

# Financial models - Applying the lessons of Carillion

How can we adjust financial evaluation models to  
protect clients at selection stage and award?

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# Agenda

- ▶ Carillion – what went wrong?
- ▶ Implications for financial selection criteria
  - ▶ What do the rules say?
  - ▶ What is usual practice?
  - ▶ How can this be improved?
- ▶ Additional financial health checks prior to award
- ▶ How reliable is the case law? Are the current rules tougher? Implications
- ▶ Practical guidance for contracting authorities

# Carillion

- ▶ Carillion entered liquidation in January 2018
- ▶ NAO estimated that when Carillion collapsed it had 420 contracts with the public sector
- ▶ Carillion was the sixth largest supplier (by value) to the public sector in 2017
- ▶ Carillion first issued a profits warning in July 2017
- ▶ Carillion announced the award of several large Government contracts after its profit warning with some contracts awarded before, and some after, its disclosures.

## Constitutional Affairs Committee Report, 9 July 2018

- ▶ *“The Government must re-examine its due diligence procedures and learn from the Carillion crisis. The Government must develop a deeper understanding of its commercial partners’ supply chains and of the risks hidden behind their published accounts and public statements.”*
- ▶ *“Carillion’s balance sheet was fatally weakened by high risk construction contracts. It was also puffed up with high valuations of goodwill, reflecting no more than how much it had overpaid for acquisitions and which provided no security.”*

# PCR Overview

- ▶ Position now more restrictive from CA perspective than under previous Directives; previous “*may as a general rule*” language now deleted (Prof Arrowsmith disagrees)
- ▶ Recitals tell us that this is out of a concern to reduce burdens on bidders; note Recital 85 – acknowledges changes of circumstances/financial difficulties and need for most up to date information: Reg 59(9): up-to-date documentation from winner before award
- ▶ But wrong direction of travel in face of Carillion problem
- ▶ Distinguish between permissible criteria and means of proof: even though there seems discretion in Reg 58 as regards requirements on E+FS, Reg 60 seems to set out exhaustively the proof that may be required (Prof Arrowsmith provides a counter-argument)
- ▶ Margin of discretion as regards level of performance (save re turnover): see ***Eudukovizig and Hochtief***, C-218/11
- ▶ Note that most of the cases relate to the previous, more relaxed, regime: beware!
- ▶ GPA more open-ended (-see Article VIII)

## Reminder – what the PCR say (1)

- ▶ Regulation 57(8)(b) PCR 15: CA may exclude where an economic operator is bankrupt, the subject of insolvency or winding-up proceedings or assets are being administered by a liquidator or by the court; or if in an arrangement with creditors; or where its business activities are suspended or it is in any analogous situation
- ▶ **Nothing here assists if the economic operator issues a profit warning or is rumoured to be in difficulties**
- ▶ Selection criteria may relate to economic and financial standing (Reg 58(1)(b))
- ▶ CA may only impose as requirements for participation the criteria in Reg 58(5) to (18)
- ▶ Must be limited to those appropriate to ensure financial capacity to perform the contract (Reg 58(3)) This contract, as opposed to the totality of its commitments? (see Bellini cases 27-29/86)
- ▶ Requirements must be related and proportionate to subject-matter of the contract (Reg 58(4))

## Reminder – what the PCR say (2)

- ▶ CAs may impose requirements ensuring that economic operators possess the necessary economic and financial capacity to perform the contract (Reg 58(7))
- ▶ Regulation 58(8) - CAs may require that economic operators:
  - ▶ have a certain minimum yearly turnover (including a certain minimum yearly turnover in the area covered by the contract);
  - ▶ provide information on their annual accounts showing the ratios, for example, between assets and liabilities; and
- ▶ Reg 60 prohibits authorities from requiring other means of proof, but allows eo's to rely on “*any appropriate means*” to prove that they have the necessary resources

# Turnover requirements and ratios

- ▶ Minimum yearly turnover requirement must not exceed twice the estimated contract value, except in duly justified cases (e.g. special risks attached to the nature of the works, services or supplies) (Regulation 58(9))
- ▶ Probably total (not annual) contract value, so could still be a very significant number. NB needs to be proportionate
- ▶ If CA uses a turnover requirement in excess of twice the estimated contract value it must indicate the main reasons in the procurement documents or its Regulation 84(1) report (Reg 58(9)) . See Recital 83 for possible justifications of a higher figure
- ▶ Ratios between e.g. assets and liabilities
  - ▶ May be taken into consideration where CA specifies the methods and criteria for their consideration in the procurement documents (Reg 58(10))
  - ▶ Methods and criteria for considering ratios must (of course) be transparent, objective and non-discriminatory (Reg 58(10))

## In practice...

- ▶ Cabinet Office standard form selection questionnaire Part 3 is limited:
  - ▶ Can you provide audited accounts for past 2 years if requested?
    - ▶ If not, can you provide an alternative means of demonstrating financial status?
  - ▶ Self-certification that any minimum turnover requirements are met
  - ▶ Can you provide parent company accounts if requested?
    - ▶ If yes, would the parent provide a guarantee if necessary?
    - ▶ If no, would you be able to obtain a guarantee from elsewhere (e.g. a bank)?
- ▶ Para 32 of CO Guidance – expectation is no deviation from questions in Part 3. Any deviations must be reported.

## What do we see in practice?

- ▶ Use of credit ratings: **our view: offside as subjective**
- ▶ Desktop studies of media reports: **horribly subjective; probably discriminatory against UK bidders, larger bidders, quoted companies**
- ▶ Some authorities use turnover thresholds and various financial ratios but often a “tick box” exercise: **ideally should do more, especially on large and/or long-term contracts**
- ▶ Does the average CA just use the CO template without thinking about it?

## Alternative (more robust?) approaches

- ▶ OGC Supplier Financial Appraisal Guidance (April 2008)
  - ▶ Advice on how to conduct the financial appraisal of candidate suppliers bidding for significant public sector contracts
  - ▶ Scope and effort of financial appraisal should be proportionate to size and risk of contract
  - ▶ Guidance endorses a broad business approach
  - ▶ Not mandatory but recommended by OGC

## OGC Supplier Financial Appraisal Guidance (April 2008)

- ▶ Only suitably experienced staff should conduct supplier financial appraisals
- ▶ Use of specialist expertise as necessary
- ▶ Assessment of risk should be based on sound business judgment rather than just the mechanistic application of financial formulae: **how do we spell that out in transparent terms?**
- ▶ P&L account and balance sheet alone do not provide sufficient information. A candidate's cash generating ability should be assessed where possible: **how is this to be assessed?**
- ▶ Financial data and credit ratings from specialist on-line providers are useful snapshot indicators but should not be used as a substitute for a detailed examination of a candidate's financial statements: **and in our view are offside anyway**

# OGC Supplier Financial Appraisal Guidance (April 2008)

- ▶ Authority should for major award check whether a candidate is rated by one of the leading debt rating agencies (although a candidate should not be penalised if it does not have a debt rating)  
**obvious unequal treatment?**
- ▶ Authority must apply commercial judgment. **subjective**
- ▶ 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 over-reliance on numerical formulae **Prof Arrowsmith considers an “overall discretionary assessment” might be permissible, giving unlawful state aid as an example of where a more discretionary approach is required**
- ▶ Over-emphasis on historical accounts is not a helpful guide to a candidate’s current suitability: **but that is unfortunately what the PCR prescribe**
- ▶ Scope of analysis should cover each candidate and, if applicable, their ultimate parent(s)

# OGC Supplier Financial Appraisal Guidance (April 2008)

- ▶ Analysis should draw attention to any significant items in the accounts including: turnover, trading results and their trends, cash movements and balance sheet strengths and weaknesses  
  
And having 'drawn attention' then what?
- ▶ Turnover may be a useful indicator as to capacity but far from the only factor. Too simplistic to be used as a "yes / no" factor **Quite!**
- ▶ Limitations of backward looking assessments **This is probably the biggest flaw in the PCR approach, along with the fact that the data may be out of date**
- ▶ 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 **One can expect a contractor which is in financial difficulties to fight hard against any exclusion, so approach likely to receive close scrutiny**

## OGC Supplier Financial Appraisal Guidance (April 2008)

- ▶ The P&L and balance sheet alone do not provide sufficient information to enable a thorough financial assessment of a candidate.
- ▶ P&L 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 flow information should be requested from a candidate – this should be carefully assessed to establish whether there is sufficient cash flow to cover working capital requirements, capital repayments and interest.
- ▶ (Aside: national differences in the way accounts are configured does not seem fatal: see ***Eudukovizig and Hochtief***, C-218/11)

# Practical Advice for Contracting Authorities – pre award

- ▶ Deploy appropriate ratios in assessing E+ FS, **and consider them**; remember that you will have to be transparent about the tests and methods that will be applied
  - ▶ Consider asking for bank guarantees (but note cost)
  - ▶ Ask for PCG's (-but not a complete answer)
  - ▶ Require up-to-date information pre-award
  - ▶ Consider inclusion of “Financial Distress” provisions in draft contract and using them as a lever pre-award; can probably include:
    - ▶ Profit warnings
    - ▶ Credit reference agency ratings
    - ▶ Debt / payment problems and associated litigation
- remember to pick up guarantors and key sub-contractors as well as the main contractor

# Practical Advice for Contracting Authorities – post award

- ▶ Financial Distress mechanism
- ▶ Guarantor step-in: payment and performance guarantee
- ▶ Authority step-in?
- ▶ So, if I get out of the contract, what do I do then?
  - ▶ Reg 72(1)(d) and business succession – refers expressly to insolvency: selling the business of performing the contract, but:
    - ▶ New contractor must fulfil SQ criteria
    - ▶ No substantial modifications
    - ▶ Non-circumvention (what is this?)
  - ▶ Urgency?

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