Accounting Standards Board.

US GAAP United States Generally Accepted Accounting Principles. The Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) draw these up. They also include the interpretations and explanations furnished by the Securities and Exchange Commission (SEC).

Working Capital Working capital, or net current assets, is the excess of current assets over current liabilities (creditors due in less than one year). If a company has insufficient working capital and cannot meet its liabilities, it becomes insolvent.