Guide

to

Financial Assessment Reports

July 2019

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**Introduction**

## Purpose of the financial assessment process

## The purpose of the financial assessment process is to:

## determine whether a contractor has the financial capacity to take on a contract for the provision of services without becoming insolvent or experiencing financial distress before the services have been delivered.

## where there are risks to a contractor’s financial capacity, highlight what these risks are and whether there are ways to mitigate these risks.

## A financial assessment must be undertaken prior to a contract being awarded.

## The financial capacity assessment will not provide absolute assurance of a contractor’s financial capacity. The assessment is only part of the overall risk management process and it does not, on its own, reflect the contractor’s ability to deliver the project.

## The financial assessment process does not address the operational or technical capability of the contractor to undertake the work. You should consider the contractor’s operational and technical capacity to undertake the contract as part of a broader risk assessment process.

## Financial Assessment Reports

## The Financial Assessment Report (FAR) addresses core questions to be considered when determining a contractor’s financial capacity. These core questions address a range of commercial criteria and fall under three broad categories:

## understanding the contractor’s ownership and structure

## understanding the contractor’s business

## understanding the contractor’s financial capacity.

## Addressing the core questions will assist you to understand and interpret the recommendations presented in the FAR and allow you to form a view on the key risks and mitigating strategies.

## There are three types of Financial Assessment Reports being Basic, Medium and Comprehensive. The determination as to which report is applied is based on both the size of the contractor being assessed and the size of the contract being tendered. It is up to you to determine what type of assessment is suitable for your requirements.

## Irrespective of which type of report is utilised, the core questions used to determine financial capacity will be consistently applied to all contractors.

## Overview

## This guide has been prepared to assist you with understanding and interpreting the information presented in the Financial Assessment Reports.

## This guide contains a worked example with sample responses and commentary to help you to interpret the findings of the Financial Assessment Report and understand the key risks and their impact on the contractor’s ability to deliver the work without becoming insolvent or experiencing financial distress.

## The worked example reflects a Medium assessment. Some of the analysis included in the worked example will not be applicable to a Basic assessment. Additionally, there may be some more detailed forecast analysis included in the Comprehensive assessment which is not captured in this worked example, however, the core questions will be the same as those presented in this guide.

**Worked Example**

**and**

**Guidance**





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|  | In order to be considered eligible for a contract, at a minimum the contractor must meet the following criteria:   * + 1. Net tangible assets (total assets less total liabilities less intangibles) must be greater than 5% of contract value     2. Working capital (current assets less current liabilities) must be greater than 10% of contract value     3. Current ratio (ratio of current assets to current liabilities) must be greater than 1. |
|  | This section summarises the key profitability and cash flow risks identified as part of the financial capacity assessments and any known mitigants to address these key risks. |
|  | This section summarises other factors and considerations and may also include possible mitigants and recommended actions to be undertaken by the project manager to limit exposure to the key risks which have been identified as part of the financial capacity assessment.  In the example the financial assessor identified a number of overdue amounts owing from customers and a large loan owing from a related party. The project manager should discuss with the contractor to understand their ability to recover overdue amounts from customers and should ensure there is an agreement in place (by requesting and sighting documentary evidence) for the related party to repay amounts owing to the contractor to mitigate the risk of any cash shortfall during the period of the contract. |



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|  | The party providing the services must be the same legal entity who enters into the contract for the work. If not, both the contracting entity and service providing entity will require financial assessment since failure of either entity could result in non-performance of the contract. |
|  | Reliance on other entities through business relationships or loans could increase the risk of business failure of the contracting entity. If an entity relied upon fails, this could result in a ‘domino’ effect and ultimate failure of the contractor.  In the example the contractor has been rated a high risk due to there being a significant loan owing from a related party (an entity within the contractor’s corporate group) which has increased over the last three years and for which there has been no interest received and there is no set repayment term. This loan needs to be recovered from the related party in order for the contractor to be able to repay its loan to the bank due in 18 months. |
|  | Director disqualifications or adverse press relating to the directors of the company could be indicative of improper management practices or a history of having managed businesses which have had financial difficulty. Disregard for rules and regulations will likely increase the risk of business failure. |



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|  | Proven technical expertise in completing work of a similar nature or of a similar size to the contract being tendered is preferred. Risk will be increased where the contractor has little or no track record of completing similar projects. |
|  | A key man risk may exist where substantially all sales are generated by a single person, one person manages substantially all projects or one person possesses expertise or ‘know how’ critical to the contract which is not shared by others in the business.  The key man risk may be mitigated by a succession or contingency plan put in place by the contractor to mitigate the loss in the event of ‘key man’ departure. |
|  | Contractors may have disproportionate exposure to different parts of the economy which are experiencing varying degrees of growth or decline such as residential development, commercial construction, resources related infrastructure and public sector construction.  Risk may be increased where the majority of a contractor’s business is reliant on a declining market with no plans to diversify. |



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|  | Reliance on a small number of projects or customers who contribute a high proportion of a contractor’s revenue presents two main risks:   * + 1. Termination of a single project or loss of a single customer may have a significant negative impact on a contractor’s revenue and profitability.     2. Any delay in a single project or failure of a customer to pay a large receivable could have a significant negative impact on a contractor’s cash flow. This risk will be further increased if key customers are known to be experiencing financial difficulty.   In the example the contractor has been rated a high risk as 83% of revenue in the last financial year relates to a single customer (Customer 1). Further, the review identified delays in the payment of amounts owing to the contractor by Customer 1 which has impacted the contractor’s ability to pay its suppliers on time. |
|  | Risk will be increased where:   * the contractor makes use of specialist suppliers or unique materials which are critical to the completion of a contract * there is a lack of contingency planning to mitigate any breaks in critical supply * there is an indication that a critical supplier is in financial difficulty.   In the example the contractor was rated a low risk as it has a reasonably broad supplier base and is not reliant on any one supplier or material. |



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|  | A history of outstanding claims against the contractor may indicate underperformance, dissatisfied customers or poor contract management on previous jobs. |
|  | Indicators of higher risk may include (but are not limited to) revised construction regulations requiring more onerous testing or safety processes which will increase costs or banning of a key material or construction technique used by the contractor.  Positive regulatory changes may include (but are not limited to) a release of land for development or lifting of other use restrictions resulting in increased opportunities for the contractor. |
|  | Significant reliance on the success of a new service or entry into a new market to meet forecast revenue and profitability targets will increase risk. Consideration needs to be given to the assumed win rate for new projects for which the contractor has no proven track record. Further, there is also the risk of project failure or cost overruns if the contractor wins work in an area where it has no experience.  Where the contractor’s existing markets are in decline, new services or entry into new markets may mitigate the risk of reliance on these deteriorating markets. |



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|  | Negative trends such as declining revenue or declining profit margins are indicators of higher contractor risk.  In the example the contractor was rated a medium risk as while revenue was increasing, the gross margin had declined as a result of tendering at lower margins and increased costs. |
|  | Negative cash flows and declining cash reserves may indicate deterioration in performance caused by:   * trading losses * poor management of receivables, tightening terms from suppliers or a build up of inventory.   In the example the contractor was rated a medium risk due to delays in collecting amounts owing from customers (increasing debtor days) and subsequent difficulties in being able to pay amounts owing to suppliers (increasing creditor days).  Having undrawn facilities (i.e. available headroom), the ability to borrow additional funding from the bank or access additional funding from shareholders may be a mitigant to any short term cash flow risks which have been identified. |
|  | A contractor’s forward pipeline will include all secured work on hand and identified opportunities. Indicators of higher risk may include:   * a low value of current work in hand relative to historical and or forecast revenue levels indicates limited secured work going forwards * a low value of identified opportunities (pipeline) in relation to annual revenue (after applying the historical win rate on tenders) * a number of pipeline opportunities comprising projects of a size or nature substantially different to the contractors proven capabilities * significant value attributed to projects with no apparent back up or basis.   In the example the contractor was rated a medium risk as while 69% of forecast revenue is currently secured, greater than 50% of secured work relates to a single project indicating significant reliance. While the contractor needs to win an additional c.$11m worth of work to meet its forecast revenue target, it was noted that Management had assumed a more conservative win rate on tenders relative to what had been achieved historically. |



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|  | Negative indicators will include a history of breaching loan terms and loans expiring in a short period (i.e. less than 6 months) with insufficient cash to repay and no alternative source of funding having been arranged.  Bank covenants reflect the conditions imposed by banks when they lend large sums of money. A breach of a covenant may result in the bank demanding immediate repayment of the loan or imposing higher rates of interest.  In the example the contractor was rated a medium risk due to having a large bank loan which is due to expire in 18 months. |
|  | Excessive levels of bank loans and borrowings or a poor credit history with the existing lender may limit the contractor’s ability to obtain additional bank loans should they be required to support the operations of the business.  This may be mitigated through shareholders having the capacity and willingness to put additional money into the business to support ongoing operations should it be required.  In the example the contractor was rated a medium risk due to having a significant level of bank borrowings. The contractor has a loan of $8m with a profit of $0.2m in FY12. A broad benchmark is that greater than four years equivalent profit to repay a loan is approaching higher risk category.  Should the contractor need further money from the bank to support the operations of the business the contractor would likely need to justify its ability to repay the current bank loan of $8.0m. |



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|  | Where the contractor is assuming a significant growth in contract volumes, significant improvement in margins compared to those achieved historically or aggressive reductions in operating costs with limited or no plans in place on how the cost reductions are to be achieved, the risk of achieving the forecast will be greatly increased.  In the example the contractor was rated a low risk as the forecast was substantially supported by secured work in hand with the business needing to achieve a lower success rate than what had historically been achieved in order to win new projects.  Where a contractor’s secured work in hand is limited this may lead to a drop off in work if new projects cannot be won or new projects are delayed. This will increase risk where the contractor is required to carry labour through periods of downtime. |
|  | Forecast cash short falls with no or questionable sources of funding assumed to fill the gap (such as an increase in borrowings over and above what is currently available from the bank, or amounts from shareholders without evidence those shareholders are able or willing to provide those funds) will significantly increase the risk of business failure. |
|  | Sensitivity analysis is undertaken to determine the extent to which a major change in the contractor’s business will impact its profitability and cash flow position. Examples of such include the loss of a major project or customer, and increase in labour rates or cost of materials or a change in the terms with a major supplier or customer.  In the example the contractor was rated a medium risk as the business needs to achieve similar revenue to the previous year in order to continue to be profitable. Termination of a major project or failure to win sufficient levels of new work will result in the contractor being loss making unless significant cost reduction can be achieved to compensate for the lower revenue. |



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|  | This table details the current contract under tender including contract value, start date and duration.  The contract value is compared to the Last Twelve Months (LTM) revenue to measure the size of the contract relative to the size of the business. The LTM figure is used in the Financial Assessment Report to avoid comparing to out of date financial information (such as where the assessment is carried a number of months after the financial year end). |
|  | The level of financial assessment required is based on both the size of contractor (by revenue) and the size of the contract.  The example reflects the requirement for a “medium” assessment to be undertaken as the contract value is greater than $10.0m and the contractor’s annual revenue is less than $300.0m. |
|  | The Department’s prescribed criteria specifies that in order to be eligible for a contract the contractor must meet the following minimum assessment criteria:   1. Net tangible assets (total assets less total liabilities and intangibles) must be greater than 5% of contract value 2. Working capital (current assets less current liabilities) must be greater than 10% of contract value 3. Current ratio (ratio of current assets to current liabilities) must be greater than 1   Note, it is not the intention of the criteria to be exclusive. The assessment criteria must be considered together with the key questions presented in the executive summary. |



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|  | This chart details the ownership and corporate structure of the contractor’s business. Understanding a contractor’s ownership and other related businesses gives insight to:   * Potential risks where financial distress of a related business could impact the contract * Potential financial resources which may be accessed by the contractor from its owners or related businesses.   Where a contractor is commercially reliant on or exposed to a related business or party consideration should be given to undertaking a financial capacity assessment on the related entity or the wider group.  In the example Company ABC has extended a loan of $9.4m to Company DEF to fund the start up of DEF’s business. Consideration should be given to the financial capacity of DEF to repay the loan in whole or part should Company ABC need access to additional funds during the period of the contract. |
|  | This section details a brief history of the contractor including any changes in ownership, key performance highlights and recently completed projects. |



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|  | Consideration should be given to the whether the Director’s or Management’s experience sufficiently demonstrates the capability to undertake the proposed contract?  **Note: the Financial Assessment Report does not address the operational or technical capability of the contractor to undertake the work. The operational or technical capacity of the contractor should be understood as part of a broader risk management process.** |



The **statement of Profit & Loss (P&L)** summarises the performance of the contractor’s business, with the **P&L ratios** used to evaluate the profitability of the contractor over time. Comparing ratios on a yearly basis allows performance trends to be identified. Key indicators of performance include:

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|  | **Revenue** is the dollar value of sales a contractor generates. Increasing revenue is a positive performance indicator. |
|  | **Gross margin (GM) and GM %** – gross margin ($) (revenue less direct costs such as materials and subcontractor costs) and gross margin % (gross margin ($) divided by revenue ($)) indicates how profitably a business sells its goods and services.  A contractor’s gross margin and gross margin % will decline when either its revenues fall and costs are not reduced or if costs increase and increases in revenue are not achieved. Declining gross margin and gross margin % usually indicates a contractor is needing to bid for projects at lower prices to be competitive or has been experiencing cost overruns on projects. |
|  | **Overheads** reflect the general and administrative costs of the business. **Overheads as a % of revenue** is a measure of overheads in relation to the size of the business (represented by revenue). An increasing ratio could indicate lower profitability potentially leading to increased risk. |
|  | **Earnings before interest, tax, depreciation & amortisation (EBITDA) and EBITDA Margin %** – EBITDA measures a contractor’s profitability after overhead costs and reflects the earnings used to pay interest. A declining EBITDA and/or EBITDA margin indicates deteriorating performance. |
|  | **Net profit after tax (NPAT)** is the contractor’s net earnings after all expenses and taxes have been deducted. This is the bottom line measure of the contractor’s performance. In the example, the contractor’s NPAT has declined for two consecutive years, indicating worsening performance and potentially higher risk. |
|  | The **forecast** is determined by the contractor’s management and represents their best estimate of the next financial year’s performance. Achievement of the forecast will be subject to a number of factors outside management’s control and therefore will be an estimate only.  Consideration should be given to any unusually large increases ($ or margin %) relative to historical levels or the broader trends in a contractor’s market. |



**Customer concentration** aims to identify incidences of over-reliance on individual customers. Over-reliance on a single customer exposes the contractor to a higher degree of risk in the event that the customer becomes insolvent or ends the business relationship.

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|  | The table outlines customers or projects which the contractor is currently engaged on. A small number of customers may indicate significant reliance and therefore increased risk. |
|  | **Revenue** is the amount of revenue earned from a customer in the period. |
|  | **Percentage of total** illustrates the degree of revenue concentration by customer and is calculated as the revenue earned from a customer in the review year as a percentage of total revenue  In the example a significant percentage of total revenue was earned from a single customer (83%), indicating significant reliance. A delay in the collection of amounts owing from this customer will negatively affect cash flow and in turn Company ABC’s ability to pay supplier invoices as they fall due. |



**Work on hand** outlines the number and value of secured projects the contractor is currently undertaking. A higher value of total secured work on hand (as a proportion of forecast or typical annual revenue) improves future earnings certainty and is a positive indicator provided there is sufficient cash flow to support it.

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|  | **Total value** represents management’s best estimate of the total dollar value of each secured project. |
|  | **Percentage completed** represents the proportion of the project completed to date (by costs). |
|  | **Revenue to go** represents the estimated remaining revenue to be earned on secured work on hand. A small value of revenue to go may indicate increased risk as the contractor will be more reliant on being able to win work in its identified pipeline.  In the example, one project accounts for a significant proportion of revenue to go which may indicate a high degree of reliance on this project and potentially increased risk were this project be delayed or terminated and no other significant projects can be won. |
|  | **Completion date** is Management’s estimate of when the project should be completed. A large proportion of projects ending on a similar date may indicate that a shortage of work will occur at this date unless identified pipeline opportunities are able to be converted into wins. |

The **pipeline** summarises the potential project opportunities identified by the contractor’s management. A small pipeline net value in proportion to forecast annual revenue may indicate a shortfall in future work and potentially higher risk.

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|  | **Bids submitted** is the number of identified opportunities for which the contractor has submitted tenders. |
|  | **Identified opportunities** represents the total number of potential opportunities that the contractor’s Management has identified. The contractor may or may not have submitted tenders for all of these opportunities. |
|  | **Net value** is the probability weighted value of opportunities as estimated by Management. |
|  | **Effective win rate** **(EWR)** is the implied estimation of project tenders and opportunities that will be won as a percentage of all opportunities identified. This measure should be assessed with reference to the **historic win rate**, which is the percentage win rate the contractor has historically achieved.  In the example, the estimated EWR is less than the historic win rate with Management taking a conservative position due to tough market conditions rendering wins more difficult to achieve than in the past. An EWR higher than the historic win rate will be more challenging for the contractor to achieve and will increase contractor risk. |



The **Statement of Financial Position** provides a point in time snapshot of a contractor’s assets, liabilities and equity (assets less liabilities) at a given point in time. Key balance sheet accounts include:

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|  | **Cash & cash equivalents** – funds that are available to the contractor immediately. A high cash balance represents a ‘buffer’ for the contractor, and is a positive financial indicator if increasing over time. |
|  | **Receivables** – amounts currently owed to the contractor by its customers. Receivables will typically increase in line with an increase in revenue, however, an increase in receivables where revenue is flat or declining may indicate higher risk. Refer debtor days commentary below. |
|  | **Creditors & accruals** – amounts currently owed by the contractor to its suppliers. Creditors will typically increase in line with an increase in expenses (direct costs and overheads), however, an increase in creditors where expenses are flat or decreasing may indicate higher risk. Refer creditor days commentary below. |
|  | **Long term debt –** amounts typically borrowed from the bank repayable in a period not less than 12 months. Any long term or bank debt presented within current liabilities reflects amounts to be repaid within a 12 month period which may be an indicator of higher risk. |
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|  | **Net assets (Equity)** – reflects the value of total assets less total liabilities. Decreasing net assets is a negative financial indicator, and represents a decline in the net value of the contractor. |
|  | In this example, the contractor has a large outstanding **receivable from a related party**. It will be important to understand the capacity of this related party to repay the amounts owed to the contractor. Should the related party not have the financial capacity to repay this receivable this presents a key risk to the contractor’s ability to pay its debts as they fall due. |

**Financial position ratios** are used to assess the financial health of a contractor over time. Comparing ratios on a yearly basis allows trends in financial condition to be identified. Key ratios include:

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|  | **Debtor days** – reflects the average time it takes to receive payment on an invoice from a customer. In the example, this measure is increasing and indicates it is taking longer for the contractor to collect cash from customers which in turn impacts the contractor’s ability to pay its suppliers on time. |
|  | **Creditor days** – reflects the average time taken by the contractor to pay an invoice from its suppliers. Increasing creditor days is often a sign a contractor is having cash flow issues. |
|  | The **current ratio** is a measure of the extent to which the contractor is able to meet its short term obligations such as supplier payments and payroll. A high current ratio is a positive financial indicator, whereas a low current ratio may indicate a shortage of funds. The DFS assessment criteria specifies a minimum current ratio of 1.0. |
|  | **Net debt to equity** indicates what proportions of debt and equity the contractor is using to fund its assets. An increasing ratio represents greater levels of debt which carries a higher degree of risk with regard to ongoing interest payments and ultimate repayment of the debt when it falls due. |
|  | **Total debt to EBITDA** indicates the level of debt relative to the earnings of the business. A broad benchmark is greater than four indicates higher risk. |



The **Cash Flow statement** summarises the flow of cash in and out of the contractor’s business. Key cash flow items include:

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|  | **Net profit after tax (NPAT)**, as outlined in the P&L section, is the contractor’s net earnings after all expenses and taxes have been deducted. Increasing NPAT is a positive performance indicator. |
|  | **Working capital movement** principally reflects the net year on year change in accounts receivable, inventory and accounts payable balances. A negative number typically reflects an increase in accounts receivable greater than the increase in accounts payable. |
|  | **Cash flows from operating activities** is the net cash flow that the contractor generates from its core activities and should be a positive figure (a cash inflow). A decline in this measure indicates deteriorating operating performance and increased risk. In the example the net operating cash flow is negative (a cash outflow) due to Company ABC not collecting payments from its major customers within trading terms. |
|  | **Dividends paid** is a cash flow out of the contractor’s business to its shareholders. A consistent dividend outflow may be a favourable indicator of a contractor’s ability to generate cash from operations. However, year on year increases in dividends as a proportion of earnings may increase risk.  As a general rule the amount of dividends paid should not exceed the profit. Typically, companies will pay 50-75% of profit as a dividend. |
|  | **Net cash flow (NCF)** is the remaining cash from a contractor’s operations after it pays its obligations and dividends to shareholders for the period. Increasing net cash flow enhances the contractor’s ability to pay off debt or invest in future projects and is therefore a positive indicator. |
|  | **Closing cash** is the total amount of cash the contractor has on hand after all cash inflows and outflows during the period. In the example closing cash has deteriorated due to low cash collections from customers. In turn, the ending cash balance is significantly lower than in prior periods, potentially indicating increased risk. |



Working capital management investigates a contractor’s efficiency in collecting cash from customers (with reference to trading terms) and in turn in satisfying its obligations to suppliers. Key items include:

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|  | **Debtors ageing** aims to identify any potential customer payment issues by comparing the ageing of outstanding customer invoices with trading terms. Debtor amounts that are outside of trading terms will negatively affect a contractors cash flow and increase bad debt risk (the risk that the invoice will not be paid). These amounts outside trading terms may also be an indication of dissatisfied customers.  In the example, 22% of receivables are outside trading terms indicating the contractor is facing collectability issues.  Additionally, a large proportion of receivables relate to one customer. This indicates reliance on that customer’s ability and/or willingness to pay its invoices when they fall due and therefore increases contractor risk. |
|  | **Creditors ageing** aims to identify any payments due to creditors (suppliers) outside of trading terms (a situation referred to as ‘creditor stretch’). Overdue amounts outside of trading terms may indicate the contractor was not able to pay these invoices when they fall due, which in turn may damage the ongoing relationship with that supplier. |
|  | As outlined in the Balance Sheet section, **debtor days** reflects the average time it takes to receive payment on an invoice from a customer and **creditor days** reflects the average time taken by the contractor to pay an invoice to its suppliers.  In this example both of these measures are increasing, indicating that it is taking longer for the contractor to collect cash from its customers which in turn is impacting its ability to pay its suppliers on time. Both the debtor and creditor days were outside of average trading terms (45 and 30 days respectively) in FY11 and FY12 indicating higher contractor risk. |



This section aims to identify the funding facilities and total funds currently available (headroom) to the contractor and any scope for additional or alternative funding should it be required.

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|  | **Facility limit** is the maximum amount which can be drawn from a facility or account. |
|  | **Available balance** is the total funds available to the contractor for immediate use (facility limit less amount drawn). |
|  | **Remaining term** is the time period left on the loan. Some facilities, such as many overdrafts and corporate credit cards, will be provided on a rolling basis.  In the example, a significant loan is expiring within a short time frame, representing increased risk if the contractor does not have the funds to satisfy its loan obligations or has not arranged for the loan to be refinanced. |
|  | **Refinancing required in contract period** - indicates if a loan or facility requires repayment or refinancing (due to expiration or other reasons) within the time period that the contract would be carried out.  This could increase risk where the contractor is unable to negotiate a new loan. The status of the contractor’s relationship with its financier and the financier’s willingness to provide additional finance should be considered when assessing this risk. |
|  | **Covenants** - outlines the terms of any covenants within loan or facility agreements and whether the contractor is currently (and forecast to be) in compliance with those covenant terms.  Bank covenants reflect the conditions imposed by banks when they lend large sums of money. A breach of a covenant may result in the bank demanding immediate repayment of the loan or imposing penalty interest rates.  Any past, current or forecast covenant breach may negatively affect a contractor’s position when refinancing existing loans or seeking alternative funding arrangements and therefore will increase risk.  Typically, small businesses are unlikely to have large loans and will often not be subjected to covenants. |
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|  | The charts presented reflect a graphical presentation of the contractor’s historical revenue and profitability (left) and detailed movements in profit and loss statement line items over the last twelve months (right).  In the example while the contractor’s revenue decreased slightly between FY10 and FY11 before growing significantly in FY12, profitability has been declining significantly over the past three years as a result of increased competition leading to lower project margins. |











**Further Considerations**

**and**

**Frequently Asked Questions**

## Overview and potential actions to mitigate risk

This section of the guide details frequently asked questions, further considerations and potential actions that may be taken to mitigate risks which have been identified in the Financial Assessment Report (FAR).

Where a number of risks have been identified, the use of a bank guarantee or retentions will provide access to funds that may be utilised in the event the contractor cannot fulfil their obligations and the work needs to be transitioned to a new contractor for completion.

Further commitment may be sought from the owners to support the financial capacity of the business. The commitment should guarantee the owners have the capacity and willingness to invest additional funds into the business should it be required during the course of the contract.

Where risks have been identified it is recommended you undertake ongoing monitoring of key risk indicators (such as cash and working capital balances, ongoing performance against contract programme, relationships with key customers and suppliers) over the life of the contract to identify any negative trends or performance issues which suggest the contractor will no longer be unable to meet their obligations under the contract.

## Frequently Asked Questions

**Understanding the contractor’s ownership and structure**

*The tender has been submitted by an unincorporated joint venture which does not meet the definition of a legal entity. Is the joint venture eligible to be awarded the contract?*

You may still be able to award the contract to the joint venturers, however, a separate financial assessment must be carried out on each of the parties to the joint venture and you must be satisfied that the joint venture parties have the financial capacity to meet their obligations to the joint venture.

*Company A has submitted a tender for the contract, however, the work will be principally carried out by a related entity within Company A’s corporate group (i.e. all employees of the group are employed by the related entity, Company B). Is Company A still eligible to be awarded the job?*

Company A may still be eligible to be awarded the job, however, a separate financial capacity assessment must be carried out on the related entity which will be undertaking the work.

*While the contractor is currently profitable and meets the prescribed assessment criteria, the financial assessment report highlighted a number of large loans owed by related parties. Do these loans prevent me from awarding the contract? How can this risk be managed?*

No, these loans will not necessarily prevent you from awarding the contract, however, it will be important to understand the extent to which the contractor is reliant on repayment of these loans owing from related parties during the period of the contract.

Where the contractor is reliant on the repayment of these loans you should consider requesting a financial capacity assessment to be undertaken on the related party in order to understand the capacity of that entity to repay amounts owing to the contractor should the need arise during the period of the contract.

*The FAR noted a Director of the contractor was previously a Director of a failed business. Is the contractor still eligible to be awarded the job?*

You should review the ASIC report by the administrator regarding the conduct of the Directors of the failed business to identify any instance of Director misconduct (Report at ASIC under s422, s438D, s533 of the Corporations Act 2001).

*The FAR noted the contractor had only minimal experience in completing work of the size (or nature) of the contract being tendered. Does this lack of proven experience prevent me from awarding the tender to the contractor and how can this risk be managed?*

While not preventing you from being able to award the tender to the contractor, consideration should be given to the contractor’s operational and technical capability to undertake the work. While not covered in the financial capacity assessment, the operational and technical capability of the contractor must be considered as part of a broader risk management approach.

Consider the risk of the contractor overtrading should you award them the contract. The contractor may not have the facilities available to support the working capital of the business should large amounts of cash be needed to fund bank guarantees or be held by you as retentions in relation to the contract.

*The FAR identified the Managing Director as being critical to the contractor’s ability to complete the contract. How can this key man risk be addressed and managed?*

Ensure the contractor has a second in charge capable of stepping in should the key man be unavailable for limited periods. Any longer-term absence of the key man may lead to broader financial or performance issues for the contractor.

**Understanding the contractor’s business**

*The FAR noted that the contractor was in a highly competitive market and had experienced a decline in margins as a result of competitive tendering. What is the risk here and how can it be addressed?*

You should consider the tender price submitted by the contractor relative to other tenders submitted (i.e. is it higher, lower, or on par). A tender price significantly lower than other submitted tenders may indicate low margins and may increase the risk of the contract becoming loss making for the contractor if they encounter any problems in delivering the work.

*The FAR noted the contractor has significant reliance on a single customer to meet its forecast for the next 12 months. How can this risk be managed?*

You should discuss with the contractor the status of its relationship with the customer and the current status of work being performed. For additional comfort you should carry out periodic monitoring of the ongoing relationship with the customer and level of work being undertaken to identify whether there is any decline in the level of work which could lead to a point where financial difficulty arises.

*The FAR noted the contractor will be reliant on a particular subcontractor to complete the work. How can this risk be addressed?*

You should discuss with the contractor the status of its relationship with the subcontractor. Further, consider whether the service provided by the subcontractor is unique and not easily substituted.

Where this is the case and where the work of the subcontractor will comprise a substantial or critical part of the overall contract being awarded, consider the need to undertake a financial assessment on the subcontractor to ensure they have the financial capacity to complete the work required by the contractor.

*The FAR noted a number of claims against the contractor on work completed within the last 18 months. Does this history of claims prevent me from awarding the contract to the contractor?*

While not preventing you from being able to award the tender to the contractor, you should consider the nature of the claims and whether they indicate a history or underperformance or poor management on previous work.

The financial capacity assessment does not consider the operational or technical capability of the contractor to undertake the work. This capability should be taken into consideration before awarding the contract.

**Understanding the contractor’s financial capacity**

*The FAR identified the contractor’s revenue has been steadily declining each year, however, they are still profitable. What is the risk here and how can it be addressed?*

Declining revenues may indicate a declining market and/or increased competition which is making it more difficult for the contractor to win work. Where the contractor is in a declining market consideration should be given to whether the contractor has any plan to expand into new markets or new services.

It is recommended you understand the point at which the contractor would become unprofitable should the decline in revenue continue at the same rate and whether that would result in the contractor requiring additional funding during the period of the contract.

*The FAR identified a large number of overdue receivables which if not received may have a significant impact on the contractor’s cash flow. How can this risk be managed and what additional protection can be taken?*

You should discuss with the contractor the status of its relationship with its customers. Consider discussing with the contractor’s key overdue customers the reasons for late payment (i.e. is the customer dissatisfied with the work performed by the contractor, disputing an amount owed to the contractor, or experiencing cash flow difficulties?).

Where the risk is significant (but you choose still award the work to the contractor) it is recommended you carry out periodic monitoring of the contractor’s receivables to understand whether overdue amounts identified in the FAR are subsequently collected or identify any cash shortfall which results from amounts not being received from customers.

*The contractor has only a small amount of secured work on hand and will be reliant on winning significant levels of new work. The FAR noted the contractor has assumed a higher win rate on tenders than what had been achieved historically. How can this risk be addressed and managed?*

Consider the sensitivities presented in the FAR to understand the level of revenue required for the contractor to break even. While the Basic and Medium financial assessments do not specifically include a detailed assessment of forecast cash flows, you may request this work to be undertaken to understand the capacity of the business to fund a period of losses should the required level of revenue to break even not be met.

*The FAR identified a large bank loan that is due to expire within the contract period. How can this risk be addressed and managed?*

You should engage with the contractor’s financier to understand their current relationship, the status of any negotiations and the likelihood that the loan will be refinanced.

You may wish to seek confirmation from the owners that they have both the capacity and willingness to contribute more money to the business (either as a loan or as equity) should the contractor be unable to refinance with the bank.