Scrutinising big business

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Payment periods undoubtedly contribute to the debt in the construction industry, but change management and loss-making contracts are the real culprits for the precarious situation in which we find ourselves maintains Chris Green

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There has been much coverage by the industry press regarding performance data on the time taken to pay invoices. According to a recent report by Build UK on its members? payment performance, the best member organisation ? within the scope of the report ? is taking around 14 days to make payment and the worst around 86 days. But are the construction industry?s problems really constrained to lags in payment? Was it delayed payment that resulted in the demise of Carillion and is still putting pressure on many tier-1 contractors and leading consultancies?

A cursory review of leading contractors? published accounts (see Table 1) gives a clear indication of the increasing debt cost for businesses to operate in the UK. Many of the top 10 contractors have debts in excess of ?100m.

Contractor	Turnover (?m)	Profit/loss (?m)	Debt cost (?m)	Annual report (year)
Balfour Beatty	8,264	117	73	2017
Carillion	4,394	147	60	2016
Kier	4,493	106	29	2018
Interserve	3,667		28	2017

Laing O?Rourke	3,173	?67	19	2017
Galliford Try	2,932	144	18	2018
Morgan Sindall	2,793	65	4	2017
Amey	2,581	?190	41	2017
Keller	2,070	111	15	2017
Mace	2,037	23	4	2017

Table 1: An overview of major contractors? recent annual reports

Debt finance is provided to many businesses in the form of revolving credit facilities, allowing access to a pre-agreed debt facility into which repayments can be made on a day-to-day basis. As businesses are unable to recover payments for work undertaken within the period in which costs are incurred, the debt requirement increases ? resulting in a debt cost to the contractor.

Standard payment terms under most UK contracts require an application for payment to be made following the completion of work within a period, usually 1 month, followed by another for certification of the amount due before an invoice can be raised. The Local Democracy, Economic Development and Construction Act 2009 requires all construction contracts to identify a due date for payment from which payment periods are determined. If the contract specifies a long payment period, that is 60?90 days, then payments will be legitimately made long after works are undertaken and costs are incurred, but will not be judged as being late. If all work is subcontracted, then this same mechanism can be applied to the supply chain and cash flow can be regulated. If work is undertaken directly, either by delivery contractors, specialists or subcontractors, then payments to operatives are made on a weekly basis and cash flow requires financial support.

The Public Contracts Regulations 2015 require that all payments under construction contracts for the public sector be made within 30 days. Payment periods contribute to some of the debt requirement, but this is not the major cause of debt for the UK?s large construction businesses, which tend to operate a subcontracting model. So, why do these business have such big debt requirements? There are 2 primary causes: change management and loss-making contracts.

Change management

Most common forms of contract, including JCT, NEC, FIDIC and ICC, specify different time periods for the identification, notification, quantification and particularisation of change. A failure to adhere to these may delay agreement and payment or, worse, prevent the change being recognised at all. However, most forms of contract do not specify a period of time within which the value of individual items of change must be agreed, other than the longstop date for the completion of works certificate.

The NEC4 contracts attempt to address this issue and set out a defined notice period for identifying change in clause 61.3, and a reply period in clause 61.4. Clause 62.3 states the period for submitting a quotation for the compensation event and finally, clause 62.6 details the period for acceptance and implementation. Even with this prescriptive mechanism there is often poor adherence to these set time periods. Often custom and practice prevails, and change is dealt with during the final account negotiations. It therefore falls to the quantity surveyors acting for both clients and contractors to act professionally and address the change as it arises. Clients must also acknowledge that change has occurred, and contractors must remain vigilant in order to recognise change at the earliest point.

If change is not managed efficiently, the contractor will not be paid the income needed to cover the costs. This lag in payment for variations significantly influences the requirement for debt finance to bridge the gap between payment of costs and receipt of income. It is this lack of available cash that leads to the failure of many businesses. You will see evidence of poorly managed change being a significant contributing factor in the demise of most contracting and consulting organisations.

As previous articles in Construction journal have noted, high-performing quantity surveyors acting for both clients and contractors must manage change in accordance with the contract and understand the importance of agreeing the value of change quickly, accurately and progressively. The RICS Black Book guidance note Valuing change provides guidance on administering the change control mechanism.

Loss-making contracts

Contracting inevitably requires the acceptance and management of risk. Standard forms of contract have been written to apportion risk fairly between client and contractor. However, many clients amend standard forms of contract to redistribute the risk ? this often requires the contractor to accept risks that are out of its control.

If the contractor fails to make adequate provision in the pricing for this risk, it will lose money. However, making a full provision for risk often leads to the tender being uncompetitive. As a result, all competitive contractors will experience loss-making contracts occasionally.

Financial loss leads to a cash outflow that will not be made good until sufficient profits have been generated from future contracts. Debt finance is required in the intervening period to fund these losses.

The executive team at Carillion cited unpaid change ? and the associated losses ? as 1 of the key causes for the collapse of the organisation.

The industry?s response

There has been much press coverage of businesses taking action to reduce their debt requirements: many have sold assets or businesses to release capital and pay off debt; others have been forced to swap debt for equity, effectively giving partial ownership of their business to the provider of debt finance. This is similar to having your house repossessed when you cannot make your mortgage payments.

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Many chief executives are focusing on cash management and debt reduction to reduce the cost of their debt; this is not necessarily a voluntary action but down to increasing pressure from debt providers to decrease their debt requirement.

At the time of writing, many of the top 10 construction contractors are unable to publish their statutory accounts. This is not because they are trying to suppress bad results, but as a result of action being taken by the providers of debt finance to the industry. Most of the banks providing working capital to contractors have taken a very risk-averse stance since the demise of Carillion and have been slow, or unwilling, to renew credit facilities.

Many chief executives and finance directors are spending a significant amount of time negotiating the renewal of credit facilities and any attached covenants. If negotiations in the renewal of credit facilities remain unresolved, the business is unable to publish its audited accounts as the auditors cannot confirm the business is a going concern: operating and making profit. Essentially, this means the auditors cannot confirm that the business will be able to continue to trade until it has secured a source of working capital.

Many organisations are being forced to take drastic action to reduce debt, which is in turn suppressing investment. In the long term, this will improve the health of our industry by reducing our reliance on debt finance but, in the short term, the lack of debt finance may prove fatal for some of the larger businesses on which clients depend.

Quantity surveyors and project managers play an important role in helping the industry to address these challenges. We must be aware of the pressures in the industry and do all we can to reduce the impact the withdrawal of credit has on the industry. Advocating fair procurement practices, being efficient in contract administration and ensuring prompt payment are some of the simple steps we can all take to help the construction industry through these challenging times.

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Further information

- Related competencies include: Commercial management , Procurement and tendering
- The RICS Black Book guidance notes detail how quantity surveyors should conduct their services. Refer to: Tendering strategies , 1st edition July 2014; Interim valuations and payment , 1st edition August 2015; Commercial management of construction , 1st edition March 2016; Valuing change , 1st edition May 2010; Retention , 1st edition March 2013; Final account procedures , 1st edition December 2015
- This feature is taken from the RICS Construction journal (June/July 2019)
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