Title: **Transforming Payment Processes in UK Construction: Enhancing Efficiency and Reducing Stress on Unsecured Sub-Contractors**

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## Introduction

The UK construction industry is a cornerstone of the nation's economy, contributing significantly to GDP and providing employment opportunities for millions of people …

… the construction sector is one of the largest in the UK economy – according to reliable data employing around 3.1 million people or over 9% of the workforce and relies on a labour intensive business model, which is becoming unsustainable due to the impact of demographic change. Of the current UK construction workforce, 32% are aged over 50, with a further 58% aged between 25 and 49. Only 10% are under 25.

The sector faces the twin challenge of equipping workers with the skills needed to adopt digital and manufacturing technologies effectively, while recruiting and retaining enough people with traditional skills to replace those leaving.  The pace of change in the technology, infrastructure and banking sector also impacts heavily on the construction industry where, in simple terms, the whole supply chain links are predominantly based around payment relationships and some form of banking.

## More than a decade of challenging times

Despite its economic importance, the sector grapples with persistent challenges, particularly in payment processes and supply chain difficulties. Unsecured sub-contractors are often the most vulnerable in this ecosystem, experiencing delayed payments and financial stress. In this article, I will delve deep into the current payment processes and procedures in the UK construction industry, examine the existing supply chain difficulties, and propose some thoughts of comprehensive solutions.

I will focus on one area: the implementation of escrow-type project accounts because escrow embodies important wider factors with the introduction of independent certification and sign-off processes, and I will analyse their pros and cons in some detail.  An 'escrow' is a legal arrangement in which a third party temporarily holds money or property until a particular condition has been met

When I refer to 'wider factors' I mean the same processes of 'independence and sign-off' can be applied to much of the construction sector including quality too, but that is for another article beyond the scope of this article which focuses on finance.

In 2013 the UK Government Department for Business Innovation & Skills [BEIS] published its Research Paper 118 '*Trade Credit in the UK: An Empirical Analysis of Construction Contractor Financial Positioning and Performance*' within which particular questions were addressed with particular emphasis on:

• How do companies in the construction sector finance their work? What is the balance between assets, bank borrowing and trade credit? How important is the role of trade credit for construction companies?

• How do finance structures within the construction sector compare to those of the economy as a whole? Do construction companies make more use of trade credit than other sectors?

• How does the way construction companies fund themselves differ between main contractors and subcontractors? How does this vary by firm size?

• What implications do these findings have for companies in the construction sector?

• Since the financial and banking crisis, has the structure of construction industry finance significantly altered?

Although a decade has now passed since that earlier BEIS research was conducted, I believe the current situation has worsened to a point where much uncertainty exists regarding financial resourcing ─ that earlier research looked at finance structures in the construction sector comparing those of the economy as a whole ─ and finding construction firms relatively undercapitalised, compared with firms across the rest of the UK economy. That is, the weighted mean shares of their combined balance sheets contributed by both capital employed (45%) and equity (25%) are much lower than in the rest of the economy (60% and 34% respectively). This is most especially the case for Tier 1 contractors (capital 41% and equity 22%) and for large contractors (capital 41% and equity 24%).

It is worth noting the BEIS study did not investigate 'micro' firms, and had only limited information on firms below the size at which they are required to file full accounts at Companies House. The construction sector comprises the micro and small firms that are prolific and in aggregate account for a substantial proportion of output. The BEIS findings refer specifically and only to construction contractors.

I believe that the 2023++ landscape perhaps paints an even bleaker picture. Much of the 'friendly face' of banking on the high street has all but gone. The loss of so many local bank high street branch offices often where Tier 2s, SMEs, and micro subcontractors would go to find supportive human knowledgeable managers and staff team on counters to help has all but evaporated to online impersonal apps and AI bots!

The 2013 research found the key difference in the structure of financing of assets in construction is the higher proportion of trade creditors and accruals compared to the rest of the economy; between two and three times as much depending on the measure used ─ I guess reasonably from accounts publicly available at Companies House records that the situation has worsened considerably in 2023++.

Greater use of trade credit allows each £ of capital employed by construction firms to support firstly a larger value of total assets and secondly to support a larger value of output or sales (£3.7 compared with £1.5 in the economy as a whole).

**Building Safety Act 2022**

Although this article predominantly focuses on finance, it cannot be taken in isolation to the massive cultural shift in the context of safety within the industry post the Grenfell tragedy that led to the enactment of the Building Safety Act 2022. There is a direct correlation between the provision of adequate and appropriate measures for safe working paid for by the financial resources made available and maintained at all times throughout the project.

As the UK construction sector transitions into the new safety era of digital records and golden thread of information so too for finance and trading. However, a survey reveals around 40% of the workers in the construction sector aren't able to do the minimum of at least one task in each of the five work essential digital skills – clearly these are serious issues the sector must address.

**Payment Processes and Supply Chain Challenges: An In-Depth Analysis**

To comprehend the magnitude of the challenges faced by the UK construction industry, first understand the intricacies of payment processes and supply chain difficulties. There are a plethora of standard contract forms relating to a multitude of different procurement routes. Discussion as to the merits of the various procurement routes and models is beyond the scope of this article but readers are expected to have at least some broad idea of the commercial contract in terms of offer, acceptance, and consideration onto which all manner of terms, conditions, rules, riders are put and all need to be looked at with due diligence by the contracting parties. Which eventual route is determined and set by the commissioning client prior to contractor selection and certainly every contractor and subcontractor will have no say but must use whatever form and procurement model for the intended project and, from which they will need to be competent to operate to carve their business profitability.

**Delayed Payments: A Looming Crisis**

One of the most pressing issues in the industry is the epidemic of delayed payments and 2022 through to 2023 has seen a huge increase in the volume of disputes moving into arbitration and the courts. While this issue affects all tiers of contractors, it has an especially devastating impact on subcontractors of which group many are SMEs [small medium enterprise]; micro businesses or even individuals. Typically, subcontractors submit invoices to the main contractors, who are responsible for payment. However, the reality is that subcontractors often are made to wait for months, and sometimes even years, to receive all their dues. Many just simply do not have reserves to pay for legal representation to take their disputed payment claims and late payments into the courts for determination.

The main contractors broadly argue they have to originally tender against competition to originally win the projects, during which process often fierce undercutting will drive the bid pricing to unrealistically low levels. None outside of the closed boardroom will know for certain exactly what went on during the pre-bid pricing stage behind closed doors and the eventual strategy the main contractor will hope to adopt and impose upon the downstream subcontracting supply chain to bring up the profit margins. The often ill-defined and ill-understood expression 'Value Engineering' increasingly raises its presence and has become a badly used tool to benefit only the main contractor to increase profit at the detriment of quality and fair reward to the subcontractors too.

The domino effect of delayed payments is profound. Subcontractors, already predominantly operating on tight margins, struggle to cover their operational costs. As a result, they might resort to expensive short-term financing or, in some cases, even bankruptcy. The uncertainty of when payments will arrive - the ‘cash flow’ of the business - creates an atmosphere of financial instability that stifles business growth and innovation.

**Unpredictable Cash Flow: The Silent Killer**

Beyond the immediate financial stress, unpredictable cash flow poses a silent but equally destructive threat to subcontractors. In an industry where planning is paramount, erratic payment timelines make it exceedingly difficult for subcontractors to manage their finances effectively. Project delays, unforeseen expenses, and unreliable cash flow can push subcontractors into a perpetual cycle of financial instability, hampering their ability to invest in their businesses and workforce.

Cash flow is the essential life blood of the industry.  Any construction company consistently operating at close to break-even or at a loss risks that it might eventually fail, but one consistently suffering from irregular and negative cash flow is highly likely to fail.  Liquidity and cash flow problems can, and do take down even the most profitable of construction companies.  In recent times we have seen some spectacular failures in the construction sector reported in the media with unsecured creditors suffering great losses and hardship reverberating all down the supply chain

**Supply Chain Disruptions: A Vicious Cycle**

Payment delays have far-reaching consequences, particularly in terms of supply chain disruptions. These disruptions, such as material shortages and project delays, have become a pervasive issue in the UK construction industry. With subcontractors struggling to secure timely payments, they often find themselves unable to pay suppliers promptly. This can lead to strained relationships and disruptions in the flow of materials, further exacerbating project delays and increasing costs.

**The Result: Unsecured Subcontractors on the Brink**

While all subcontractors face challenges, unsecured subcontractors are particularly vulnerable. They often lack the financial resources to withstand extended payment delays. For them, every delayed payment carries the threat of insolvency, pushing their businesses to the brink.

**Proposed Solutions: A Comprehensive Examination**

Addressing these complex challenges requires multifaceted solutions. Let's undertake a comprehensive examination of the proposed solutions ─ escrow-type project accounts and independent certification and sign-off processes ─ and delve into the intricacies of their implementation.

**Escrow-Type Project Accounts: Nurturing Trust and Timeliness**

Escrow-type project accounts do offer a compelling solution to the issue of delayed payments. This approach involves the establishment of dedicated accounts held in trust by reputable third parties. Funds for the project are deposited into these accounts, and payments are released based on specific milestones and certifications.

*Pros:*

1. **Timely Payments Assured**: Escrow accounts guarantee that payments are made promptly as stipulated in the project contract. This not only ensures subcontractors receive their dues on time but also stabilises their cash flow.
2. **Transparency and Accountability**: The use of escrow accounts enhances transparency in financial transactions. All stakeholders, including subcontractors, main contractors, and project owners, can track the flow of funds, reducing the risk of disputes and enhancing accountability.
3. **Risk Mitigation**: Subcontractors have greater assurance that their payments are secure, reducing the risk of financial instability or insolvency. This security fosters a healthier business environment.
4. **Supply Chain Harmony**: Timely payments through escrow accounts can help maintain a more efficient supply chain. The reduced risk of material shortages and project delays benefits the entire industry.

*Cons:*

1. **Administrative Costs**: Establishing and maintaining escrow accounts may entail some administrative costs, which could be viewed as an additional expense for construction projects. However, the long-term benefits may outweigh these costs.
2. **Initial Complexity**: Implementing escrow accounts requires a significant shift in industry practices and may initially present challenges in terms of education and adoption.

**Independent Certification and Sign-Off: Elevating Quality and Accountability**

Another promising solution is the use of independent professionals to monitor project quality and progress according to specifications before certifying and signing off on payments. I would suggest the reintroduction of a Clerk of Works should be the norm on most projects. I

*Pros:*

1. **Quality Assurance**: Independent certification ensures that work meets specified quality standards, significantly reducing the risk of defects and the need for costly rework. This enhances the overall quality of construction projects.
2. **Payment Validation**: Payments are closely tied to project milestones and quality metrics. This alignment can serve as a powerful incentive for subcontractors to consistently meet project requirements and deadlines.
3. **Dispute Resolution**: Independent professionals can expedite dispute resolution by objectively assessing work quality and progress. Their impartiality fosters trust among stakeholders and promotes fair resolutions.
4. **Trust-Building**: Stakeholders can have greater confidence in the fairness of payment processes when independent professionals oversee them. This trust can lead to stronger relationships within the industry.

*Cons:*

1. **Additional Costs**: Employing independent professionals for certification and sign-off may introduce additional costs to construction projects. However, these costs may be outweighed by the long-term benefits in terms of quality and dispute avoidance.
2. **Potential Delays**: The certification process may introduce some delays, potentially impacting project timelines. However, these delays can be mitigated with efficient planning and coordination.
3. **Standardisation Challenges**: Implementing independent certification and sign-off processes would require standardised procedures and potentially training for professionals involved, which could be seen as a barrier to entry.

**The Path Forward: Collaboration and Innovation**

The proposed solutions offer a promising path forward for the UK construction industry, but their successful implementation requires a collaborative effort among industry stakeholders, including contractors, subcontractors, and regulatory bodies. Achieving meaningful change in the industry will involve navigating several key considerations.

**1. Regulatory Framework**: Crafting a regulatory framework that encourages the adoption of escrow-type project accounts and independent certification processes is paramount. Government bodies and industry associations should work together to develop and enforce standards that ensure fairness and transparency.

**2. Industry-Wide Education**: The transition to new payment processes will require comprehensive education and training. Contractors, subcontractors, and professionals must be well-versed in the nuances of these systems to ensure smooth adoption.

**3. Trust in Third Parties**: Trust is the foundation of escrow accounts. Identifying reputable third parties to manage these accounts is critical. These organisations should adhere to strict ethical standards and undergo regular audits to maintain trust.

**4. Collaboration Culture**: Fostering a culture of collaboration within the industry is essential. All parties involved must understand that timely payments, quality assurance, and dispute resolution benefit everyone in the long run.

**5. Technological Integration**: Technology can play a pivotal role in streamlining payment processes and ensuring transparency. The integration of digital tools and platforms can simplify the administration of escrow accounts and certification processes.

**6. Case Studies and Pilot Programs**: To build confidence in the proposed solutions, the industry could initiate pilot programs and showcase successful case studies. This real-world evidence can encourage broader adoption.

**7. Incentives for Compliance**: Providing incentives for contractors to adhere to the new payment processes, such as tax incentives or project funding advantages, can encourage compliance.

**8. Continuous Improvement**: The construction industry should commit to ongoing assessment and improvement of these payment processes. Periodic reviews and adjustments can help address any unforeseen challenges.

**Conclusion: My Vision for a Resilient and Flourishing Industry**

Transforming payment processes in the UK construction industry is not just about alleviating financial stress for subcontractors; it's about creating an environment where fairness, transparency, and efficiency prevail ─ I believe all should know and work to the Nolan Principles, where a first report in 1995 established an initial version of The Seven Principles of Public Life, also known as the Nolan Principles after the committee's first chairman. The principles were Selflessness, Integrity, Objectivity, Accountability, Openness, Honesty and Leadership

By working collaboratively and embracing innovative solutions, I believe the industry can aspire to a future where timely and equitable payments are the norm, ensuring greater stability and growth for all involved, and a safer, more resilient and sustainable industry will evolve over time.

I do appreciate the challenges ahead are formidable, but so is the potential for positive change. As we navigate the complexities of implementing escrow-type project accounts and independent certification processes, we must remain steadfast in our commitment to building a resilient and flourishing construction industry that benefits the entire UK economy. Together, we can lay the foundation for a brighter future in construction ─ one that prioritises fairness, quality, progress and embodies trust.