Submission to

Ministry of Business Innovation and Employment

on

Retentions in construction contracts

INTRODUCTION

This submission is provided by Civil Contractors New Zealand in response to Ministry of Business Innovation and Employment on **Retentions in construction contracts**

ABOUT THE SUBMITTER

Civil Contractors New Zealand, an incorporated society, is the national industry body comprising the full spectrum of road construction, road maintenance, civil and general contractors. Civil Contractors New Zealand was previously the New Zealand Contractors' Federation (NZCF) representing the full spectrum of contractors as above since 1944 and Roading New Zealand (RNZ), representing road maintenance, surfacing and civil contractors who build and maintain New Zealand's transport infrastructure since 1988.

Civil Contractors New Zealand continues the work of both NZCF and RNZ represents contractors who carry out the country's civil infrastructure construction and maintenance work. CCNZ estimates that the civil construction sector carries out more than $12 billion of work annually and employs in excess of 60,000 workers.

Question 1 *Should there be a minimum amount of retention money to which the trust obligation applies, and if so, how much? Currently there is no minimum, and the trust obligation will apply to all retention money. This current approach is consistent with the aim of protecting retention money withheld from small subcontracting businesses.*

This question can only be answered with any surety when the accounting requirements are known.

If the cost of complying with the accounting requirements is high, then the threshold must be set at a correspondingly high level.

If the accounting requirements can be easily complied with, and with virtually no cost to the payer, then the threshold amount could be set lower, however we strongly suggest a higher de-minimis amount is used.

Any threshold amount must be in proportion with the likely cost to the payer of establishing accounting arrangements and administering its obligation. Any threshold amount should relate either to the total amount of retention money withheld by a payer from any payee on all contracts, or to the amount of retentions held in respect of any one contract. The imposition of a threshold in either case will substantially increase the complexity and cost of establishing accounting procedures as some retention money will be subject to the regime while others will not.

In our submission on the Regulatory Impact Statement (March 2015) we recommended that the Chartered Accountants Australia and New Zealand be asked to give an opinion on the likely impact of

the proposed trust funds on the presentation of accounts under Generally Accepted Accounting Practice. This would have flow on effects into handling covenants by the banks and lenders.

In the Regulatory Impact Statement in 'Effect of Option 1', it states "However, the payees most affected by the insolvency of Owners are head-contractors who are not the target group for the problem in this Regulatory Impact Statement ..." That this issue, at the start of the chain, is not dealt with is unfortunate as it is the prime cause of the losses that this regulation attempts to address.

The mishandling of retentions trust monies will be deemed a criminal offence. It would be appropriate to apply this same standard of offence to Directors, who as principals, trade insolvently and cause losses through the entire contracting industry chain.

Question 2 *What (if any) methods of accounting should be included in regulations to describe 'liquid assets'?*

There has been a considerable amount of debate as to whether or not certain types of assets are liquid assets, and in the absence of any clear definition the debate is futile. The problem with storing retention money in liquid assets is that certain assets that would ordinarily be realisable may not be when a company fails. For example, when a head contractor fails and defaults on a contract in progress, payments ordinarily receivable are likely to be withheld by payers who will apply the money to completing the head contractor's obligations under its defaulted contract.

Some types of liquid assets would be readily realisable in the event of a payer's failure, whereas others may not. Therefore rather than seeking to define what is and what is not a liquid asset the objective should be:

a) to define a range of accounting treatments or vehicles that may be legitimately treated as liquid assets; and

b) to require the payer to declare the form or forms of liquid asset in which the retention money is withheld

Question 3 *What (if any) methods of accounting should be included in regulations to cater for situations where retention money is mixed with other money?*

Currently, payers can use any method of accounting that complies with the Act. Regulations could potentially describe some methods of accounting that are consistent with the Act. However, payers would not necessarily be limited to using the methods of accounting described in regulations.

GENERAL

Many construction companies, will not be in a position to put sufficient funds aside to meet the requirements of the legislation. As a result, we expect that there may be company failures within the first year that the new legislation becomes fully effective. There must be a transition phase which could be achieved by amending the Act to provide that the regime applies only to contracts entered into from 31 March 2017.

Reasons are:

1. As the Act stands it merely adds cost to the payer for nil benefit to payees.
2. It would be easier and much less costly to establish the accounting processes and procedures to apply progressively as new contracts come on stream, than to restructure accounts in respect of past transactions with no apparent benefits.
3. It would achieve a change in industry behaviours going forward, but would not remedy the past.
4. Payers who elect not to use retentions in the future will not have to do anything - they will not incur any cost. This may result in a move away from the use of retentions which are a 'crude stick' when it comes to assuring defect-free construction work.

5. The ‘drop dead’ imposition of the regime on 31 March 2017 is likely to have a devastating impact on the balance sheets of certain companies, causing avoidable failures and industry losses far greater than the retention money that the regime is designed to protect.
6. A progressive implementation can be factored into tender pricing, and would have a gradual impact, allowing industry to move away from any reliance on retentions.
7. It will not fix the past, but it will change the future – when the ‘bad’ pre-regime retentions have eventually been worked out of the system the industry may have confidence that all retention money is being held responsibly and is properly accounted for.

Principals (with government agencies being the most predominant), will need to each hold the full value of retentions in a deemed trust. For each party we conservatively estimate this at 3% of the value of work in progress in any one year. With the annual value of non-residential construction work in NZ at $17b this amounts to approximately $500m being held in deemed trusts by principals, $500m being held by main contractors and an unknown amount held by subcontractors. This means that in excess of $1b of funds/assets will be tied up in deemed trusts driving up costs and reducing construction sector capacity.

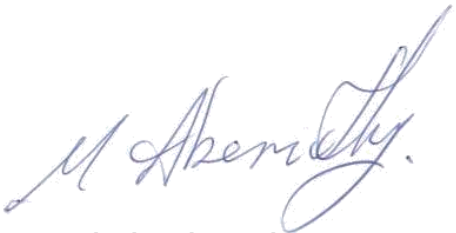
We reiterate that it is our view that Government undertake detailed financial modelling by an accounting firm with extensive experience in construction contracts. The model would need to include all relationships in the chain from principal to main contractor and flowing through the various layers of subcontractors and suppliers.

The modelling should include:

1) technical accounting,
2) quantified risks,
3) commercial impact, and
4) scenario analysis under failure

It is essential that the form of controls which end up in place do not make the sector weaker. With modelling complete, it should be an easy step to implement changes to the legislation that would enable the intent to be satisfied without damage to the industry participants.

Thank you for the opportunity to provide comment. We trust the content of our submission is helpful and look forward to discussions and assisting with the further development of any regulation of the retentions regime.



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