

LATE AND NON-PAYMENT ISSUES IN THE MALAYSIAN CONSTRUCTION INDUSTRY – CONTRACTORS’ PERSPECTIVE

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ABSTRACT

To eliminate poor payment practices and to assist continuous uninterrupted construction, some countries have drawn up construction-specific statutory payment security acts/legislations. This paper presents findings of a research conducted amongst Malaysian contractors with the aims to identify the main factors, effects and reactions to late and non-payment issues, and to identify ways to sustain the payment flows in the Malaysian construction industry. The research focused on contractual payments from the employer (government or private) to the contractors. The main factors for late and non-payment in the construction industry identified from the study include: delay in certification, paymaster's poor financial management, local culture/attitude, paymaster's failure to implement good governance in business, underpayment of certified amounts by the paymaster and the use of ‘pay when paid’ clauses in contracts. The research findings show that late and non-payment can create cash flow problems, stress and financial hardship on the contractors and that some reactions to late and non-payment adopted by the contractors may have adverse effects on their own businesses. Amongst the most appropriate solutions to overcome the problem of late and non-payment faced by local contractors include: a right to regular periodic payment, a right to a defined time frame for payment and a right to a speedy dispute resolution mechanism.

Keywords: construction, contractors, late and non-payment, payments act

1. INTRODUCTION

Malaysia has set its vision to be a fully developed nation by 2020. During the President’s & CEO’s Roundtable Discussion (2004), the construction industry has set its own vision to be ‘among the best in the world’ by 2015 and to achieve this vision, the issues of payment has been identified as one of the priority areas in the construction industry. The practice of efficient and timely payment in construction projects is a major factor that can contribute to a project’s success. A smooth cash flow brings an effective delivery, on time and within budget so that projects can be completed within the planned time and with acceptance of quality (CIOB, 2004). Payment issues in the construction industry are considered a factor of significant concern to all the players in the industry. A survey of the payment performance has shown that construction industry, in particular, is prone to late-payment culture (Johnston, 1999).

Late and non-payment will cause severe cash flow problems especially to contractors. In view of such problems, Ameer Ali (2005) urges 'everyone in the construction industry pays all appropriate amounts due in a timely manner.' Abdul-Rahman and Berawi (2002) found that top management of construction companies in Malaysia confirmed that financial problem is the main cause of delay in addition to manpower shortage.

It was reported that about 16,000 of the Grade G1* contractors were on the brink of bankruptcy when several umbrella contractors failed to pay them for rural roads they had built, despite the government having paid the umbrella contractors in full (Suhaini, 2005). The failure to pay can be attributed to an attitudinal problem which, if commonly accepted by the industry or society in general, can become a culture of a particular industry. Elsewhere, Nicholas (2005) mentioned of a stern warning from a credit manager indicating that small companies faced the greatest risks from the late payment culture in the United Kingdom. The same report pointed out that 1.6% of income was lost because of late payment and that the average payment time in the United Kingdom was about 17.4 days late.

According to Murdoch and Hughes (1996), 'it is not uncommon to find that a contractor or sub-contractor who has not been paid what is due threatens to suspend work under the contract until payment is made'. It must however be noted that without a clear contractual right to suspend the works, the contractor is not entitled to do so even though the employer has failed to pay him within the time stipulated in the contract. In this respect, if the contractor suspends the work the courts may find him guilty of repudiating the contract.

According to Kennedy (2005) 'payment, not unexpectedly, has always been the main subject of disputes'. It has to be noted that the construction payment blues have domino effects on the payment chain of a construction project (Davis Langdon & Seah Consultancy, 2003). For instance, the late payment due to the contractor by the employer will also delay the payment due to the sub-contractor or suppliers who are bound in contract with him. Due to these circumstances, late and non-payment can possibly lead to a formal dispute resolution. According to Bob (2005), in order to recover payment for over the past few years 'the claimant was forced to commence arbitration or litigation' and 'those processes are very costly and take a long time.'

Due to late and non-payment problems, some countries like United Kingdom, Singapore, New Zealand and some states in Australia, e.g. New South Wales, have already legislated their construction specific statutory payment security regime. These legislations purposely enact provisions to address issues on prompt payment in the construction industry to eliminate poor payment practices and smoothen the contractor's cash flow (Lip, 2005; Ameer Ali, 2005).

Acts and the respective countries and states, which enacted them to address the problem of late and non-payment, are listed as follows:

- Housing Grants, Construction and Regeneration Act 1996 – United Kingdom

* Contractors under the Construction Industry Development Board of Malaysia categorization who are eligible for tendering projects not exceeding RM100,000.00.

- Building and Construction Industry Security of Payment Act 1999 (NSW) - New South Wales, Australia
- Building and Construction Industry Security of Payment Act 2002 (VIC) - Victoria, Australia
- Building and Construction Industry Payments Act 2004 (QLD) - Queensland, Australia
- Construction Contracts Act 2002 - New Zealand
- Building and Construction Security of Payments Act 2004 - Singapore

Due to the lack of research on the issues of late and non-payment in the Malaysian construction industry, a study was conducted to identify the problems and effects of late and non-payments in the construction industry. The research was conducted in a timely manner when the local Construction Industry and Development Board was also seeking pointers on payment issues. This paper presents results of a study on late and non-payment issues facing the Malaysian contractors. Another portion of the study, that describes the same issue facing consultants, is presented elsewhere (CIDB, 2006)

2. OBJECTIVES OF RESEARCH

The main purpose of the study is to identify current problems in relation to late and non-payment issues encountered by contractors in the Malaysian construction industry. It also looked into the effects of late and non-payment with the aims to identify the possible solutions to resolve the issues of late and non-payment, which could effectively create “a win-win situation” for all the parties involved. Common methods or responses adopted by the parties in dealing with these issues will be identified to illustrate the effects they have on the parties. The findings of this study is useful for the introduction of a legislation called the Construction Payments Act or Security of Building Payment Act as already found in many advanced countries.

3. RESEARCH METHODOLOGY

The principal method used for the study was the use of a questionnaire survey. The survey was conducted to coincide with the Construction Industry Development Board’s plan to incorporate the survey’s outcomes in the Cabinet Paper which includes the Construction Industry Payment and Adjudication Bill 2006 which is targeted for submission to the Ministry of Works of Malaysia in March 2006. Considering the fact that a short time period was given, pilot study and interview sessions were not conducted for the purpose of data collection and the only method seems viable were the literature survey that leads and the questionnaire survey. The questionnaire was designed according to the objectives of research by reviewing literature dealing with late and non-payments and other relevant topics. It has been designed to be brief, concise and straightforward to encourage a high response rate from the potential respondents. The respondents just have to contribute their views and opinions by selecting the appropriate answer or giving short answers to the questions. The sources of literature review include relevant case law, books, journals, magazines, dissertations and seminar proceedings, as well as materials published by the Construction Industry Development Board (CIDB), the Malaysian Institute of

Architects (PAM), the Institution of Surveyors (ISM) and the Public Works Department (JKR).

The review of literature has provided useful information on the causes, effects, reactions and possible solutions related to the issues of late and non-payment in the global construction industries.

Target Respondents

A questionnaire survey was conducted on the contractors. The criteria for the selection of respondents were established and 6,000 active contractors from Grade G1 through G7 were randomly selected using the Construction Industry Development Board of Malaysia database. Of the 6000 fielded questionnaires, 333 replies were received, which represents a response rate of around 5.6%. The low response rate may have been contributed to the short response period given to respondents or simply because the prospective respondents were not interested in providing feedbacks.

Questionnaire Structure

The questions in the questionnaire were set to three types of answering methods, namely: rating-based, selective-based and open-based formats. For the rating-based questions, the statements were devised to measure the respondents' opinions by registering them on a four-point scale ranging from "never to very frequent" and "not serious to very serious." The selective-based questions only required respondents to tick the appropriate box or boxes in the questionnaire. The open-ended questions allowed respondents to record down their answers to the questions. Findings of the survey were analyzed to provide a better understanding of the issues of late and non-payment in the Malaysian construction industry. The Statistical Package for the Social Sciences (SPSS) was used to handle the statistical calculations.

4. THE SURVEY RESULTS

The findings of this survey are categorized into two main types of problems associated with late and non-payments in government and private funded projects. Analysis of the completed and returned questionnaire shows that 62.8% (147) of the contractors reported that they have experienced late payment situation in government funded projects whilst 65.4% (178) of the respondents affirmed the same situation in private funded projects. With regard to non-payment, about 24.1% (48) and 44.8% (111) of the respondents pointed out that they have not been paid for the works executed involving government and private clients, respectively since January 2000. Other findings from the questionnaire survey are presented under appropriate headings as follow.

Causes of Late and Non-Payment

Based on Figure 1, some general observations may be made. For the purposes of these observations five most frequent causes of late payment were "*Delay in certification,*" "*Paymaster's poor financial management,*" "*Local culture/attitude,*" "*Paymaster's failure to implement good governance in business*" and "*Underpayment of certified amounts by the paymaster*" with their overall means of 1.826, 1.734, 1.63 and 1.565, respectively. Figure 2, shows the responses on the question about the causes of non-payment. Based on Figure 2, five most frequent causes of non-payment were

“Paymaster’s poor financial management,” “Paymaster’s failure to implement good governance in business,” “Delay in certification,” “The use of ‘pay when paid’ clauses in contracts” and “Local culture/attitude” with their overall means of 1.896, 1.848, 1.768, 1.672 and 1.632, respectively. In the questionnaire, the score of three (3) represents the largest scale and zero (0) represents the least.

Respondents have specified additional causes of late/non-payment in addition to the ones listed in the questionnaire which include corrupt practice among consultants, pending on VO approval, money used up for other purpose, paymaster's ill intention of not paying when works are completed, consultant's working culture/attitude, main contractor lack of professionalism and economic slow down.

Effects of Late and Non-Payment

Respondents were also asked to rate the effects of late payment based on the extensive list given. A further analysis of the effects of late payment revealed that, three most grave effects of late payment based on Figure 3 were *“Create cash flow problems,” “Create stress on contractors” and “Creates financial hardship”* with their overall means of 2.377, 2.185 and 2.135, respectively.

Meanwhile, the three most prevalent effects of non-payment based on Figure 4 were *“Create cash flow problems,” “Creates financial hardship” and “Create stress on contractors”* with their overall means as 2.546, 2.454 and 2.40, respectively.

Additional effects of late or non-payment specified by respondents include: create accounting problem & tax computation, poor perception of industry players, affect the overall growth of a company, suppliers’ require cash purchase/LC/bank guarantees - heavy cash flow for the main contractor to operate, bad image to the government, affect quality of end products and possibility of sabotage by sub-contractor’s workers who have not been paid as a result of the chain effect, and results in delay and LAD.

Reactions to Late and Non-Payment in Government-Funded Projects

Figure 5 illustrates that the three most preferred reactions by the respondents when experiencing a late payment situation with government paymasters were *“Plead with employer for payment even after due date,” “Ignore and follow up with another claim the following month” and “Slow down works”*, with overall means of 2.049, 1.648 and 1.337, respectively.

Figure 6 indicates that the three most common reactions to non-payment in government-funded projects are: *“Plead with employer for payment even after due date,” “Slow down works” and “Ignore and follow up with another claim the following month”* with their overall means of 2.197, 1.724 and 1.651, respectively.

Additional reactions specified by contractors who encountered late/non-payment problem in government-funded projects are: find other source of fund, reschedule work to help developer ease their cash flow, mutual discussions with employers, giving discount to employer, and employment of stricter controls due to lack of trust.

Reactions to Late and Non-Payment in Private Funded Projects

In this question, respondents were asked to identify prevalent reactions when they face a late payment situation involving private clients. Based on Figure 7, three most

frequent reactions in dealing with late payment problem in private funded projects are: *“Plead with employer for payment even after due date,” “Ignore and follow up with another claim the following month”* and *“Slow down works”*, with their overall means of 1.844, 1.688 and 1.068, respectively.

Figure 8 shows the responses to the question on how respondents’ would react when they encountered with non-payment situation in private funded projects. The results show that the three most prevalent reactions when dealing with non-payment scenario in private funded projects are to: *“Plead with employer for payment even after due date,” “Ignore and follow up with another claim the following month”* and *“Slow down works”*.

Possible Solutions for Late Payment or Non-Payment Issues

This question asked the respondents about the probable solutions to overcome the problem of late and non-payment faced by local contractors either main contractors or sub-contractors. The three most possible solutions to counteract the payment problems based on Figure 9 are *“A right to regular periodic payment,” “A right to a defined time frame for payment”* and *“A right to a speedy dispute resolution mechanism, for example, Adjudication,”* with their overall means of 3.72, 3.695 and 3.509, respectively. For this question, four is the largest scale and one is the least. Interestingly, the overall nine possible solutions in the questionnaire were all given a high score of importance as the least score was even as high as 3.147 as shown in Figure 9. Other solutions to late or non-payment situation provided by respondents are listed as follows: setting up of a commission to investigate errant paymasters, payment guarantee, restructuring work progress proportionate to payment’s entitlement, amending the existing PAM or JKR contract, strictly follow milestones for payment, formation of an appropriate body to look into contractors' payment woes, issuance of advanced payment for contracts with a value > 5 million Malaysian Ringgit, and suspension of irresponsible main contractors’ licenses with the CIDB.

5. CONCLUSIONS

Findings from the questionnaire survey indicate that more than 60% of the local contractors have experienced late problem may it be in government funded projects or private funded projects. As for non-payment, about 24.1% (48) and 44.8% (111) of the contractors reported that out that they have not been paid for the works executed involving government and private clients respectively, since January 2000.

The results of the study indicate that the most frequent causes of late and non-payment include: paymaster's poor financial management, paymaster's failure to implement good governance in business and local culture/attitude. The authors feel that it is necessary for employer’s financial capacity and credit rating be made transparent to facilitate contractors in choosing the right employers and to increase chances of the latter getting paid. As the respondents felt that local culture or attitude is one of the frequent causes of late and non-payment, it is recommended that contractors consider this problem as a major risk that has a high probability of occurrence and account for it when completing estimates for tender.

The survey results indicate that the three most serious effects of late and non-payment are “Create cash flow problems”, “Create stress on contractors” and “Creates financial hardship”. It is anticipated that late or non-payment most likely will cause undue financial stress on the contractors and this would have a devastating knock-on effect down the contractual payment chain.

The results of study also show that some reactions to late and non-payment taken by the contractors may have adverse effects on their own businesses. For instance, contractors may not be able to justify their claims if they purposely “Slow down works” due to late or non-payment problem as the contractors could be treated as repudiating the contract in the event if there is no such right available in the contract. Most of the respondent contractors agreed that a mechanism for avoiding or reducing this problem need to be taken in the form of contractual or statutory rights with the overall mean of 3.72. This study indicates that the three most possible solutions of payment problems are “a right to regular periodic payment”, “a right to a defined time frame for payment” and “a right to a speedy dispute resolution mechanism, for example, adjudication”. It is perhaps timely for Malaysia to consider introducing its own legislation on the Payment and Adjudication Act. Nevertheless, introduction of such an act cannot be regarded as a panacea for all ills, rather it must be regarded a means to an end. Professional bodies and government agencies should study and amend the existing standard forms of contract to provide protection and, promote balance allocation of risk and fair contract to all related parties. Promptness of submitting, processing, issuing interim payment certificates and honouring the certificates are extremely important issues in relation to progress payment claims. Perhaps, an increased sense of professionalism in construction industry could overcome some of the problems related to late and non-payment issues. Another crucial issue that needs to be addressed in why and how to change the sometimes lackadaisical attitude on payment issues in the construction industry.

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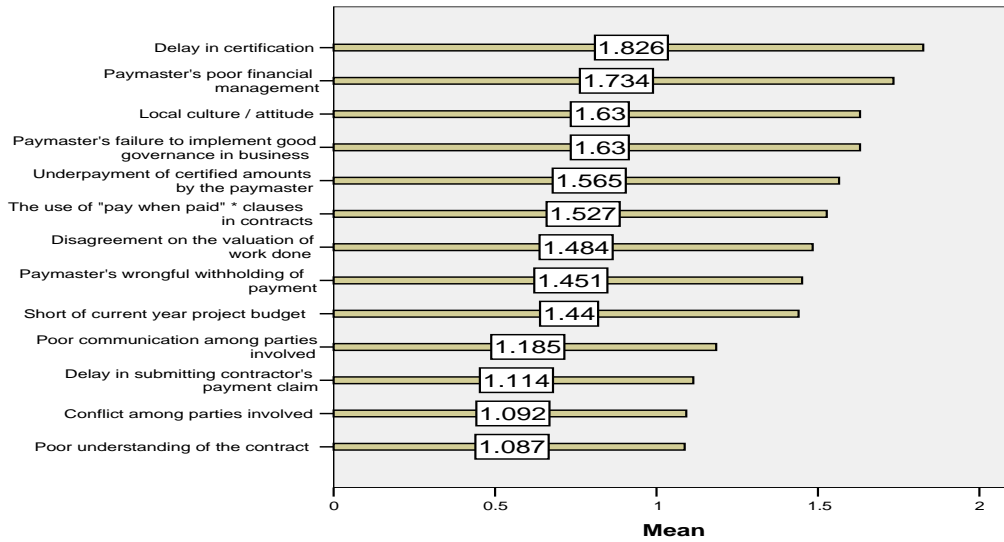


Figure 1: Causes of Late Payment for Contractors

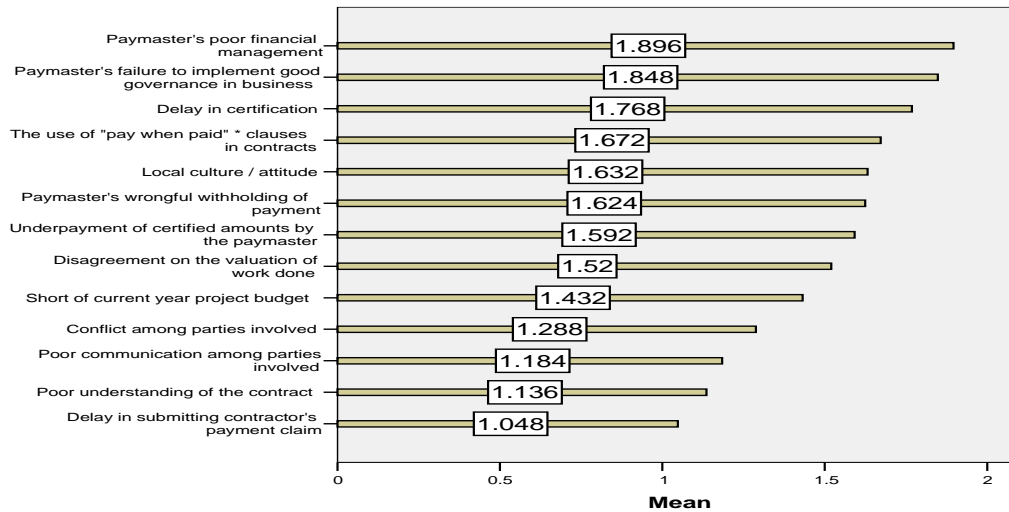


Figure 2: Causes of Non-Payment for Contractors

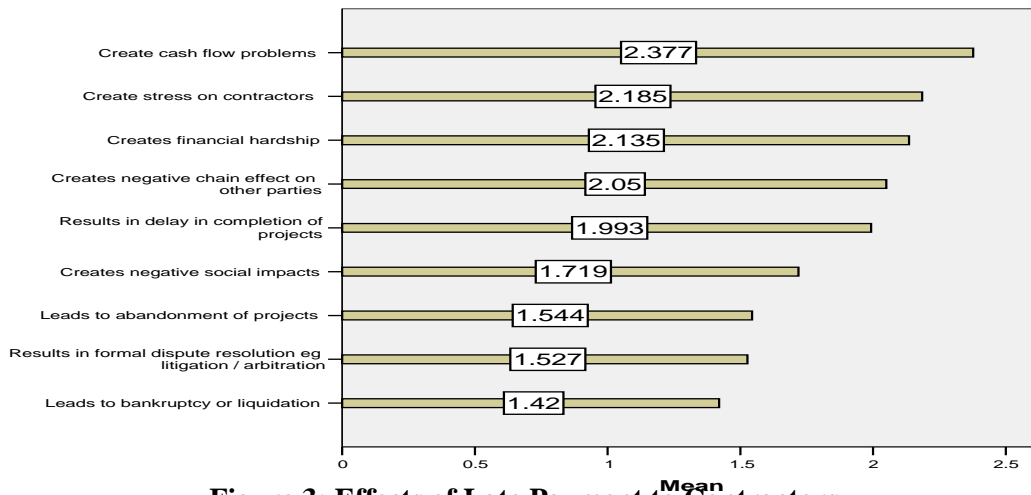


Figure 3: Effects of Late Payment to Contractors

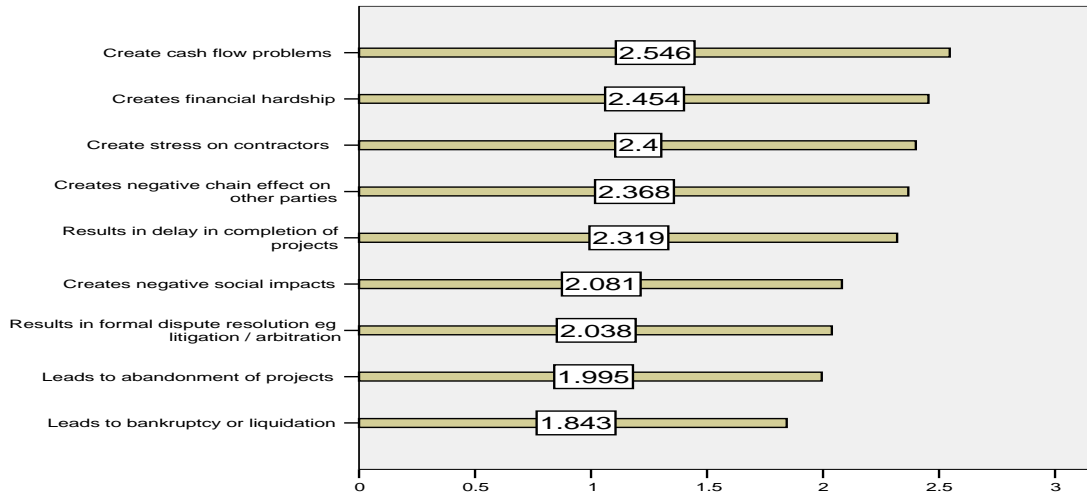


Figure 4: Effects of Non-Payment to Contractors

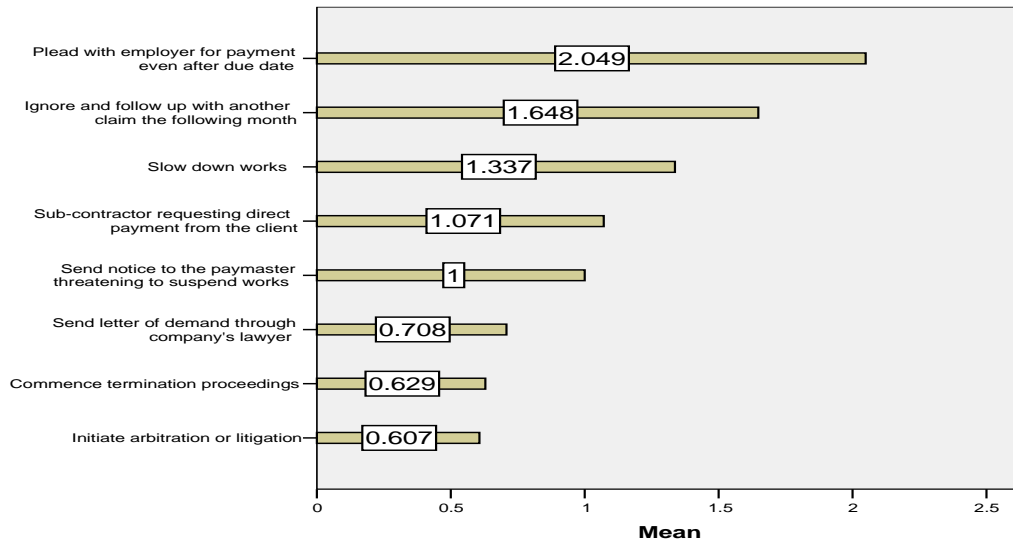


Figure 5: Contractors' Reactions to Late Payment in Government Funded Projects

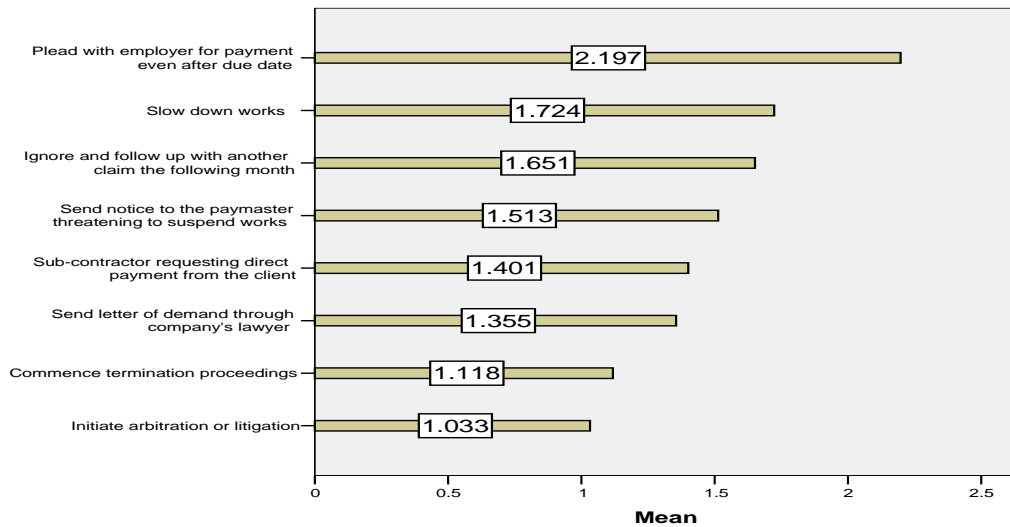


Figure 6: Contractors' Reactions to Non-Payment in Government Funded Projects

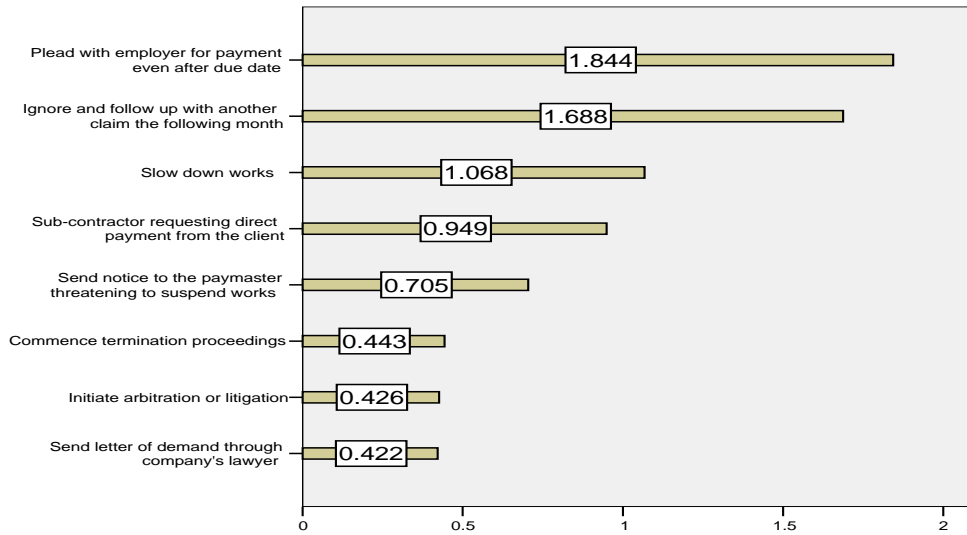


Figure 7: Contractors' Reactions to Late Payment in Private Funded Projects

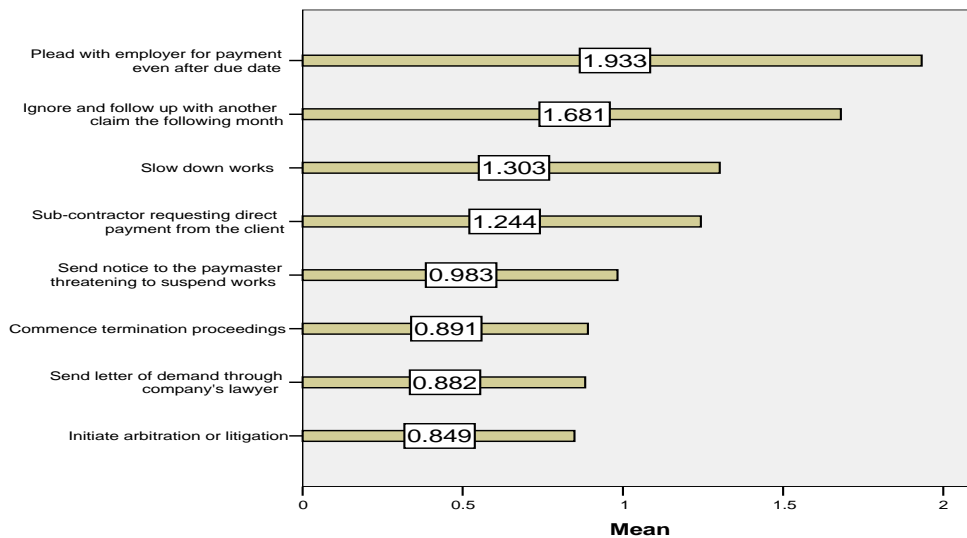


Figure 8: Contractors' Reactions to Non-Payment in Private Funded Projects

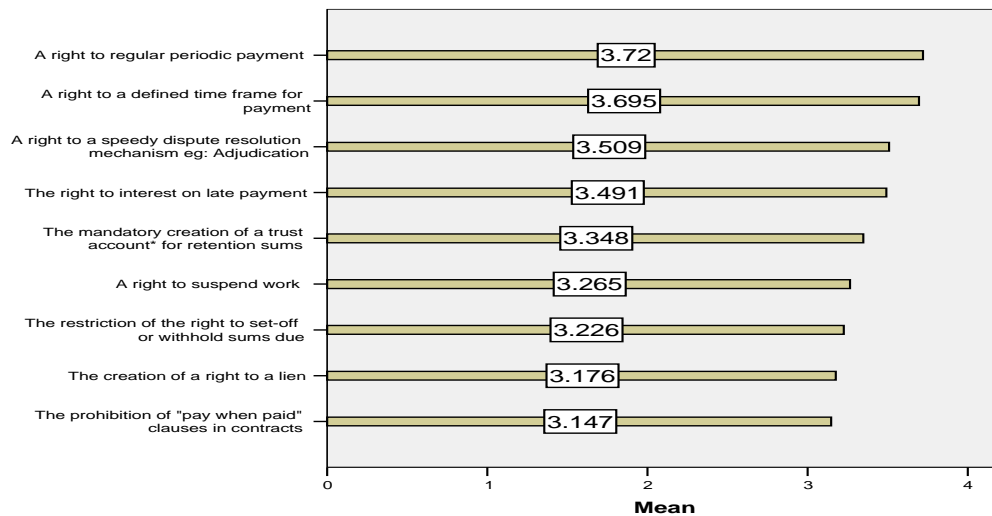


Figure 9: Possible Solutions According to Contractors