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To Raphael Scerri, Director General, Funds & Programmes Division

From Marilyn Grima, Senior Manager, Financial Control Unit

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Subject Due Diligence Checks

Financial Due Diligence checks are to be undertaken by the Managing Authority / Responsible Authority on private sector applicants and NGOs before progressing to the signing of the grant agreement

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Introduction

When appraising an EU funded project it is important that consideration is given to the financial viability of the private applicant organisation / NGO, particularly whether it has sufficient resources and is financially stable to manage and successfully deliver a project.

Financial 'Due Diligence' checks aim to provide the Managing Authority with a level of assurance that applicant organisations have the financial capacity for entering into a contractual relationship with the Managing Authority.

If the applicant organisation is unable to manage a project because of its financial structure, EU funds could be placed at risk particularly if the Managing Authority is required to seek recovery of any of the funds awarded. The purpose of this Memo is to assist the undertaking of an appraisal of the financial structure of the applicant organisation.

Due Diligence checks are to be undertaken on private sector organisations and NGOs which have submitted project applications.

Due Diligence considerations are:

- **Does the applicant have the necessary finances in place to cash flow the project in arrears on a quarterly basis?; and**

- **Does the applicant have the necessary finances to be able to repay grant in the event of an irregularity?**

Process

The effective start date of expenditure for a project must be aligned with the National Eligibility Rules. For the Maltese MA, projects start from the date of signing of the grant agreement.

As part of the project selection process, the financial status of the applicant organisation is to be reviewed. The assessors undertake the checks outlined in Annex A and following such, an opinion should be formed based on the information provided in the report, consulting Finance or other colleagues as necessary.

In line with the general eligibility criteria evidence of financial viability shall be ascertained and an opinion is to be provided by the MA based on the results of the Financial Analysis Form. Different documents shall be requested depending on the type of undertaking as explained below:

Companies

A financial appraisal is undertaken by an analysis of an applicant's formal (published) accounts supplemented by applying recognised accounting formulae and from interpreting financial ratios and trends.

Companies are required to file annual accounts with MFSA:

Private Companies within 10 months following year end and 42 days to submit them to the Registrar of Companies

Public Limited Companies with 7 months following year end and 42 days to submit them to the Registrar of Companies

Hence, audited accounts shall be requested in case of companies for the last three financial years.

In addition, VAT and Income Tax Compliance Certificates will be requested – certificates issued not earlier than three months from the date of the application, by the VAT Department and Inland Revenue Department confirming that the Applicant has no liabilities in respect of VAT and Income Tax or is otherwise honouring an agreement for settling any outstanding amounts. Additionally, a certificate shall also be requested by the Inland Revenue that the company has no pending liabilities in respect of Final Settlement System (FSS) and of Social Security Contributions (SCC). The certificate is also to be issued in the three months preceding the submission of the application.

Sole traders and partnerships

Sole traders and partnerships are not required to publish their accounts but they must submit an income statement for tax purposes. Considering that in such cases, the accounts do not necessarily have to be audited, copies of the submitted income statements shall be requested.

Additionally, copies of bank statements for the last three years shall be requested if considered necessary by the Managing Authority.

Self-Employed individuals and NGOs

In the case of self-employed individuals and NGOs, copies of bank statements for the last three years shall be requested if considered necessary by the Managing Authority. Additional documents may also be required in order to obtain the necessary assurance that the applicant has the required financial capacity needed to cover the financial component.

In the case of individuals, VAT and Income Tax Compliance Certificates as explained above shall be requested together with a Final Settlement and Social Security Contributions Compliance Certificate – a certificate issued by the Inland Revenue Department confirming that the Applicant has no liabilities in respect of the Final Settlement System (FSS) and of Social Security Contributions (SSC) or is honouring an agreement for settling any outstanding amounts. The certification should have been issued in the three months preceding the submission of the application.

Considerations

The assessors will take a view on the level of risk associated with an applicant organisation in line with general eligibility criteria. Considerations, to be judged on a case-by-case basis, include:

- The proposed operation may be sufficiently innovative, or pilot, to warrant EU support.
- To enable the delivery of the Operational Programme in a locality or thematic area, the choice of applicants is limited.
- The provision of a guarantor (i.e. an organisation other than the applicant (which themselves may require Due Diligence checks), which agrees in writing to guarantee the security of the EU funds on behalf of the applicant.
- The total level of funding an applicant is exposed to. Refer to 'Multiple Due Diligence checks' further on in this document.

Applicants trading for three years or less

Where an applicant organisation has been 'trading' for 3 years or less and/or, is being set up as a 'special purpose vehicle' specifically for the project, the assessor should exercise judgement in assessing any financial and delivery risks. In this case, management accounts shall be requested in order to be assessed. Where these are not available / the company is in the first year of operation, the Memorandum and Articles of Association shall be requested.

Consideration shall also be given to the risk associated with the sector the company shall be operating in together with the number of employees that shall be employed with the organisation. It shall be assessed whether the funds being requested fall in line with the operations of the organisation newly set up.

Multiple Due Diligence checks

Due diligence checks may have previously been undertaken by a colleague within the same or another local team. The Managing Authority assessor should exercise judgement when determining whether reliance can be placed on a previous assessment. For instance, where there have been Due

Diligence checks undertaken in the last 12 months, then the checks do not need repeating as the underlying data will remain the same[1]. If 12 months has elapsed since the last checks, they will need repeating. When using the results from previous checks, the assessor will however need to consider the aggregate level of grant requested through the new application, and that already obtained.

[1] An exception to the 12-month period would occur where new evidence is presented suggesting the Due Diligence checks should be repeated.

Annex A

Financial Appraisal of an Applicant Organisation

1. Financial Appraisal

The primary purpose of the financial appraisal is to establish that the applicant organisation/company:

- has sufficient resources to support the management of an EU funds
- is financially sound and potentially stable enough to remain in business for the period of the grant and any post-contract period required.
- has the necessary finances in place to cash flow the operation in arrears on a quarterly basis
- has the necessary finances to be able to repay grant in the event of an irregularity

The financial strength of the applicant is assessed by looking at its turnover, gross and (pre-tax or net) profits, net worth and certain financial ratios. Consideration of the accounts for the last three/four years enables an opinion to be made on continuing information, rather than just at one point in time.

Applicants are appraised against a number of indicators including the following:

The level of turnover, profits/surpluses are assessed to ascertain if they are improving or not (i.e. what trends there are, if any), and whether any losses/deficits have been incurred.

Consideration should be given to ensuring the organisation's resources are not being overstretched. In addition, consideration needs to be given as to whether a company is overly dependent upon its business from European funds, other Departmental grants and any other grants and the effect upon the business should these grants cease.

Whilst there is no central database for checking this, the organisations' website and/or access to published accounts, may provide this information. If the information is unclear then the assessor may wish to consult with the applicant for clarification.

It is important to ensure that the applicant has capacity to deliver the required activity, and a grant that is relatively high compared to an organisation's turnover might suggest that their capacity is not sufficient. Consideration may be given to the organisation's management capability and governance arrangements.

The liquidity of a company is measured by the current and acid test ratios to see how easily it will be able to meet its short term (current) debts with the current assets that are readily available to it. Ideally current ratios should be between 1.5 to 3 whereas for acid test ratios these should be at least 1.0 or greater (i.e. there should be at least €1 of current assets to each €1 of current liability). The lower the ratio is below 1.0, so then the greater the risk is, which the

MA assessor would then have to take a view upon and it would mean the company is not in a position to pay its current liabilities.

Capital employed is an important calculation to consider and is also known as funds employed. This is the total amount of capital used for the acquisition of profits. It is the value of all the assets employed in a business and can be calculated by adding fixed assets to working capital or subtracting current liabilities from total assets. By employing capital, you make an investment.

If the capital employed is negative then this indicates that the company could be 'technically insolvent', (i.e. that it owes more than it owns). When a company reaches this point, then its ability to continue to carry on trading is at far greater risk, especially if its creditors demand payment, it could go into administration or be wound up.

Another ratio worth considering is the gearing ratio which reflects the value of long term loans and any preference shares compared with its other capital employed. If the gearing ratio is high, the company may be committed to substantial interest payments, and may be limited in its ability to raise further funds, to support either expansion or short term liquidity. So the higher a gearing ratio is, then the greater the risk becomes.

Assessing these factors may sometimes give conflicting indications of a company's position and no two companies are ever exactly the same – the accounts will often reflect the role and nature of the organisation's business and what is acceptable in one area may not be in another. Overall the final recommendation for an appraisal is taken by arriving at a view of these factors and assessing what a company's financial position is.

The bare numbers can provide a good indication of the financial security of the organisation, but the financial appraiser should also take into consideration other factors which can be interpreted from the accounts including:

- If irregular expenditure is subsequently identified in a claim will the organisation have the ability to repay some or all of the funding
- What are the risks to the Department and EU's reputation?
- Are there any actions that can be recommended to protect the Department's risk exposure (e.g. the imposition of pre-conditions that have to be met before funding is paid to the applicant)
- Are any additional managerial, financial or legal safeguards required prior to grant award?
- What will be the impact upon the Department and/or the project's beneficiaries if the organisation fails?
- Are there any actions that the Department could take to reduce the risk of the supplier failing (e.g. payment terms)
- Has the organisation any history of managing EU projects (information from the application)

- If the applicant has submitted a number of applications, what is the total level of funding an applicant is exposed to?

The financial statements for most organisations will be the subject of an external audit. The auditor's report can provide useful information about the standard of organisation. The auditor will offer an opinion on the accounts which will be one of the following:

- Unqualified Audit Report – Should be expressed when the auditor concludes that the financial statements give a fair and true view in accordance with the identified reporting framework

- Qualified Opinion – should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material or pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being "expect for the effects of the matter to which the qualification relates"

- Disclaimer of Opinion – should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements

- Adverse Option – should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements

Any opinion offered by the auditor other than an Unqualified needs to be considered very carefully by the appraiser.

2. Appraisal Process

As explained, the Appraiser needs to take a view on the evidence provided either by the Organisation. To assist, a Financial Analysis Form is provided which allows the appraiser to insert key financial information from the Organisation's financial statements.

The sheet also provides a template for the appraiser to provide narrative of their assessment of the organisation and any recommendations. The formulae and purpose of the some Key Financial Ratios that can be used in the assessment of the organisation are described in Annex A1. The definitions of the Financial Statements and some key financial terms are shown in Annex A2.

Annex A1: Financial Ratios

Financial Ratio	Formula	Purpose
Debt Ratios		
Gearing Ratio	$\frac{\text{Long Term Debt + Short Term Debt + Bank Over drafts}}{\text{Capital Employed}}$	The gearing ratio measures the proportion of a company's borrowed funds to its equity. The ratio indicates the financial risk to which a business is subjected, since excessive debt can lead to financial difficulties. A high gearing ratio represents a high proportion of debt to equity, and a low gearing ratio represents a low proportion of debt to equity. As a guide, the lower the gearing, the less the company relies on debt
Liquidity Ratios		
Current Ratio (Working Capital Ratio)	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	The current ratio measures the ability of an organization to pay its bills in the near-term. The current ratio is an indication of an organisation's market liquidity and ability to meet creditor's demands. Acceptable current ratios vary from industry to industry and are generally between 1.5 and 3 for healthy businesses. If a company's current ratio is in this range, then it generally indicates good short-term financial strength. If the ratio is below 1, then the company may have problems meeting its short-term obligations. If the current ratio is too high, then the company may not be efficiently using its current assets or its short-term financing facilities.
Quick Ratio or Acid Test	$\frac{\text{Current Assets – (Inventories (stock) \& Prepayments)}}{\text{Current Liabilities}}$	The Acid-test or quick ratio or liquid ratio measures the ability of a company to use its liquid assets (i.e. those assets that can fairly quickly be moved into cash at close to their book value to extinguish or retire its current liabilities immediately if it was so called upon). A company with a quick ratio of less than 1 cannot currently fully pay back its current liabilities. Non liquid currents like stock (inventory), prepayments, tax recoverables and other unnamed current assets are normally excluded from the Current Assets calculation. Generally, the acid test ratio should be 1:1 or higher, however this varies widely by industry. In general, the higher the ratio, the greater the company's liquidity (i.e., the better able to meet current obligations using liquid assets).
Receivable (Debtor) Days	$\frac{\text{Receivables (Debtors)}}{\text{Sales}} \times 365$	The Receivable (Debtor) days is the average number of days required for a company to receive payment from its customers for invoices issued to them. A larger number of debtor days means that a business must invest more cash in its unpaid accounts receivable asset, while a smaller number implies that there is a smaller investment in accounts receivable, and that therefore more cash is being made available for other uses.

Payable (Creditor) Days	$$\frac{\text{Payables (Creditors)}}{\text{Purchases (Cost of Sales)}} \times 365$$	The Payable (Creditor) days formula measures the number of days that a company takes to pay its suppliers. If the number of days increases from one period to the next, this indicates that the company is paying its suppliers more slowly, and may be an indicator of worsening financial condition. A change in the number of payable days can also indicate altered payment terms with suppliers, though this rarely has more than a slight impact on the total number of days, since the terms must be altered for many suppliers to alter the ratio to a meaningful extent.
Fixed Assets/Capital Employed	$$\frac{\text{Fixed Assets}}{\text{Capital Employed}}$$	The fixed assets to net worth ratio indicates the proportion of an organisation's cash blocked in capital assets such as brick and mortar instillation, land, factories, and machinery and the proportion of cash available in liquid form to fund the firm's operations. The fixed assets to net worth ratio finds widespread application to measure the solvency of a firm. A ratio higher than 0.75 usually reveals the firm is investing high amount in capital excessively as well as non-liquid assets, leaving too little cash to fund operations. This could make the firm vulnerable to unexpected events and changes in business climate.
Current Liabilities/Capital Employed	$$\frac{\text{Current Liabilities x 100}}{\text{Capital Employed}}$$	Indicates reliance on the equity for payment of debt. It is one of the measures of the solvency of a firm and, as a rule of thumb, should not exceed 60%; higher percentages mean significant pressure on future cash flows.

Annex A2: Financial Statement Definitions

Statement of Financial Position	Previously referred to as the Balance Sheet, this statement summarizes a company's assets, liabilities and shareholders' equity at a specific point in time. It provides interested parties and potential investors with an idea as to what the company owns and owes, as well as the amount invested by the shareholders. In basic terms, it is made up of three segments: Assets: What it owns Liabilities: What it owes Shareholders' Equity: It's owners investments in the organisations And works to the following formula: Assets = Liabilities + Shareholders' Equity
Income Statement	A financial statement that summarizes the revenues, costs and expenses incurred during a specific period of time - usually a fiscal quarter or year. This statement provides information that shows the ability of an organisation to generate profit by increasing revenue and reducing costs. The Profit and Loss Account may also be known as the P&L statement, "statement of profit and loss", an "income statement" or an "income and expense statement". It begins with an entry for revenue and subtracts from revenue the costs of running the business, including cost of goods sold, operating expenses, tax expense and interest expense. The bottom line is the net profit or loss.
Cash Flow Statement	A financial statement is concerned with the flow of cash in and out of the business. As an analytical tool, the statement of cash flows is useful in determining the short-term viability of a company, particularly its ability to pay bills.
Sales Turnover	Sales turnover is the company's total revenue, both the invoice, cash payments and other revenues.
Operating Profit	The profit earned from a firm's normal core business operations. This value does not include any profit

	earned from the firm's investments (such as earnings from firms in which the company has partial interest) and the effects of interest and taxes. It is also known as "earnings before interest and tax" (EBIT) or "operating income".
Capital Employed	This is the total amount of capital used for the acquisition of profits. It is the value of all the assets employed in a business and can be calculated by adding fixed assets to working capital or subtracting current liabilities from total assets. By employing capital, you make an investment.