FIS Response: Payment Practices and Performance Regulations

FIS Consultation Response to Amendments to the Payment Practices and Performance Regulations 2017 (full details here)

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Introduction

FIS represents the £10 Billion Finishing and Interior Sector part of the UK construction sector. The organisation has a corporate membership of around 580 companies drawn from contractors, manufacturers and distributers of ceilings, steel framed system (SFS) cladding, partitions, plastering, drylining, specialist interior fit-out and refurbishment businesses. Our wider network (managed via our Trade Magazine, SpecFinish) stretches to around 9,000 companies.

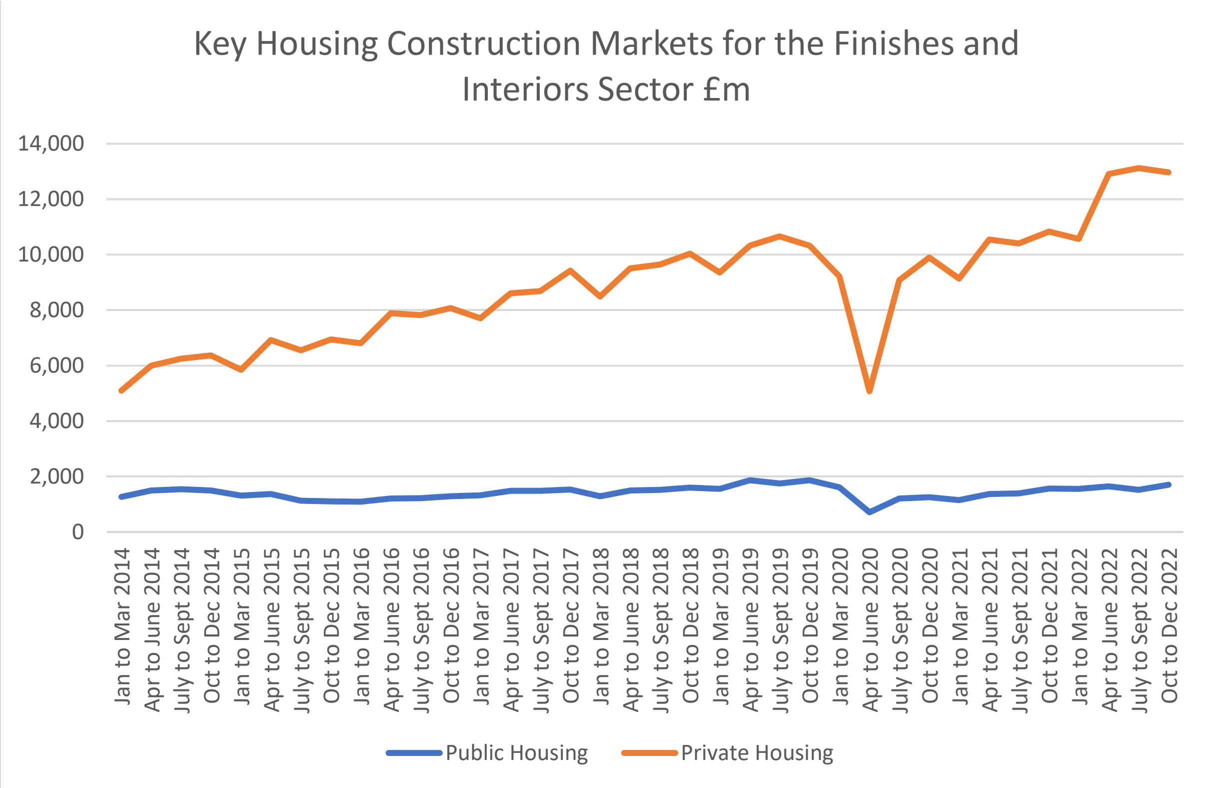
Sector turnover: £10 billion | Employment Interior Fit-out: 250,000 | Number of companies: 10,000

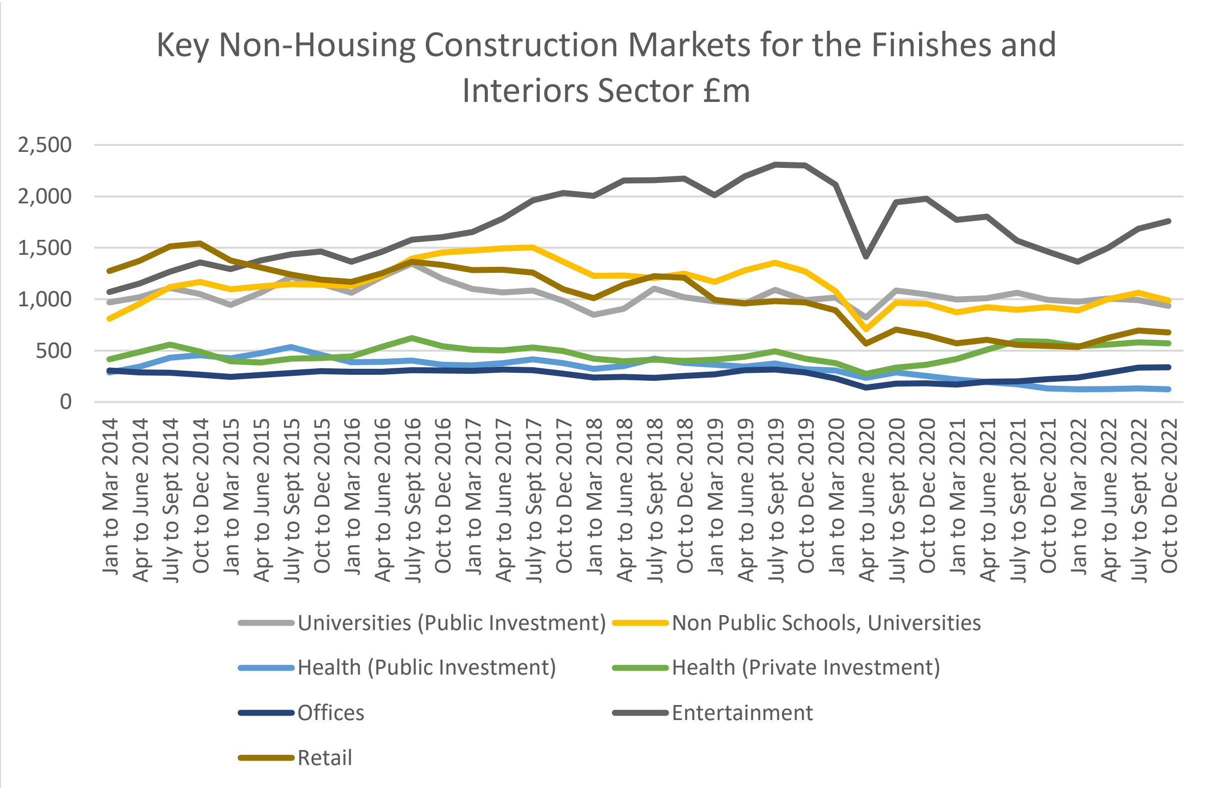
Typical trades employed: ceiling fixers, demountable and relocatable partition installers, drylining installers, plasterers, shop fitters, SFS installers and carpenters and joiners.

Modern specialist fit-out and finishing contractors operate across a range of sectors, including education, healthcare, retail and leisure and housebuilding. As well as new build, fit-out work is invariably a central component of retrofit. The overwhelming majority of firms within the sector are SMEs and most of these routinely act as subcontractors to others.

Underlying economic conditions in the finishes and interiors sector

The finishes and interiors sector, as a fundamental element of virtually all construction projects, has been subjected to challenging trading conditions over the last decade. Whilst turnover has increased and markets like housing have (until the last six months) been relatively buoyant, this is not always reflected in workloads as, particularly recently, inflation has had a distorting effect. Crucially the uncertainty and challenges the sector has faced have impacted the availability of working capital through the supply chain.





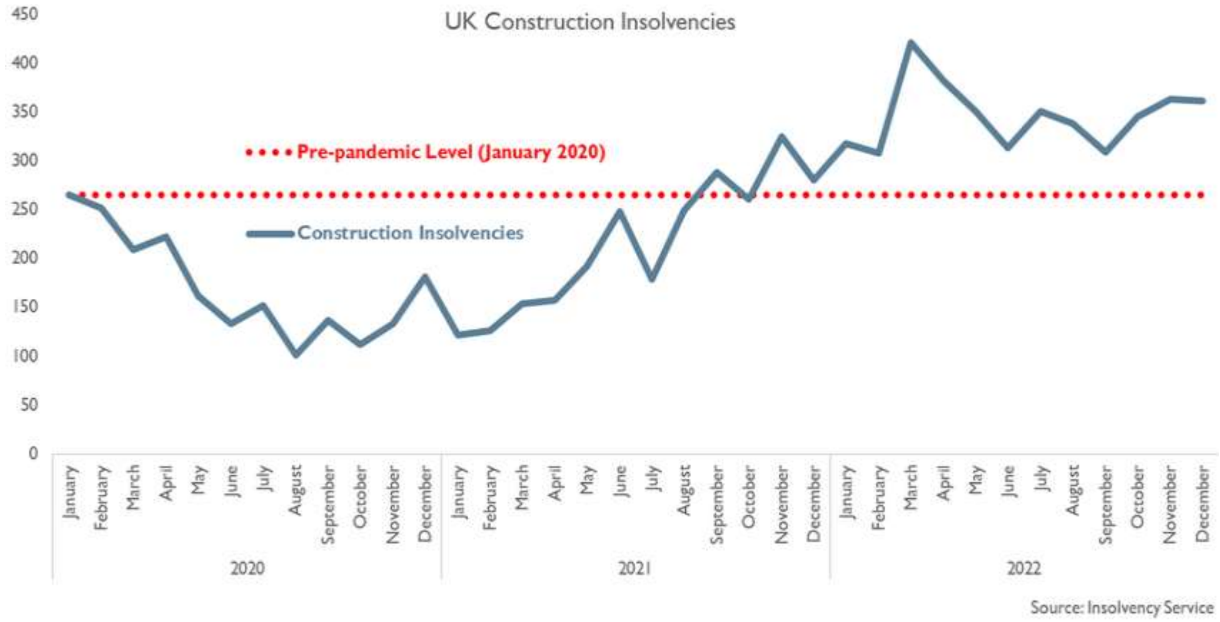
Carillion's collapse in 2017 had significant consequences on specialist contractors in the UK, leaving debts of almost £2bn owed to its 30,000 suppliers, many of whom received little back from the liquidation. This had huge impact across the supply chain not least in terms of the cost and availability of credit insurance. At the same time, the economic impact of Brexit on construction started to be felt and, whilst housing and public sector investment continued, the wider market tended to stagnate until 2018 as clients and industry alike awaited the economic fallout.

The emerging recovery was interrupted by Covid-19, which created a sharp crash and another prolonged period of uncertainty. The construction sector, whilst remaining operational throughout lockdown (in parts of the UK) saw costs increase to manage changes required in working practices and whilst, in the main, time delay damages were not imposed, equally costs were not reimbursed (further eroding working capital). Lifelines were provided by Government such furlough and loans and the sector was a significant user of Bounce-Back and CBILS loans. Concerningly, according to data obtained under the Freedom of Information Act and reported in Construction News, specifically in the construction sector,17% of the Bounce-Back loans were in default up to the end January 2023 and similarly 5% of the CBILS loans were in default.

As the sector emerged from COVID and demand started to return to pre-pandemic levels, a number of global impacts hit the sector, most notably the Russia/Ukraine conflict, which disrupted availability and production and added huge inflationary pressures, initially spiralling shipping costs, but subsequently creating an energy crisis and hyper-inflation set in. In a market driven primarily by fixed price contracts, this has created significant challenges. Beyond the price of products and materials inflation was further exacerbated by changes to the profile of the workforce in the wake of new immigration rules. The Finishes and Interiors Sector relied heavily on migrant labour, which accounted for around 40% of the workforce (higher in London and the South East). A tightening in the labour market has seen trade wage rates increase by in excess of 30% since July 2020.

Beyond managing the pressure on margins for existing work, the impact of higher costs is that larger sums of money are required to initiate jobs. The cost of capital, driven by rapid increases in interest is also hitting the supply chain, who, in a market where typically money is not deposited up front, are effectively financing the work.

Against this backdrop, traditional sources of finance have become more challenging for the construction supply chain and credit insurance more difficult to secure and prohibitively expensive. Trade debt and credit cards are the main source of credit and the cumulative impact has seen the 4,135 businesses go insolvent within the construction supply chain in the 12 months to the end of January 2023. This is a rise of from the previous year. It is also noteworthy (in light of increasing requirement for trade credit from the supply chain) that leading builders' merchants applied to the courts to wind up 185 construction firms during 2022/23 compared to just 44 petitions in the prior year.



A strong, resilient, and sustainable supply chain is in the interests of all parties in construction. It follows that there needs to be a collective responsibility for ensuring fair and transparent payment practices. The high-quality specialist services demanded from the fit-out and interiors sector makes the need for fair payment practices especially important if long-term capability is to be preserved. In light of the balance sheet issues created, the need for cash to flow through the supply chain to the SMEs and fair payment has never been more important if they are to remain trading.

Fair Payment, an update from the finishes and interiors sector

Fair payment consistently remains in the top two issues that impacts the FIS community.

Poor payment practices and the corrosive effects have been repeatedly highlighted by Latham (1994) and in a variety of reports since, through to the Construction 2025 strategy (HM Government, 2013) that lists equitable financial arrangements and certainty of payment as being among the critical factors which determine the successful delivery of construction projects. Despite well intentioned interventions is that the reality on the ground is little has changed.

The latest CN Payment 100 shows improvement in the time taken by the largest construction firms to pay their subcontractors for their work – average (median) time it takes to settle a payment is 35.5 days, down from 38 days (in December 2021), but if we look to the supply chain to understand if they are, in reality seeing the benefit we find that less than 6% of sub-contractors are paid within 30 days and 48% are at 40 days plus, this doesn't factor in delays caused by disputing payments and in the application approval process.

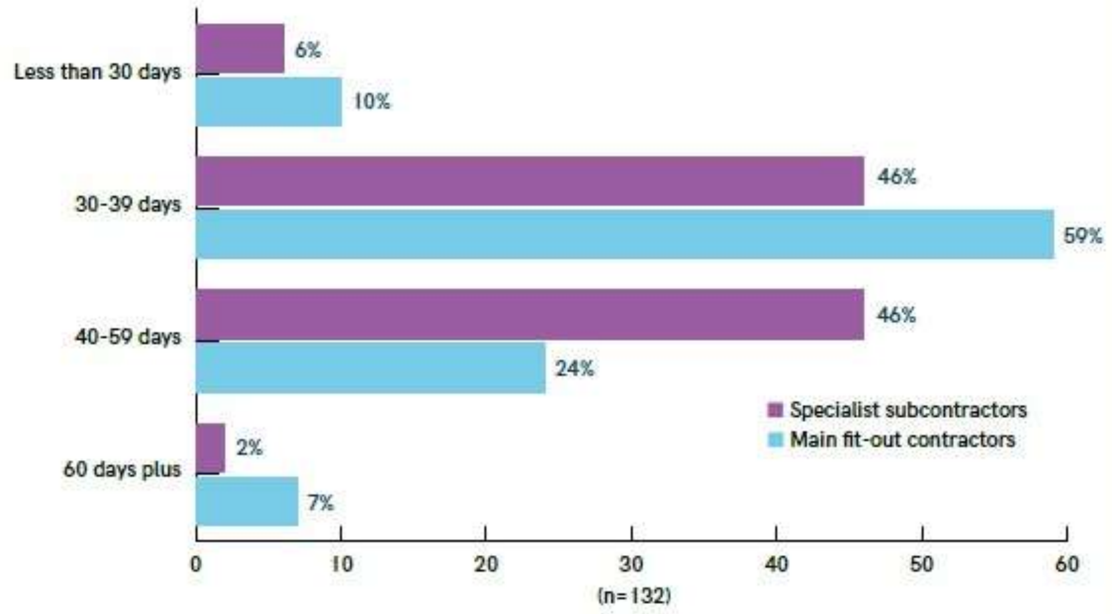


Figure 8.1 Source: University of Reading

Promptness of payment

Reflecting on the last 12 months, how long after your initial application for payment do you get typically paid?

Despite the positive reports based on these headline numbers, research Published in Q1 2023 by the University of Reading into Contractual and Payment Practices in the finishes and interiors sector indicates that, for 1 in 5, the situation is worsening.

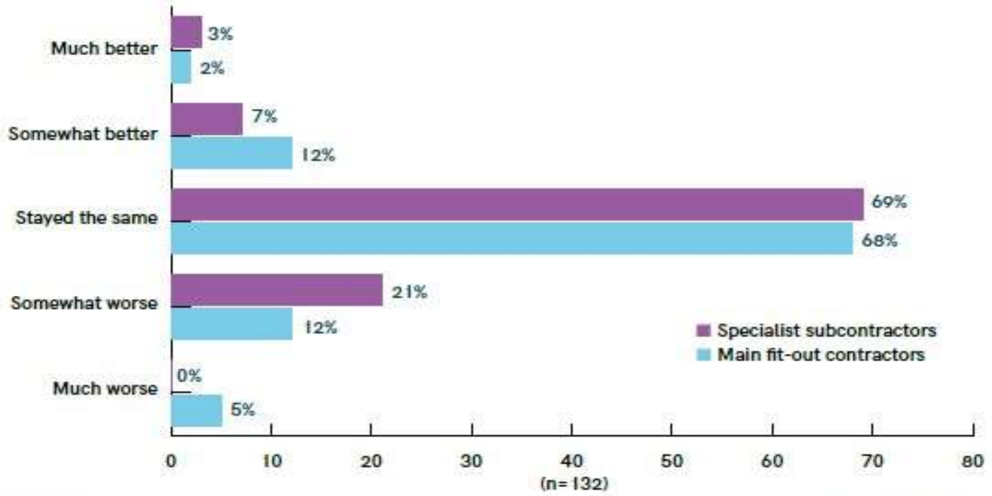


Figure 8.2

Source: University of Reading

Payment practices improving or getting worse?

Thinking about payment promptness, how do you think current payment practices compare to those of 12 months ago?

Supporting information from a recent CICV Survey of Scottish companies (supported by FIS) Answered by those businesses which operate both as main and subcontractors in the public and private sectors, its key findings included:

- 52% reporting that they still have problems getting retentions paid
- 44% revealing that they had been hit with unexpected charges
- 40% disclosing that they “always or often” had payments reduced
- 30% saying payment delays have a “major impact” on their company.

Beyond the economic aspects of Fair Payment, is the cost to the supply chain of a company failure in terms of outstanding debt and reallocating work, opportunity cost of chasing payment and ultimately the cost of disputes. Oxford Economics research commissioned by the CBI in 2020 established that the construction industry spends 1.6% of its total expenditure on services and goods from UK suppliers on legal services, around £1.27bn. While some of that is necessary expenditure, it compares unfavourably to other industries, where the UK economy’s median spend is half the size (0.8%).

The human cost on the individuals and families associated with above is immeasurable:

- The rate of suicide in construction is 2.7 times higher than the UK average and within these numbers finishing and interiors accounts for around a third.

The ground truth is that current payment practices are undermining the viability of businesses in the supply chain, putting intense strain on individuals running and managing businesses and at the same time undermining the construction process by creating an environment where it is increasingly difficult to invest in the business and forcing decisions to be made in “survival mode”.

Payment practices are currently monitored by the Construction Supply Chain Payment Charter as championed by the Construction Leadership Council (CLC), but monitoring is limited to Duty to Report reporting, which is limited in scope and use. The Payment Charter is very clear in its ambition: “Fair and transparent payment practices are essential to the achievement of successful integrated working on construction projects. This Charter applies to all parties to construction contracts with the aim of helping to create a more collaborative culture and ensure a strong, resilient, and sustainable supply chain”. This should be supported by effective policy and enforcement thereof.

Common conversations as real world examples of above

Prior to Christmas and through the Procurement Research with the University of Reading, FIS collected experiences of members of our community that reflect conversations that are worryingly common:

> ***Member A**: "Fudging the December payment run is a practice that goes back years. It is another example of poor behaviours in construction that carry on in plain sight. Continually chasing payments throughout the year and having to issue seven-day notices is something that we do not do lightly, but without these there is no guarantee that we will receive our payments. It's mid-month and we currently have £970k we consider to be overdue for December. This puts huge pressure on cashflow.*
>
> *"Everybody just puts up with it as 'normal for construction'. Some of the main contractors' QS's are fully aware of the December 'issues' and are very open about it, but their hands are tied by the 'finance teams'.*
>
> *"They use every excuse under the sun, blaming holidays and admin challenges, but the result is the same – another stressful Christmas for sub-contractors.*
>
> *"We read about Prompt Payment Codes and see these written into procurement frameworks and advocated by the government, but none of these schemes will save our business if main contractors continually certify less than 90 per cent of the application value. I keep hearing that we have a choice who we work for. Equally people have a choice who they buy from. When it comes to contracts for big public projects, is it right that they keep being awarded to companies that are happy to leave their supply chain hanging over the holiday period?"*
>
> ***Member B:** "I am sick to death of begging for money. It isn't just Christmas. It goes on all year, but definitely gets worse as we move to reporting periods. I attend meetings all the time where I am told businesses pride themselves in paying on time, but it is the spurious underpayments and unsubstantiated pay less notices that they don't talk about. It feels like death by a thousand cuts. We pay our workforce in full and on time weekly. If we didn't, we wouldn't have a workforce.*
>
> *"In the last few weeks, I was due a £240,000 payment and the remittance came through for just under £100,000. I eventually got hold of the QS after repeated phone calls and emails to be told that all the applications were approved and it must be an error in accounts. Accounts referred me back to the surveyor. All the time I am £140,000 short. The next stage is chasing the commercial team and eventually the MD. I very much doubt, and carry the weight of the fact, that this money is unlikely to come in before Christmas.*
>
> *"At the same time, another invoice for £250,000 came in, two weeks late using 'year end, you know how it is' as the excuse after repeated chasing. This problem is repeated across our client base and at any one time around £800,000 of our money can be sitting in other people's bank accounts. How can it be acceptable that bigger customers use me, the smaller supplier, as a bank and risk pushing me out of business?*
>
> *"This is building to a crisis point and it is so easy to see how companies slip off the edge. We are being pressed on competence and compliance, to do more in terms of training and sustainability, but our efforts and energy is wasted chasing cash. If we want to innovate and evolve as a supply chain we can't do this by driving smaller agile and innovative businesses into the ground."*
>
> ***Member C:** "Our biggest issue is with obtaining payment for variations and site instructions. This is a constant battle with virtually every national housebuilder. It seems that a contra charge culture has now developed within the industry to off-set any additional expenditure encountered by the housebuilder. The solution it seems is to squeeze the supply chain."*

Consultation Response:

Question 1: Do you agree that the Regulations should be amended to extend their effect beyond 6 April 2024?

Yes.

Transparency is critical to helping to lead culture change. The Duty to Report does provide information of use and it also starts to create a healthy environment where large companies, often bound by their own ESG policies are forced to report on and evidence how they are treating small businesses in the supply chain.

The industry league tables too that have drawn on this data have also been helpful in keeping this important subject on the agenda.

It is the case, however, that the current scope limits the ability of the Regulation to meet the core objective to:

> *provide small business suppliers with better information so they can make informed decisions about who to trade with, negotiate fairer terms, and challenge late payments.*

Concerningly without value as a metric and other changes to tighten, reporting has the potential to be gamed and therefore mislead those it is trying to protect.

Question 2: Do you agree that the Regulations should be amended so that a qualifying business is required to report the total value of payments due in the reporting period that have not been paid within agreed terms?

Strongly agree.

Metrics on the average percentage of volume of payments made are useful but fail to give us a true picture of payment performance. As it stands efficient payment of small invoices for e.g. business facilities or stationary could mask differing practices within the construction sector, typified by larger payments. Data can therefore appear falsely positive.

The reality in construction is that whilst the headlines indicate that payment is improving, this is not the experience of the supply chain. In a recent survey conducted by the University of Reading into our sector, only 10% of specialist contractors experienced any improvement with 21% noting has worsened and the vast majority experience no real change.

The cost of this in the current climate with interest rates rising is a real concern.

If the data is to *provide small business suppliers with better information so they can make informed decisions about who to trade with, negotiate fairer terms, and challenge late payments,* **we require both metrics.**

It is essential that a measure of value is introduced or the Regulation will not *remain effective and [will] encourage businesses to 'game the system'.*

Introduction of data on value of invoices paid within terms will provide much needed transparency on the financial impact of late payments, this also needs to be combined with stricter requirements on the data reported in line with the guidance (covered below) which is not routinely followed.

Any argument to the contrary to date has been framed around added burden of reporting, but evidence suggests that there is little added cost in introducing this metric and any cost pales to insignificance in terms of the cost of bad practice on the supply chain.

Question 3: Do you agree that it should be a requirement for a reporting business to include their payment practices and performance reports in their directors' report?

Strongly agree.

This would provide a more formal undertaking associated with reporting and provide opportunity to ensure that the Guidance is followed.

For example, a big issue for construction is how the measure "invoice payment" is triggered. In the complex world of applications, valuations, pay less notices and certification there remains some confusion about what triggers the invoice. The guidance is actually clear:

> *For construction contracts in scope of the Housing Grants, Construction and Regeneration Act 1996 or the Construction Contracts (Northern Ireland) Order 1996, businesses must use the earliest point at which they have notice of an amount for payment.*

> *This would generally be the date they receive an application for payment or, in cases where there is no application for payment, the date on which they receive a payment notice (or default payment notice) or on which they issue a payment notice – whichever is earliest. Day 1 of the time taken to pay will be the day after the day on which the business has this notice.*

But, this guidance is not enshrined in the regulation and therefore different definition may be applied in the existing reporting regime. There are no meaningful checks or procedures in place to ensure that individual companies are actually reporting.

Whilst failing to report, or intentionally publishing false or misleading information, is a criminal offence under the Regulations this is softened by the undefined caveat "all reasonable steps" to ensure that the requirements under the Regulations were satisfied.

Added to this, enforcement of the Duty is under-resourced to the point of being virtually non-existent, we understand that only 18 companies have been contacted for failing to report and no fines or sanctions have been imposed. Without adequate enforcement the reliance is on the supply chain to flag issues, however, companies will not report because they fear being exposed and blacklisted.

There is therefore a need to formalise reporting procedures in this way.

Question 3a: Do you agree that making it a requirement for a reporting business to include their payment practices and performance reports in their directors' report is a sufficient additional requirement for a reporting business?

Strongly disagree.

It is not "sufficient". Making it a requirement for a reporting business to include their payment practices and performance reports in their directors' report is positive step, but existing mechanisms to check remain wholly inadequate and therefore there is no way to ensure that this is verified information.

Information presented in this way would only be audited for consistency with the accounts. Our preference would be mandatory reporting requirement in the Notes to the Financial Statements of performance against the Regulations. Including it in this way would ensure it is subject to full audit coverage and would reduce the burden on the Regulator to spot-check and audit enforcement separately.

Question 4: Do you agree that the Regulations should be amended to clarify payment dates used for reporting when supply chain finance is used?

Strongly agree.

The purpose of Supply Chain Finance has drifted and it is often less about improving speed of payment and more about large businesses shifting any costs associated with paying on time onto the supply chain. Being paid under a Supply Chain Finance arrangement often commands fees for being paid on time by the finance provider. Further those payments are typically linked to repayment (claw-back) arrangements should payer does not pay the finance provider.

Question 5: Do you agree that the Regulations should be amended to consider disputed invoices as a separate entity, to improve the accuracy and transparency of the reporting data?

Neither agree nor disagree.

Whilst we applaud the intent and there is evidence businesses use dispute to delay payment, it is difficult to see how this would work in practice and how it could be audited. This is something that should be explored for future iterations of this regulation or by linking the Prompt Payment Code to initiatives like the Conflict Avoidance Pledge into a more holistic process administered by the Small Business Commissioner.

Question 6: Do you agree that the Regulations should be amended so that payment practice and performance reports should include information on the standard retention payment terms in qualifying construction contracts?

Strongly agree.

The CLC roadmap to zero retentions does say that they retentions should be phased out no later than 2025, but there appears to be little meaningful progress, so issues associated with retention should absolutely be subject to scrutiny. The retention debate often gets derailed by trying to solve two problems at once. There are two distinct parts to this debate:

1. the underlying concept of retention – how we work, as a sector, manage trust and quality with clients to evolve away from retention and ultimately how our Standard form Contracts support this evolution.
2. how they are fairly and consistently deployed within the supply chain

Question 7: Do you agree that the Regulations should be amended so that payment practice and performance reports should include statistical information on retention payments?

Strongly agree

A key conclusion FIS research is that the further down the supply chain, the less likely you are to actually get your retention.

Construction typically works on low margin and with Main Contractors making around 3% profit on average. The value of retention is at a similar level to profit.

FIS Research conducted by the University of Reading identifies 33% of main contractors always secure retention, compared to 14% of specialists. This concern here is that a significant proportion of retention that should cascade through the supply chain is actually realised as profit. It should not be forgotten too that in the liquidation of Carillion £800m of retention was lost.

For this reason, FIS continue to advocate for the ultimate abolition of retention, but in the interim, to ensure that retentions are protected, associated only with the work packages undertaken and AUTOMATICALLY RELEASED based on a defined date (rather than abstract event). This should be monitored to prevent nefarious practices through these Regulations.

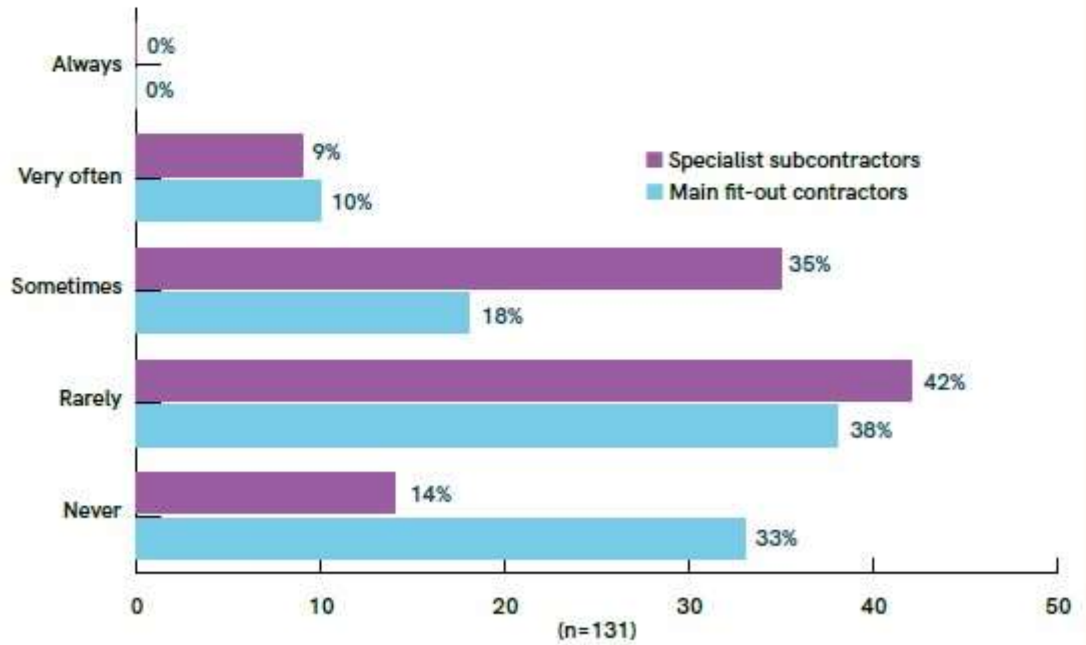


Figure 8.4 Source: University of Reading

Failure to recover retention monies

How often do you fail to recover retention monies to which you are contractually entitled?

Question 8: How many hours does your business spend and which staff are required (please give an indication of hours by level of seniority) in order to comply with the Reporting on Payment Practices and Performance Regulations 2017?

FIS cannot answer this question directly, but can attest to providing significant support to members through our QS and Legal Helplines, with payment being the number one reason for referral.

Question 9: What does this cost your business in terms of pay for each level of seniority?

See above

Question 10: What (if any) additional costs did your business incur (beyond staff pay) in complying with the Reporting on Payment Practices and Performance Regulations 2017?

See above