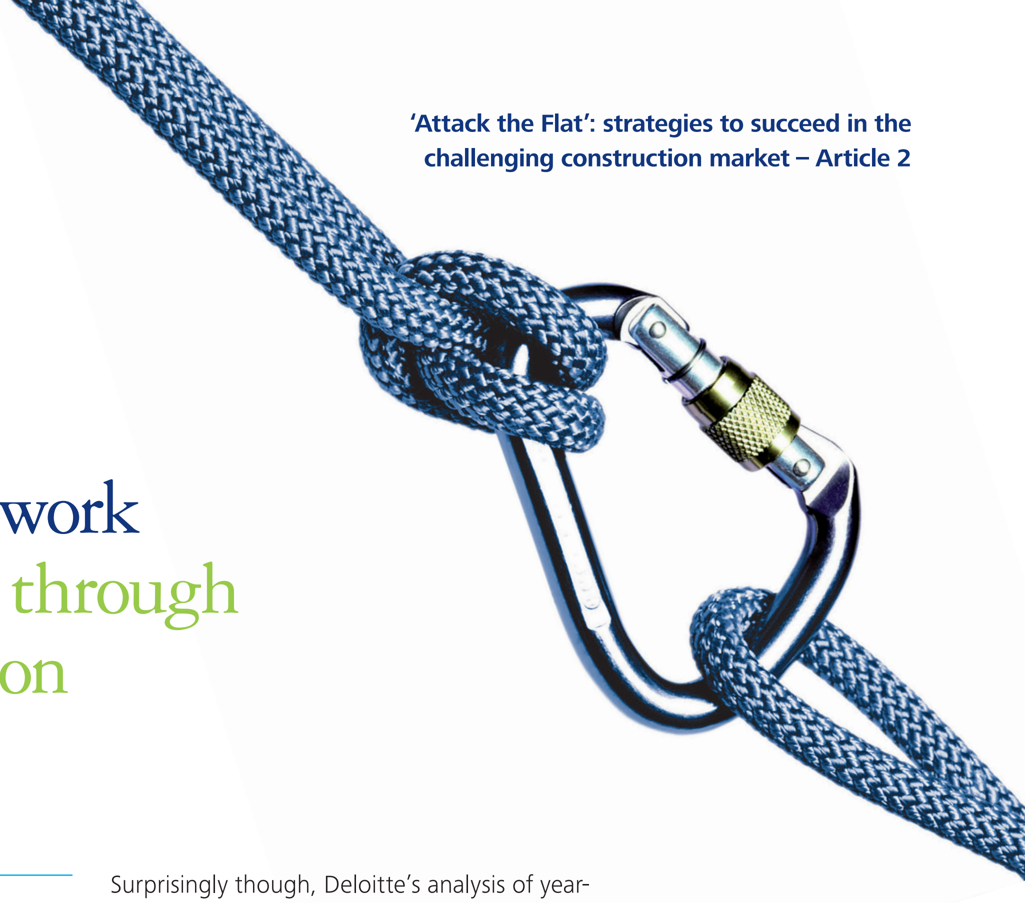
'Attack the Flat': strategies to succeed in the challenging construction market – Article 2



Making capital work
Unlocking cash through cross-collaboration

In today's challenging construction market, leading practice working capital management is vital. By breaking out of a 'Finance' mind set to energise the whole organisation, contractors can quickly unlock cash, strengthening not only their own resilience but also that of the broader supply chain.

Working capital management has never been so important for UK contractors. While contraction in the market is resulting in ever more fiercely contended bids, reducing advanced payments from customers and rising commodity prices are squeezing margins still further.

All members of the construction supply chain are looking to use their leverage and positioning to avoid playing the role of banker, and as banks and credit agencies seem to have lost their flexibility, firms have had to become more efficient.

Surprisingly though, Deloitte's analysis of year-end financial statements suggests there is still an opportunity for many UK contractors to improve their working capital, with one study identifying excess working capital of at least 20% across the sector.

Tackling working capital by delaying supplier and sub-contractor payments, and pressurising customers to pay faster is clearly not the answer. Although this may deliver a short-term fix, it risks damaging the underlying business and threatens the security of the supply chain, as sadly we have seen across the market in recent years.

So, how can contractors achieve fast yet sustainable improvements in working capital, whilst also supporting the supply chain as a whole?

In the second of Deloitte's 'Attack the Flat' series, we examine how to achieve the right level of working capital in this challenging market – understanding and managing what drives performance, and breaking out of a 'Finance' mind set to energise the whole organisation, and beyond.

What really drives working capital performance?

While senior management teams are left to sweat over working capital performance, the real drivers lie in the myriad of transactions that take place much lower down in the organisation:

- Work-in-progress drives accounts receivable performance – if work is not agreed with the client on a timely basis and then not invoiced, payment cannot be collected. Invoicing performance can be adversely impacted by delays in receiving certificates. It is important to agree and bill work in a timely manner for small as well as larger projects, as any build-up of work-in-progress will impair accounts receivables performance.

- Accounts receivable performance, including retention collections, is driven by factors across the contract-to-cash cycle, from the set-up of customer contracts to the allocation of cash receipts. For example, overdue accounts receivable can be driven by bills being raised prior to the necessary inspection and certification of work completed as per contractual agreements. In addition, we have also seen cash flow problems being driven by not following the processes and schedules of rates set out in framework agreements. Compliance is essential.

- Accounts payable performance is driven by factors across the purchase-to-pay cycle, from the placing of orders with suppliers to the payment of supplier invoices. For example, accounts payable under-performance can be driven by early payments being made to suppliers when invoices due between weekly payment runs are pulled into the earlier rather than the later payment run.

These points may sound elementary, but the challenge for the CFO is often how to address them without absorbing a disproportionate amount of senior management time. Having the right controls in place is vital, and by identifying weaknesses in the operational processes, initiatives can be developed to address specific working capital performance drivers across the organisation.

What does 'good' look like?

Drawing on experience with contractors across the UK and insights from comparable industries, Deloitte specialists have developed a model of what leading working capital practice looks like for building contractors, to help clients develop their own improvement strategies.

Assessment of an organisation's performance in this area covers many different facets, of course, but at the outset, key questions often include:

Accounts payable		Accounts receivable/work-in-progress	
Process stage	**Leading practice**	**Process stage**	**Leading practice**
Contractor procurement	Do you have a structured approach to assessing the financial standing of sub-contractors together with the payment terms required?	**Tender response**	Do your teams undertake a proactive assessment of customer terms around penalties, retentions, disputes and potential impact upon project cash flow?
Materials procurement	To what extent is your approach to setting supplier payment terms coordinated in line with the customer billing schedule and payment terms to optimise cash flow?	**Credit risk**	Do you undertake a finance-based assessment of the required security in relation to client, country and project specific risk?
Contractors & supplier contracts	Do you have a standard template in place and used to document all contractor/supplier contracts, including payment terms?	**Customer contracts**	Is a precise definition of standard payment terms and conditions in place by country/region, with authority levels to approve acceptance of tender-based variations?
Purchase orders/ instructions	Are system-generated purchase orders in place which include unique reference numbers, payment terms and clearly stated order requirements?	**Build & commission**	Is a structured procedure documented in the customer contract covering the request and approval of variation requests?
Invoice validation	How effective is your document management system in supporting invoice validation?	**Invoicing**	Do you have a clear policy and process for adjustments to billing schedules following design variations and rework?
Dispute management	Is an immediate payment hold applied to any sub-contractor or supplier payment where disputes have been surfaced?	**Dispute management**	Has a structured procedure been agreed with the client, QS team and sub-contractors for advising and resolving claims or deductions?
Invoice payment	Are structured weekly payment runs in place?	**Cash collection**	Do you receive regular updates of current, due and overdue receivables by client to support collection activity?

But how ‘good’ do you need to be?

Although prime and sub-contractors’ working capital positions are impacted by different drivers across the supply chain, both can benefit from leading practices around work-in-progress, accounts receivable and accounts payable.

However, this should not be seen as a binary exercise where the objective is to achieve leading practice in everything. To deliver the required level of working capital performance, it may be perfectly adequate to simply maintain or marginally improve certain processes and practices. The key is to identify where along the axis between current and leading practice the business needs to be to support the right level of working capital investment (see Figure 1).

Figure 1. Working capital maturity assessment – Accounts Payable

Lagging practice	Assessment	Leading practice
Payment clock starts from the date of the supplier’s invoice		Payment clock starts from either date of goods receipt or delivery of service whichever is later
No official supplier payment term policy with invoices paid according to the terms quoted		Official supplier payment term policy applied to all suppliers with exceptions approved by Finance
Supplier invoices falling due between payment runs paid immediately by manual payment		Supplier invoices falling due between payment runs paid in arrears to avoid any early payments
Suppliers contacted to expedite resolution of disputed invoices		Disputed invoices withheld for payment with no proactive contact with supplier to expedite resolution
Supplier negotiations prioritised towards cost with little or no importance attached to payment terms		Importance of securing acceptable payment terms recognised during supplier negotiations

Seven ways to help unlock cash from the balance sheet

Leading practice and maturity assessments help to identify potential initiatives to address performance drivers. From our experience across the sector, the following interventions deliver particular value in unlocking cash from unproductive working capital for contractors:

1. Working capital policy

Driving sustainable working capital performance improvement requires all members of the organisation from Finance through to on-site QS teams to embrace leading practices in their day-to-day activities. This includes instilling a sense of responsibility based on the impact of specific actions upon working capital performance.

Creating and communicating a working capital policy that covers all subsidiary policies around credit risk, payment terms, billing, cash collection and dispute management enables the organisation to raise the profile of working capital management. This will also help in instilling a cash mind set across the organisation.

2. Major project cash flow forecasts

80% of working capital value can typically be wrapped up in 20% of current projects. Building a separate cash flow forecast for each of these major projects prior to setting up and agreeing contractual terms and conditions enables working capital investment to be assessed which may drive pricing and/or specification dimensions.

Project cash flows provide weekly visibility of cash inflows from the client (based on contractually agreed billing schedules and payment terms) and cash outflows to sub-contractors and materials suppliers (based on build and commission schedules, payment terms and payment run dates). Forecasts should be periodically reviewed against actuals to identify deviations and assess impact on future cash flows enabling corrective and pre-emptive actions to be taken.

The different contracting and payment cultures of overseas clients can impact significantly on the management of working capital and are an important factor to consider when managing project cash flows. For example, Middle Eastern clients will tend to work on verbal agreements, and Southern European clients will tend to operate on longer payment terms than those in Northern Europe.

3. Supply chain finance

Following success in the automotive and retail sectors, banks have now effectively entered the construction supply chain through the increasing use of supply chain finance (or reverse factoring).

Supply chain finance can enable major contractors with strong credit ratings to secure their supply chains by offering immediate payment of sub-contractor and material supplier invoices via a banking intermediary, as well as providing a low cost source of funds to suppliers. Such a scheme can also facilitate the extension of payment terms without the risk of driving sub-contractors and material suppliers out of business.

Ensuring that invoice validation and dispute resolution processes are timely and efficient is critical as banks will only make payments based on fully approved invoices.

4. Customer contract template

Accounts receivable performance issues manifested as billing delays, billing disputes or payment delays can be created by a lack of clear, comprehensive and unambiguous contractual terms and conditions that are agreed and signed off by both parties at the start of the project.

Putting in place a standard customer contract template that incorporates payment terms, billing schedules and procedures around bill content, supporting documentation, work inspection, definition of rework and application of penalties/ retentions provides a foundation for minimising disputes and their impact upon working capital performance. This should also include procedures for managing and approving contract variations.

The organisation’s working capital policy should mandate the use of the standard customer contract template for all projects and include procedures applied when customers insist on using their own contract documentation.

5. Structured dispute management

Delays in receiving payment from customers are often caused by snagging or more major contractual disputes. Until such disputes are resolved to the satisfaction of the customer, invoices will not be paid. Introducing structured procedures that are agreed with customers, QS teams and sub-contractors drives a proactive approach to surfacing and resolving snags and disputes. This should include clear responsibility and a fixed timescale for resolution and escalation procedures to address any non-compliance. Fast track resolution should be in place for any major disputes that threaten major cash flow and customer service impacts.

Wrapping up this procedure into an overall customer care policy and programme supports improved customer service and simultaneously supports improved accounts receivable performance.

6. Design variation controls

During the course of a project, it is likely that there will be requests to adjust designs and specifications. When the work associated with such variations is billed, customers may raise disputes when comparing the work billed with the scope detailed in the contract.

Documenting procedures for the request and approval of design and specification variations in customer contracts helps to reduce the incidence of such disputes.

It is also important to be able to model the impact of such variations on the overall project cash flow as this may highlight a requirement to renegotiate milestone payments and payment terms so that the variations are cost and cash neutral.

7. Proactive cash collection

Having raised bills and sent them to customers for payment with all the required supporting documentation, it is of course important to ensure that customers adhere to the agreed payment terms and conditions documented in the contract.

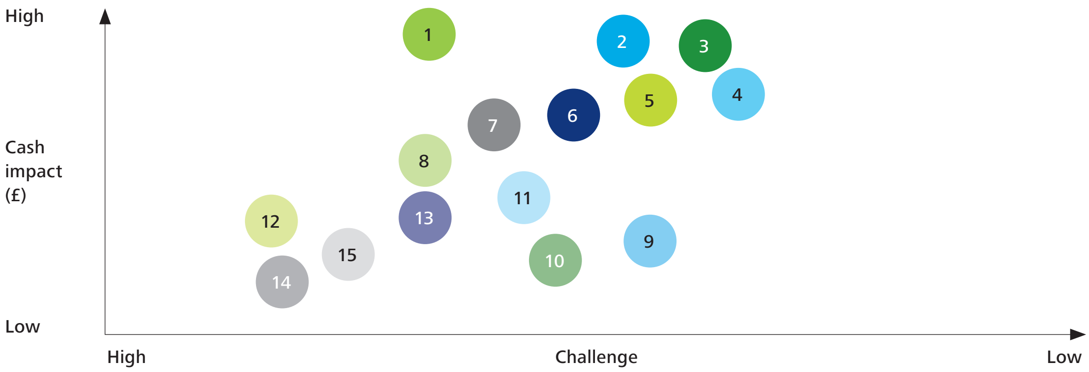
Contacting the customer prior to the due date of the invoice enables any disputes to be surfaced and resolved before the invoice becomes overdue for payment. Such contact can be made in conjunction with the overall customer care policy mentioned above and need not be seen as chasing for payment before payment is due.

Proactive cash collection eliminates the risk of customers interpreting any delay in chasing for payment after the due date as an extension of payment terms which they may ultimately build into their payment processing.

Where to start?

Categorising potential initiatives based on impact on performance versus investment and the challenge associated with implementation can help to identify priorities (see Figure 2 below). Initiatives which can be implemented quickly by the Finance team without the need to liaise with other stakeholders, e.g. proactive cash collection, can drive quick wins and should be prioritised. Other interventions that are dependent on the support or cooperation of other internal functions (e.g. QS teams) and/or external parties (e.g. customers, sub-contractors, material suppliers, banks) should be categorised in relation to the challenge associated with obtaining buy-in or cooperation.

Figure 2. Prioritising improvement initiatives



1. Working capital policy
2. Major project cash flow forecasts
3. Supply chain finance
4. Customer contract template
5. Structured dispute management
6. Design variation controls
7. Proactive cash collection
8. Proactive snagging resolution
9. Sub-contractor accreditation
10. Material supplier accreditation
11. Monthly cash collection targets
12. Invoice payment messaging
13. Inspection & certification procedures
14. On-line invoice validation
15. Supplier invoice scanning

Source: Deloitte analysis

Delivering sustainable performance improvement

Having selected the most appropriate initiatives to implement, it is important to engage with all stakeholders across the organisation at the earliest opportunity to address concerns, gain buy-in and develop realistic action plans. For example, engaging with commercial teams will support the set-up of contracts that incorporate foundations for efficient billing and payment processes. Working with on-site QS teams will support the introduction of proactive surfacing and prompt resolution of snagging and other site based disputes.

Establishing ownership and accountability for process improvement in "Cash Champions" across the organisation provides the necessary foundations for achieving and sustaining better levels of performance. It also helps to reduce the challenge of process compliance.

Getting everyone to think about the cash impact of their actions will ultimately lead to a more integrated and collaborative approach to managing working capital and keeping it at the right level for the business.

What does this really mean for your organisation?

Deloitte's working capital specialists have customised our leading practice working capital model to the UK construction sector. The model enables rapid assessment of existing performance against leading contract-to-cash and purchase-to-pay practices, covering process, policy, systems, reporting, organisation and people, highlighting areas of potential opportunity.

We would be delighted to discuss your working capital management issues, and explore how this model or other tools could help to address the challenges in your organisation. Please contact us through your Deloitte contact or at infrastructure@deloitte.com

The right mix for the challenging construction market

Deloitte works with many of the world's leading building contractors. As well as supporting clients in designing and implementing working capital performance improvement initiatives, we offer a truly comprehensive range of business advisory services across the sector. From strategic and financial advisory to PPP bid support and operations consulting, as well as specialist contract and commercial risk management expertise, our dedicated Contractors network brings together the best of Deloitte's leading expertise into practical, integrated solutions to address the key business challenges facing the construction market.

www.deloitte.co.uk/contractors

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