Retention Money Provisions

An implementation review of the retention money provisions in the Construction Contracts Act 2002

27 August 2019

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1 Executive summary

1.1 Scope

The Construction Contracts Act 2002 ("CCA", the "Act", or the "Legislation") regulates payments, retention money and disputes under construction contracts. Amendments to the CCA effective from 31 March 2017 ("the Retention Money Provisions" or "the Retention Regime") required retention money in commercial construction contracts to be held on trust in the form of cash or other liquid assets readily convertible to cash, unless a complying financial instrument is used to protect payment. The amendments also introduced requirements in relation to the keeping of, and access to, financial and accounting records relating to retention money.[1]

This report presents findings from an independent review of the implementation and operational effectiveness of the Retention Regime. The Ministry of Business, Innovation and Employment ("MBIE") engaged KPMG to undertake an evidence based review that would inform MBIE's understanding of:

- The sector's awareness of the regime;
- The attitude to, and extent of compliance, and how businesses are choosing to comply;
- What, if any, early signs there are of behaviour changes in the sector; and
- The intended and unintended consequences of the legislation on solvent and insolvent firms.

The scope of the review excluded identifying non-compliance, or creating an avenue of enforcement against any particular party, as well as the development of a policy position on, or recommendations for changes to, the CCA.

1.2 Approach

KPMG invited contributions from a wide range of construction sector participants that are impacted by or dealing with the Retention Regime. Industry contributions were collected through a survey issued to head contractors and subcontractors alongside interviews and focus groups conducted with head contractors, subcontractors, industry bodies, solicitors, banks, principals, adjudicators, accountants, insolvency practitioners, and insurers. Industry contributions were aggregated and analysed to produce data that would inform MBIE's understanding of the implementation and operational effectiveness of the Retention Regime.

Desktop research into construction company failures and an assessment of other publicly available information regarding the CCA and Retention Regime was also undertaken to supplement the findings from the survey and interview evidence.

1.3 Key findings

- Evidence indicates that a large portion of the sector is complying with the Retention Regime. While a number of participants indicated they believed construction firms were not complying, we have been unable to gather significant evidence of widespread non-compliance.
- In some cases, and for a large dollar value of, retention payables captured by the trust requirements, the Retention Regime has provided protection to subcontractors in the event of insolvency. This has resulted in returns to subcontractors. Previously these monies would unlikely have been available for distribution. In some insolvencies where non-compliance has been identified, subcontractors have not been protected.
- The Court's decision[2] relating to Ebert Construction Limited (in Receivership and Liquidation) ("Ebert"), has highlighted a number of issues with the Retention Regime, some of which may be addressed over time through

[1] Construction Contracts Act 2002, ss 18A-18I.

[2] *Bennett & Ors v Ebert Construction Limited (in receivership and liquidation)* [2018] NZHC 2934

case law (noting that this is at the expense of creditors). One of the key issues highlighted is that the Act does not provide appropriate mechanisms to administer the retention account on insolvency.

- Compliance with the Retention Regime was aided by good corporate governance practice as well as by banks encouraging compliance.
- A lack of available capital or complying financial instruments appear to be the main reasons why businesses are not compliant with the Retention Regime. Some non-compliance was also attributed to inadequate accounting and financial processes, leading to the retention account not being fully funded.
- While there has been a funding and administration cost for complying with the Retention Regime, KPMG is not aware of any cases where these costs have been included in tender prices.
- Some market participants indicated that they comingle retention monies with other monies. While this is allowed under the legislation, this creates a greater risk that funds will not be identifiable and clearly on trust in the event of insolvency.
- Under the Retention Regime payees have the right to inspect accounting records of payers to confirm compliance. Subcontractors rarely exercise their inspection rights, or otherwise request confirmation of compliance, and when responses were provided by payers these were varied.

1.4 Recommendations

KPMG makes four recommendations to MBIE, drawn from the findings of this report, on how to improve the operational efficiency of the Retentions Regime:

To improve awareness

- Payees may benefit from further guidance on what records should be requested for inspection, what they should expect to receive back from a request or suggesting a pro-active approach from payers to provide compliance information to payees.

To improve compliance

- Payers may benefit from further guidance about how to comply with the Act, including what constitutes a liquid asset and a complying financial instrument, best practice guidelines on record keeping and financial processes to manage the retention fund, and information about the consequences of non-compliance.

To continue to encourage positive behaviour

- MBIE should consider encouraging the industry and business leaders in endorsing the positive behaviour towards compliance already in place and encourage behaviour that maintains ongoing compliance across the sector.

To address early impacts

- Further consideration should be given to how to address operational issues concerning how retention money held by a firm is administered in the case of insolvency of the firm.

1.5 Responses to MBIE's key questions

MBIE identified seven key questions the review would seek to obtain feedback on, which we answer below.

1.5.1 Awareness

How have payers, payees, directors, accountants, liquidators, banks and insurance providers developed their awareness of the retention provisions?

- Participants advised the biggest source of industry awareness has been from industry bodies, the media, MBIE or building.govt.nz and law firms. Law firms often partnered with industry bodies to present to the sector and published media articles, so were a key driver of the sector's awareness.

- Overall awareness of the regime and its provisions was high. There was some uncertainty from payees regarding what to request for inspection and what they should expect back from a request.

1.5.2 Compliance

To what extent do:

a. Private and confidential adjudicators reinforce the intent of the provisions?

- Interviewees considered it unlikely that the provisions would be addressed in an adjudication and there was limited evidence that adjudications had occurred in respect of the Retention Regime.

b. Subcontractors exercise their right to check that their retentions are held on trust?

- Subcontractors rarely exercise their right to inspect the retention records of head contractors. If requests are made, subcontractors (and head contractors) are more likely to request confirmation that funds are held on trust as opposed to inspecting records.
- Subcontractors advised that the right to inspect is rarely used due to competing commercial factors, namely not wanting to impact the relationship with the head contractor.
- Where requests were made, responses received were mixed with some providing bank statements and term deposit statements, through to defensive responses asking why the requests were made. During interviews, head contractors confirmed they provided some form of positive confirmation to subcontractors.

c. Liquidators, Receivers and Courts enforce the intent of the Retention Money Provisions?

- Where funds are clearly held in separate retention accounts, it appears insolvency practitioners are enforcing the intent of the legislation to return these funds to payees. The Ebert decision has provided insolvency practitioners with useful guidance to apply to future cases given the court approved the receiver to administer the funds and provided guidance on when a trust was created. No other matter has gone to Court for directions, but KPMG understands one insolvency practitioner may also apply to Court for directions.

d. Directors ensure that their firms are abiding by the Retention Money Provisions?

- Some directors require regular reporting and monitoring of compliance. This is especially true of larger businesses who have independent directors on their boards.

e. What are the drivers and barriers to compliance with the legislation?

- Drivers for compliance observed included:
  - Directors requiring compliance and regular reporting of compliance to them;
  - A desire to show good corporate governance, protect the reputation of the business and demonstrate sector leadership;
  - Banks requesting that customers comply and in some instances insisting a separate retentions account is set up; and
  - Principals requesting confirmation of how head contractors are complying and examining compliance as part of their procurement processes.
- Barriers to compliance identified included:
  - Lack of funding/working capital;
  - Insufficient information/knowledge of how to comply;
  - Impression there was limited compliance;
  - A lack of maturity of the corporate governance function; and
  - No availability of insurance or financial instrument products.
- In addition to these barriers one further issue identified was there was a lack of penalties for non-compliance. A number of interviewees commented that if a successful claim is pursued against directors of a failed business for non-compliance, then this would likely act as a stronger driver for compliance.

1.5.3 Behaviour change

What are the changes in attitude and behaviour of payers, payees, directors, accountants, liquidators, banks and insurance providers over the past two years?

— The most noticeable change in behaviour of payers is the actions payers have taken to comply with the regime, some of this has been driven by banks and procurers seeking confirmation of compliance before entering a contract. Beyond this, participants reported minimal behavioural changes observed for payers and payees that can be attributed to the Retention Regime.

— Boards have generally driven compliance with the Retention Regime as part of their corporate governance practices. Larger more sophisticated business have amended their policies and procedures to specifically address the risks arising from the Retention Regime.

— Banks have been conservative with what steps they take to manage and enforce compliance or offer alternative funding structures, as they have not wanted to assume a constructive trustee role. There are however examples of banks positively encouraging compliance across the construction sector.

— While construction firms have an appetite to use a complying financial instrument, there have been limited products available. One provider has not been able to write a policy due to the poor financial resilience of the applicants.

— Where there have been clearly identified retention accounts, insolvency practitioners have taken steps to administer these accounts to enable subcontractors to recover retention funds due. One insolvency practitioner is looking to recover the shortfall in the retention account from the director.

1.5.4 Early impacts

In what context has there been reduced use of retention money as working capital?

— For some businesses cashflow has been significantly impacted and the reduction in cash reserves has reduced the buffer to manage any one-off shocks or project losses.

— In order to comply with the Retention Regime, some contractors have had to retain profits, recapitalise, advance funds from shareholders or other group entities or seek increased debt facilities.

— While some businesses are technically more capitalised as a result of the regime, the additional capital is not available to support general trading for these businesses. The cash impact of the regime is continuing as payers build up the retention account balance to a normalised level.

What is the current situation and trends so far for:

a. faster and more certain payment of retentions to subcontractors.

— To date, there is limited evidence of the regime resulting in changes to the speed and certainty of payment. Over time this may change, as some head contractors advised they were likely to pay out retentions earlier (given retentions were being held on trust).

b. earlier warning of financial issues (including insolvency) in those withholding retention money.

— There was limited evidence that the regime has provided earlier warnings of financial distress, this may be partly attributable to the limited use of inspection rights. Regardless there is uncertainty that inspection rights would highlight issues in any event (see Ebert and Arrow International (NZ) Limited (in Liquidation) ("Arrow") as examples).

— A number of head contractors have identified the regime has led them to implement better control over cash flow forecasting and monitoring due to reduced cash buffers.

c. payees being sufficiently protected in cases of payer insolvency.

— The regime has resulted in retention funds being available for distribution to subcontractors in a number of cases. Based on the four cases KPMG is aware of, approximately $8.35m in funds were held in retention accounts and available for subcontractors.

— There are cases where retention monies were not held (either at all or not for the total retentions balance). Some of the non-compliance in these cases is due to classification issues of pre and post Retention Regime contracts.

d. improved efficiency and productivity in the construction sector and can this be attributed to implementing the Retention Money Provisions.

- Interviewees and survey respondents did not consider the Retention Regime had improved the efficiency and productivity of the sector.

What have been the unintended consequences of the Retention Money Provisions on the health of the construction sector, and are these likely to continue?

- The reduced cash available in the businesses has impacted bonding capacity for some businesses. Bonding is generally a constraint for many businesses as a result of banks reducing risk exposures to the sector in general. The Retention Regime may further constrain working capital and cash potentially impacting the industry's capacity.

- The insolvency of Arrow has been partially attributed to cashflow impact of the Retention Regime, amongst a range of other factors.

- Senior management from one construction business advised that the sale of the business by the shareholder was partially attributable to the impact of the Retention Regime.

  For stable businesses, the cashflow impact will largely have worked its way through once retention accounts are fully funded. Therefore, the cashflow impact may not have a long term impact, given retention funds are anticipated to be fully funded in the next year.

2 Background

2.1 Retentions in the construction industry

Retentions are used in the construction industry as a means to secure obligations under a construction contract and ensure defects are remediated. Retentions represent an amount deducted and withheld from each progress payment made to a contractor or subcontractor. A commercial construction project will often involve a cascading set of contracts. Principals contract with head contractors who then subcontract much of the work to specialist trade contractors. It is common practice for each party in this hierarchy of contracts to hold retention money to secure the contract and defect remediation performance of the party below it.

The retention amount is typically calculated on a sliding scale and can represent as much as 10% of the total contract value (capped at specified levels). The retention is then typically released in two parts: 50% on practical completion; and 50% at the end of the defect liability period. In some instances, this may mean a recipient will wait up to two-years (or more) for the retention to be released. Retentions are prevalent throughout the construction industry and are applied to most contracts.

Historically there has been little regulation on how a party withholding retention money could use it, and it has been common for principals and head contractors to use retention money to fund the working capital of their business. In this regard KPMG notes the findings in England from Pye Tait's report into retentions in the construction industry,[3] where only 40% of tier one contractors were not using the retentions monies as part of their cashflow. Therefore, those who had retentions withheld against them had no protection in the event of an insolvency prior to the introduction of legislative changes described below.

In a Cabinet Paper, the then Minister for Building and Construction, Nick Smith, noted that retentions were a common and long-standing practice in the industry and the Mainzeal collapse highlighted a number of issues relating to their use.[4] In particular:

- The risks of non-payment to subcontractors in the event of insolvency;
- The high rate of insolvency in the construction market, which creates a higher risk of loss of retentions for subcontractors, impacting growth and productivity in the industry; and
- That retentions are used as working capital by some contractors enabling under-capitalised businesses to tender for work they are not adequately capitalised to undertake and supporting other poor practices, such as low-price tendering.

The Retention Regime was partly introduced to change behaviour and ensure that clients and head contractors no longer used retention money as a means of transferring business risk to subcontractors.

2.2 Legislative context

The CCA regulates payments, retention money, and disputes under construction contracts. The Construction Contracts Amendment Act 2015 and the Regulatory Systems (Commercial Matters) Amendment Act 2017 amended the CCA by implementing changes aimed at, inter alia, ensuring that retention money is protected and responsibly managed. The principal changes made to the CCA were in relation to requirements for retention money to be held on trust, accounting records to be kept, and rights to inspect retention money records.

The amendments (collectively referred to as the "Retention Money Provisions" or the "Retention Regime") introduced subpart 2A of the CCA which contains the provisions regulating parties dealing with retention money. The Provisions came into effect on 31 March 2017 and apply to all commercial construction contracts entered into after this date.

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[3] Pye Tait Consulting *Retentions in the Construction Industry* (United Kingdom Department for Business, Energy & Industrial Strategy, BEIS Research Paper 17, October 2017).

[4] Cabinet Paper "Legislative solutions to issues relating to the use of retentions in the construction market" (7 August 2014).

2.2.1 Retention money to be held on trust

The Retention Money Provisions state that retention money can only be used to remedy defects in the performance of a contractor's obligations and it is prohibited to make the release of retention money conditional on anything else.[5] In addition, the funds cannot be used as working capital unless they are protected by a complying financial instrument.[6]

All retention money must be held on trust for the benefit of the contractor in the form of cash or other liquid assets that are readily converted into cash.[7] The retention money does not, however, need to be paid into a separate trust account and can be commingled with other funds.[8] The funds may be invested, and the party withholding the funds is entitled to the benefit of the appreciation of the investment and interest up to the date the retention money is payable. If the funds are invested, the party withholding them is also liable for any shortfall resulting from realising the investment.[9]

2.2.2 Inspection of records

A party withholding retention money must ensure it keeps proper accounting records of all retention money held on trust or that are protected by a financial instrument, as well as records of any transactions in relation to the funds.[10] These records must comply with generally accepted accounting practice (GAAP) and be readily and properly auditable. A party withholding retention money must make the records available for inspection to the party the retentions are withheld from at all reasonable times and without charge.[11]

2.2.3 CCA Regulations

Under the CCA, a number of aspects of the Retention Money Provisions can be further clarified by regulation, in particular:

- The Retention Money Provisions only apply to commercial construction contracts where the retention money is more than the de minimis amount. The de minimis amount may be prescribed by regulation;
- Who can issue complying financial instruments and requirements for the instrument;
- The methods of accounting for retention money or requirements for records; and
- The default interest rate on late payments.

There are currently no regulations concerning any of the above aspects of the Retention Money Provisions.

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[5] Section 18E(1) and 18I.

[6] Sections 18D and 18FB.

[7] Section18C.

[8] Section 18E(2).

[9] Section 18F.

[10] Section 18FC.

[11] Section 18FC(4).

2.3 Implementation review

It has been over two years since the Retention Money Provisions came into effect. As steward and regulator of the regime, MBIE engaged KPMG to conduct a review of the Provisions' implementation and report on the awareness, compliance, behaviour changes and early impacts of the regime.

MBIE identified seven key questions the review would seek to obtain feedback on:

Awareness
1. How did payers, payees, directors, accountants, liquidators, banks and insurance providers develop their awareness of the retentions money provisions?
Compliance
2. To what extent do: a. private and confidential adjudicators reinforce the intention of the Retention Money Provisions b. subcontractors exercise their rights to check that their retention money is held on trust c. liquidators, receivers and courts enforce the intent of the Retention Money Provisions d. directors ensure that their firms are abiding by the Retention Money Provisions
3. What are the drivers and barriers to compliance with the Retention Money Provisions?
Behaviour changes
4. What are the changes in attitude and behaviour of payers, payees, directors, accountants, liquidators, banks and insurance providers over the past two years?
Early Impacts
5. In what context has there been reduced use of retention money as working capital?
6. What is the current situation and trends so far for: a. faster and more certain payment of retentions to subcontractors b. earlier warning of financial issues (including insolvency) in those withholding retention money c. payees being sufficiently protected in cases of payer insolvency d. improved efficiency and productivity in the construction sector and can this be attributed to implementing the Retention Money Provisions
7. What have been the unintended consequences of the Retention Money Provisions on the health of the construction sector, and are these likely to continue?

The scope of the review expressly excluded identifying specific instances of non-compliance for the purposes of identifying an avenue for enforcement. The scope also expressly excluded the development of a policy position on, or recommendations for changes to, the CCA or Retention Money Provisions.

3 Methodology

3.1 Approach

The review focused on obtaining evidence of the construction sector's experience and observations of the implementation and operational effectiveness of the Retention Regime. To ensure the review had an appropriate degree of breadth and depth, KPMG identified a wide range of construction sector stakeholders as potential contributors. Contributions were sought from head contractors, subcontractors, industry bodies, solicitors, banks, principals, adjudicators, accountants, insolvency practitioners, and insurers. These groups were chosen as they are the primary stakeholders dealing with retention money in the normal course of business, and therefore are likely to have substantial knowledge of how the Retention Regime is operating in practice. However, it is inevitable that some stakeholder groups will only have experience in some aspects of the regime (e.g. principals generally would not be expected to have in-depth knowledge of how the regime is operating between head-contractors and subcontractors).

Three main approaches were taken to obtaining evidence from the industry:

1. A survey was issued to head-contractors and subcontractors;
2. Interviews and focus groups were conducted with a wider range of stakeholders; and
3. Desktop research was undertaken into publicly available information regarding construction company failures, the CCA, and the Retention Regime.

The Retention Regime was primarily focused on providing protection to subcontractors by addressing the way head contractors treat retention money. These groups have also been the most affected by the implementation of the regime. Accordingly, our focus was on considering the impact of the Provisions on these two groups, including understanding their perception of the implementation and operational effectiveness of the regime. Inviting responses from head contractors and subcontractors through a survey, combined with interviews and focus groups, was seen as the most efficient approach to collect feedback from these parties.

While principals also hold retentions on head-contractors, the regime was primarily implemented in response to the Mainzeal collapse and was aimed at protecting parties in the event of head-contractor insolvency. Given this, it was decided that principal's views would be better collected via interviews as opposed to the survey. Additionally, there would be a number of survey questions which would not be applicable to principals.

Interviews were used to collect more substantive industry contributions that would supplement the larger evidence base collected from the survey and provide context to survey responses. The interviews were conducted with a broader group of sector participants and sought to obtain qualitative information that could not be easily captured by the survey questions.

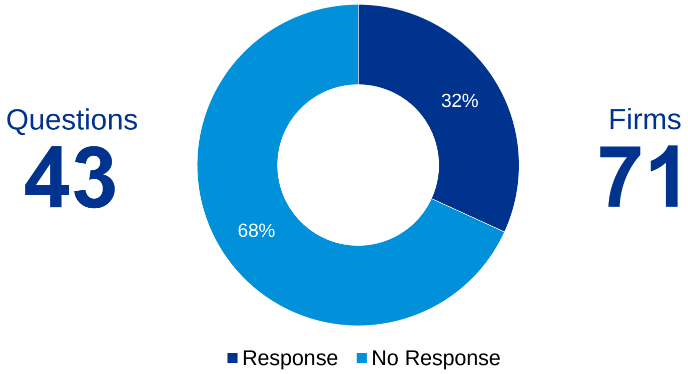
In addition to industry contributions, desktop research was used to supplement the findings in this review. Research was undertaken into construction company failures, publicly available information regarding the CCA and the Retention Regime and overseas publications where available. The results of this research provided contextual evidence in support of the industry contributions and assisted in the development of the survey and interview questions.

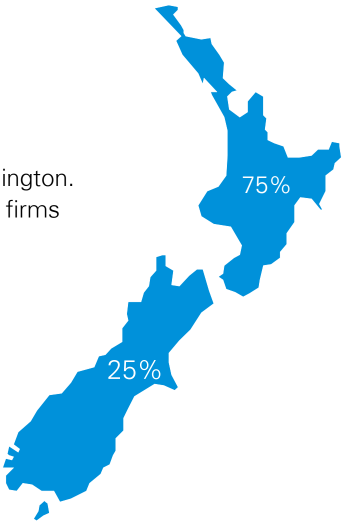
3.2 Sector participants at a glance

3.2.1 Survey

The survey was distributed to 223 construction firms throughout New Zealand, of which 32% responded. The survey contained 43 primary questions, with additional sub-questions under a number of the primary questions.

Figure 1: Survey response rate





3.2.1.1 Geography

Of the 71 respondents, over half were headquartered in Auckland or Wellington. North Island construction firms made up 75% of the responses. Regional firms (defined as firms headquartered outside of Auckland, Wellington and Christchurch) represent 29% of the responses.

3.2.1.2 Industry role

Of the 71 respondents, 69% operated as head contractors most or all of the time. Of these respondents, 65% of worked in vertical construction, 20% in residential construction and 15% in civil construction. To supplement the reduced response rate amongst subcontractors, KPMG conducted three focus groups with firms that primarily or only operate as subcontractors.

Figure 2: Respondent firms' role

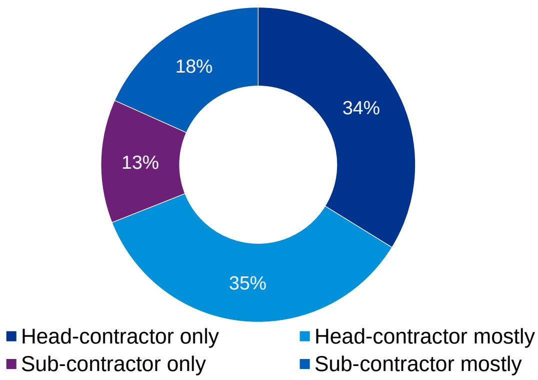
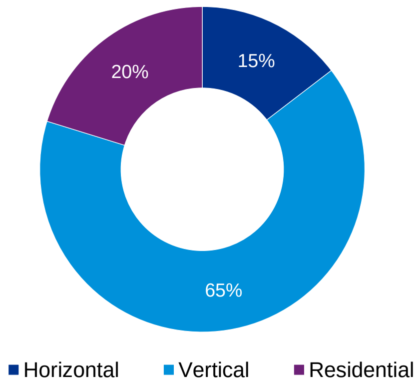


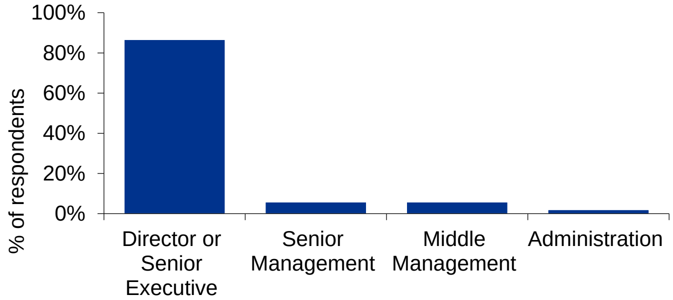
Figure 3: Respondent firms' sector



3.2.1.3 Participants

The vast majority of those completing the survey on behalf of their organisation were at Director or Senior Executive level. These individuals would likely have in-depth understanding of their organisations and the impact the introduction of the Retention Regime has had.

Figure 4: Level of individual completing the survey within their firm



3.2.1.4 Size

The respondents provided a reasonable spread of different sized firms, with concentrations in the 11 – 50 employees and $5m – $25m annual turnover groups.

Figure 5: Respondent size by number of employees

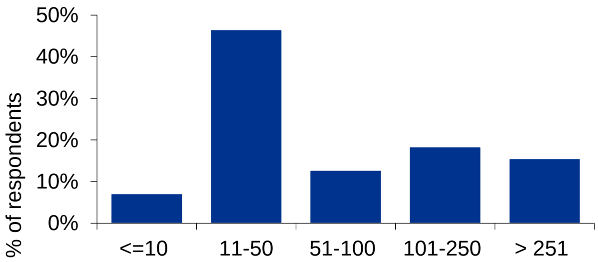
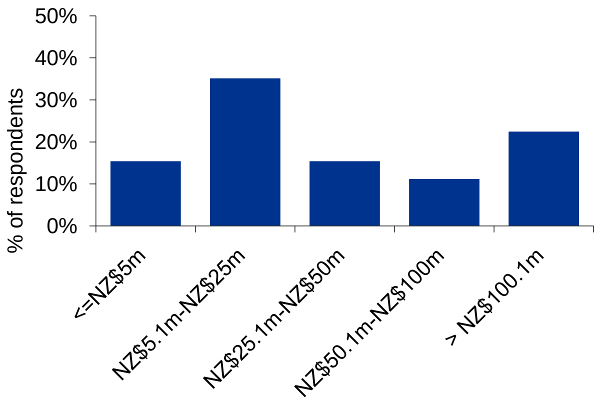


Figure 6: Respondent size by annual turnover

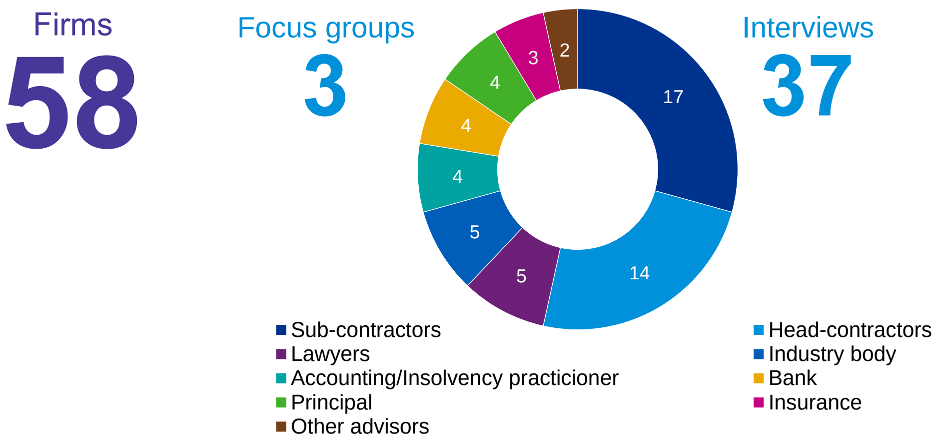


3.3 Interviews and focus groups

The in-person evidence was obtained through 37 interviews, three focus groups and a number of informal discussions. In total KPMG engaged with 58 firms.

The interviewees consisted of professionals, industry bodies, principals and construction firms. The focus groups consisted of industry bodies and construction firms. The construction firms interviewed were primarily larger entities in head contracting roles, while the focus group participants primarily operated as subcontractors.

Figure 7: Firm's role within the sector



3.4 Survey

3.4.1 Method

A survey was developed by KPMG to collect evidence that would support answers to MBIE's seven questions. KPMG reviewed MBIE's seven questions and developed internal hypotheses in response to each. A set of questions were developed that would provide evidence to prove or disprove each hypothesis. The majority of the survey questions were in multiple choice answer format and a number of questions allowed for the selection of multiple answers. This format was chosen as it would produce quality data that would be suitable for quantitative analysis. MBIE reviewed and approved the survey questions and size of the target list.

After issuing the survey to an initial group of head-contractors and subcontractors, we added additional parties to include other parties that had been recommended by interviewees. KPMG then added further parties to obtain a greater number of responses.

Respondents were provided with information for them to understand the context of the review and how their responses were going to be used. This included advising them that the responses would be entirely anonymous. In this regard, KPMG was unable to identify who responded to the survey. The only unique identifier for each respondent was their IP address which was used to remove any duplicate responses from the same organisation.

Prior to completing the substantive survey questions, participants were asked to confirm their understanding of the scope of the review and provide consent for their contribution to be presented in this report as part of a consolidated data set. The preliminary questions in the survey were designed to gain an understanding of the size and type of the participant's organisation so that responses could be aggregated alongside comparable entities to identify sub-sector trends.

All but three of the survey questions were optional, meaning a respondent could elect to skip a question if they did not wish to disclose certain information. Three questions that could not be skipped relating to information about the respondent. There were a small number of questions that were not multiple choice and instead required the respondent to input numerical data. These questions concerned the respondent's working capital and the impact of the Retention Regime on working capital.

The survey contained a total of 43 main questions; however; respondents would only be asked questions that were relevant to their relationship with the Retention Regime. The respondent was initially asked whether they hold retention money on contractors or have retention money withheld by another party. Depending on their answer to this question the respondent would then be asked a set of questions relevant only to those holding retentions, or relevant to those having retentions withheld. It was possible to be asked both set of questions if a respondent indicated they both hold retention money and have it withheld.

The data has been aggregated and analysed to produce a consolidated analysis on the response to each question and compare trends amongst similar organisations.

3.4.2 Participants

The survey was issued to 223 head-contractors and subcontractors to ensure sufficient data was gathered to draw evidence based conclusions. The survey participants were selected by reviewing internal KPMG construction sector databases, undertaking desktop research on the key participants in the sector, and through recommendations from other sector participants. Prior to issuing the survey, the potential participant list was moderated to ensure there was an even distribution of head-contractors relative to subcontractors and commercial, infrastructure and residential contractors.

Participants were invited to complete the survey through an email that linked to an online portal. Of the 223 invited participants 88 responses to the survey were received. Following the closure of the survey, KPMG reviewed the responses and disregarded 17 responses, which were either duplicates or had significant anomalies which resulted in the questioning of the accuracy of the answers. This left 71 unique data sets to analyse.

3.5 Interviews and focus groups

3.5.1 Methodology

An interview and focus group format was developed by KPMG to gather responses from a wide range of industry participants. The interviews and focus groups were structured and conducted in a consistent manner to ensure responses could be categorised and aggregated to analyse trends. A set of 13 open ended questions were designed to answer MBIE’s questions. Where possible these questions were consistent with the survey.

Interview results were used to provide substance and context to the results of the survey.

3.5.2 Participants

The invited participants consisted of adjudicators, accountants, banks, directors, head-contractors, insolvency practitioners, insurers, principals, solicitors and subcontractors. The interview participants were selected by reviewing KPMG internal databases, undertaking desktop research to identify key industry stakeholders and through recommendations of other sector participants. The participants were selected primarily based on size, weighted towards those organisations that would allow us to gain the most persuasive evidence based on exposure to volume and dollar value of contracts. Potential interviewees were then reviewed and a shortlist of interviewees was produced that would produce balanced contributions across sub-sectors. KPMG conducted 37 formal interviews in total along with a further 5 informal interviews.

Focus groups members, all being subcontractors, were identified via recommendations from trade bodies. Focus groups were held in Auckland and Wellington.

3.6 Desktop research

Research into the implementation and operational effectiveness of the Retention Regime was undertaken by reviewing publicly available information on construction company insolvencies such as, New Zealand Companies Office records, liquidation, receivership and voluntary administration reports, and media articles. Publicly available information regarding the CCA and Retention Regime were reviewed such as the BDO Construction Survey.

Although not all research results are expressly included in this report, they has been used to develop the survey and interview questions, and supplement the review’s findings from industry contributions.

3.7 Limitations

Responses to the survey and interviews have not been audited or verified by KPMG. Financial data in the survey responses was provided by respondents and no financial or accounting records have been received in support. The data and recommendations in this report represent the views of the participants in the review and do not represent the views of KPMG.

The review acknowledges that there are inherent limitations to the approach and potential outcomes of both the online survey and in-person interviews. These limitations are summarised below and need to be taken into consideration when drawing conclusions from the review.

3.7.1 New legislation

The requirements of the Retention Regime only apply to commercial construction contracts entered into, or renewed, on or after 31 March 2017. Consequently, there are still a proportion of retentions being held in the market that are not subject to the new legislation. While the percentage of contracts subject to the regime will have steadily increased over the past two years, it will likely take at least one more year before all retentions held are subject to the Retention Regime. Total contracts subject to the retention regime were estimated by interviewees to be between 50% - 80% of the project portfolio.

Until all retentions held are subject to the Retention Regime, the full impact of the legislation will not be felt by sector participants. Due to the limited timeframe that the legislation has been in place, sector participants are still working to understand what exactly the regime means for them and the impact on the sector as a whole is yet to be fully appreciated.

A further limitation relates to the perceived effect of the regime from a subcontractor perspective. Due to the lengths of construction contracts and defect liability periods, many retentions held under post-legislation contacts may not have reached the contractual retention release date, meaning the respondents' experience with retentions being released under the regime may be limited. Conversely, head contractors and retention holders are currently in a "build-up" period of ensuring sufficient cash reserves are held on trust to comply with their retention obligations under the regime. Therefore there is an ongoing impact on working capital as payers continue to build up funds in their retention account.

3.7.2 Lack of case law concerning non-compliance

As at the date of this report, no case law has been developed regarding non-compliance with the Retention Regime. In particular no actions have been brought against directors for a breach of director duties under the Companies Act 1993, or breach of fiduciary duties or trust, as a consequence of non-compliance.

This may have limited participants' perception of the regime's effectiveness and retention holders' motivation to comply.

3.7.3 Fragmentation

The New Zealand construction sector is highly fragmented with a large number of small contractors. Consequently, the inherent limitation of this review is that it is very difficult to seek contributions from the entire sector. Notwithstanding this limitation, KPMG aimed to seek responses from a range of industry participants that represented a cross section of the construction sector. Industry bodies also served as a useful contributor as a representative of a large number of sub-sector constituents. Evidence from the survey and interviews was largely consistent.

KPMG did not seek input from principals who infrequently engage in projects involving commercial construction (e.g. schools engaging contractors for minor works), or other entities that are not engaging construction firms in the ordinary course of business. Accordingly, the review has limited insight into their awareness, behaviour and compliance of the Retention Regime.

3.7.4 Limited financial analysis

The approach to collecting data for the review focused on gathering qualitative responses and contained limited analysis of financial information. While there were some quantitative questions regarding working capital in the survey, these questions had a low response rate and did not provide sufficient meaningful information for analysis. KPMG have utilised its existing knowledge of the construction sector, based on a range of other engagements undertaken, to add context to the review where possible.

3.7.5 Response rate

The response rate to the survey was 32% across 223 head-contractors and, given the large number of participants in the supply chain, the findings may not be representative of the whole of the industry. There is a risk of a sampling and response bias as participants who were unfamiliar and non-compliant with the regime would be less likely to participate in the survey and interview process. Compliant and knowledgeable respondents may be overrepresented in the responses.

3.7.6 Significant industry challenges

The construction industry is facing unprecedented levels of activity due to increased levels of infrastructure investment, and residential and commercial building development in Auckland. This has resulted in shortages of labour leading to a continued escalation in construction costs and, combined with low price tendering and poor risk management practices, has put significant strain on the industry's economic resources and capacity to deliver projects. As a consequence there has been a number of failures and large contract losses over the past two years. In this context, it is difficult to isolate the impact of the Retention Regime compared to impacts driven by current industry dynamics.

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4 Awareness

4.1 Key findings

- Participants advised the biggest source of industry awareness has been from industry bodies, the media, MBIE or Building.Govt.NZ and law firms. Law firms often partnered with industry bodies to present to the sector and published articles, so were a key driver of the sector's awareness.
- Overall awareness of the regime and its provisions was high. There was some uncertainty from payees regarding what to request for inspection and what they should expect back from a request.

4.2 Overview

The first focus area of the review, was how the construction industry had developed their awareness of the Retention Regime. In order to understand this, KPMG has primarily focussed on the key elements of the legislation, namely the obligation to hold funds on trust and the right to inspect accounting records. A level of awareness about the Retention Regime is required in order to drive compliance, and low levels of awareness are expected to contribute to non-compliance.

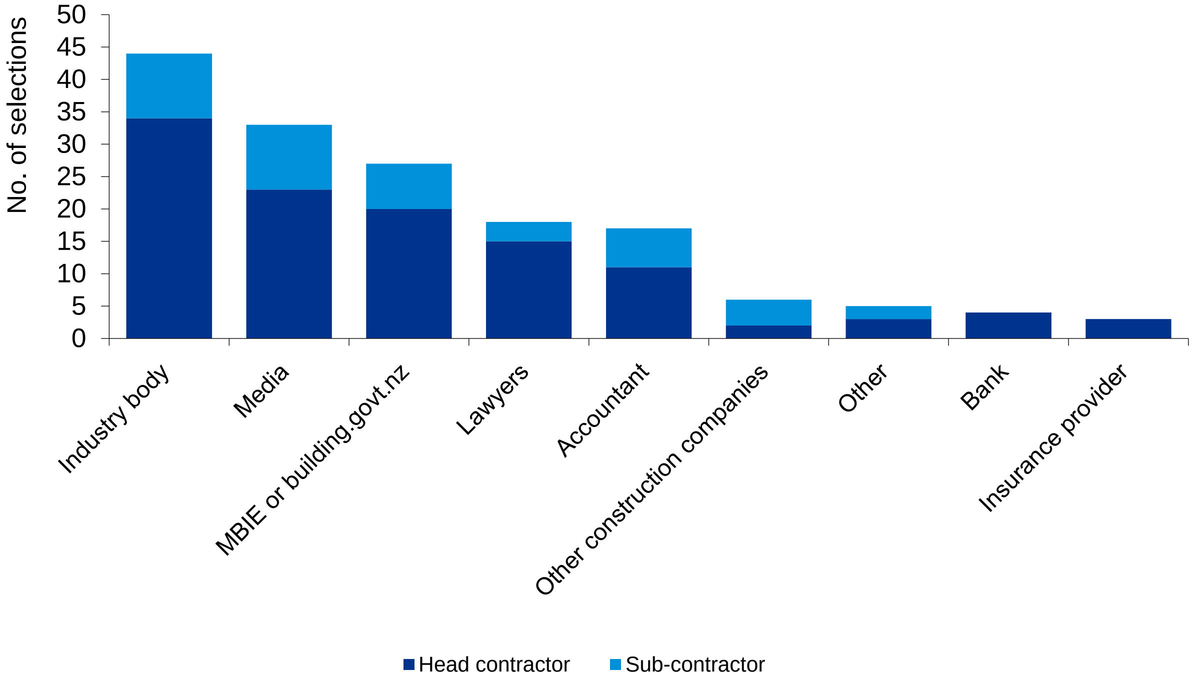
To assess awareness levels KPMG asked a series of questions in the industry survey, interviews and focus groups. This analysis was supplemented by desktop research to establish what material is available for someone looking to educate themselves on the Retention Regime.

4.3 Results

4.3.1 How participants developed awareness and what was the level of awareness of Retention Regime

Survey respondents were asked what sources were used to develop awareness of the Retention Regime. The results of which are shown below:

Figure 7: How respondents developed their awareness of the Retention Regime



The largest number of survey respondents developed their awareness from industry bodies, MBIE or Building.Govt.NZ, the media, and law firms. A number of law firms held client briefings on the Retention Regime, together with publishing articles and, in some cases, partnering with industry bodies to present to the sector. These acted as a key driver of bringing awareness of the regime to the sector.

The interview evidence was consistent with survey, with many respondents advising industry bodies and lawyers provided guidance on the regime.

Principals KPMG spoke with developed their awareness from law firms, either via specific advice on the Retention Regime or through advice during the procurement of a project.

The participants that engaged in the survey, interviews and focus groups were able to demonstrate a knowledge of the key elements of the legislation. Only 3% (2 respondents) of respondents did not select an answer to the question concerning how they developed their awareness illustrating that all most all participants were aware of the legislations existence.

The survey and interview results indicated there remains some uncertainty around the Act. In the survey KPMG asked participants whether they had difficulties in complying with the Retention Regime at any point and the reasons for this. In response, 11% (8 respondents) confirmed they had difficulties due to a lack of knowledge or information about the legislation, which resulted in a difficulty with complying at some point in time.

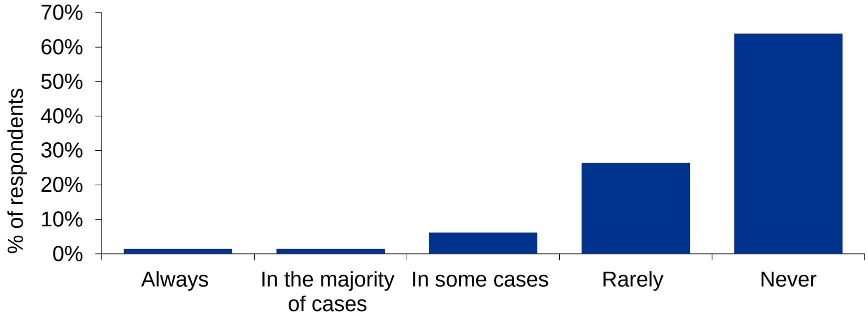
The survey results were consistent with feedback from interviews, where a number of interviewees advised there was uncertainty around aspects of the regime, particularly relating to what constitutes a liquid asset and what is required to comply with the trust requirements.

Our direct engagement with principals/clients has been limited to large developers and government departments/agencies. There are a number of organisations who infrequently engage in commercial construction projects and KPMG was unable to gauge awareness from these parties.

4.3.2 Extent of contractors and subcontractors awareness of right to inspect records

KPMG asked survey participants who have retentions withheld how often they make requests to inspect the records of the party holding retentions on them. The results shown in the graph below indicate that the vast majority of subcontractors rarely or have never made such a request.

Figure 8: How often payees request to inspect retention records



When KPMG followed this question up through interviews, it became clear that there are competing factors which are present, including:

- Payees are unclear on what to ask for; and
- The perceived impact it could have on customer relationships.

Therefore, whilst there may be limited requests to inspect records we could not infer from this it was directly related to the lack of awareness.

The right to inspect records is discussed in more detail in the compliance section of this report.

5 Compliance

5.1 Key findings

- Evidence indicates that a large portion of the sector is complying with the Retention Regime. While a number of participants indicated construction firms are not complying, we have been unable to gather significant evidence of widespread non-compliance.
- A number of drivers for, and barriers to, compliance were identified, the most significant being directors driving compliance or the lack of funds preventing compliance.
- Sector participants indicated that a claim against a director for non-compliance would provide more clarity on the potential penalties of non-compliance.
- There are limited requests to inspect accounting records of payers and when responses are received, these are varied and in some cases non-compliant. When requests were made, head contractors generally provided confirmation of compliance, rather than providing accounting records.
- Insolvency practitioners have investigated whether there was a retention account or liquid assets held on trust. Where funds have been held in a separate bank account, insolvency practitioners are administering the funds for the benefit of payees.
- There are no cases we have identified of adjudicators enforcing the intent of the Retention Regime.

5.2 Overview

The second area of this review was in regard to compliance with the Retention Regime. While this review is not focused on whether individual market participants are complying with the Retention Regime, KPMG has examined how participants are complying with respect to the two main aspects of the legislation.

- the obligation to hold retentions on trust; and
- the keeping of accounting records of retentions held that are readily available, comply with generally accepted accounting practices and are auditable.

It is also important to understand the compliance amongst different groups of market participants. To this end the review also considered the compliance of head contractors, subcontractors and principals, as well as how insolvency practitioners and independent adjudicators were enforcing the intent of the legislation.

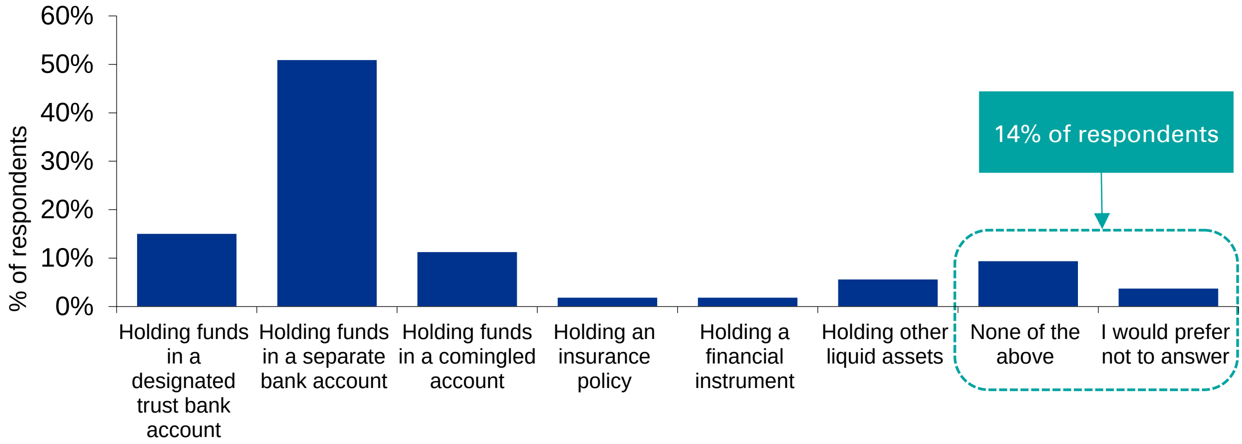
Finally, KPMG examined what the main drivers of compliance with the Retention Regime are and what barriers to compliance exist.

5.3 Results

5.3.1 Methods for complying with the Retention Regime

There is a general perception in the industry, especially from subcontractors, that a significant number of head-contractors, particularly small to medium sized businesses, are not complying with the Retention Regime. To test this perception, KPMG asked survey participants who are holding retentions how they were complying with the regime. Respondents had the option to select multiple answers if they complied in more than one way. Respondents also had the option to not answer the question.

Figure 9: How respondents are complying with the Retention Regime



The majority (77%) of respondents are complying by holding retention monies in a bank account, whether that be a separate account or comingled. Interviews revealed that bank accounts included both general trading or savings accounts and term deposits.

Fourteen percent of respondents who are holding retentions answered "none of the above" or "I would prefer not to answer". Given all generally accepted ways of complying with the legislation were covered by the other answer options, it could be inferred that those who selected these two options are not compliant with the legislation.

In 2018 and 2019, BDO issued a survey to construction industry participants (including construction companies, subcontractors, suppliers, and consultants) to provide insights on a range of issues including margins, operational issues and the Retention Regime. In the survey, BDO asked the survey participants how they were complying with the Retention Regime, In the 2019 survey, 7% answered that they would prefer not to answer this question, down from 28% in the 2018 survey. BDO also interpreted a 'I would prefer not to answer' response as non-compliance.

Our survey results and the BDO survey results both indicate a high proportion of construction companies are complying with the Retention Regime.

Other liquid assets

Five percent of respondents advised they were holding other liquid assets. Liquid assets are not defined within the CCA, but most interviewees believe the only liquid assets available for a construction company are cash or cash equivalents and any other assets would not meet the requirements of a 'liquid asset' for the purposes of the CCA. Therefore, the 5% that answered that they were holding other liquid assets, may not necessarily be complying with the Retention Regime (KPMG note as part of our pre-implementation review of the Retention Regime for MBIE in a report dated 10 October 2016, we considered what could potentially constituted a liquid asset and refer you to this report for this analysis.)

To further consider compliance, KPMG asked survey respondents to state if they were holding sufficient funds, liquid assets or financial instruments at 31 March 2019 to comply with the Retention Regime. Only one respondent (or 1%) selected the option "I would prefer not to answer", all other respondents either said yes or that they hold no retentions. This suggests that some participants may have the means to comply, but have not placed the funds on trust and will not do so until such time as the business was in a position to need to protect the funds.

Commingling

Eleven percent of survey participants hold funds in a commingled account. In addition, in BDO's 2019 survey a high proportion of respondents advised they had sufficient cash but they were not always holding the funds in a separate account. During interviews, some larger participants advised they used the treasury function of their parent to manage retention funds and, in some instances, this involved commingling. Commingling of funds is allowed under the CCA; however, this method of compliance creates a greater degree of risk regarding whether a trust has been created over the funds and whether the funds will be available for subcontractors on insolvency.

Complying Financial Instruments

There were very few respondents who comply by holding an insurance product or financial instrument, which may be driven by the limited number of insurance or financial products in the market. Please refer to section 6.3 of the report for further information.

5.3.2 Requests to inspect accounting records

In the previous section of this report it was indicated that there may be a gap in the awareness of both payees and payers of the obligation to keep auditable accounting records of retention funds and the right to inspect these records. Here compliance with this part of the legislation is examined.

Firstly, it is important to note that the legislation includes a right for a payee to inspect the retention accounting records of a payer and that the payer must maintain those records in compliance with generally accepted accounting practices. The records should also be auditable. However from our survey and interviews, KPMG identified that, rather than requesting to inspect retention accounting records, most requests made by payees are for confirmation that retention funds are held on trust, as opposed to a request to inspect records.

KPMG asked payees in the survey how often they make requests to confirm funds are held on trust and how often they make requests to inspect records. Additionally, payers were asked how often each type of request is received.

The results (shown below) show that both types of request are used sparingly. As highlighted in the awareness section, the main reason there are a lack of requests is due to competing commercial factors, namely not wanting to impact customer relationships or management of priorities.

As an example, one head contractor interviewed noted that only three requests had ever been received to confirm that funds were held on trust. All were in relation to projects that were undertaken outside of the company's home region and the requests were from subcontractors it did not regularly contract with. Other head-contractors indicated that only a handful of requests (maximum of 12) had ever been received and there were increased volumes of requests around year end or following Eberts failure. This suggests that subcontractors' behaviour is at least partially driven by their concern for the financial position of their head contractors or by reminders from their accountants. Typically head contractors are working on multiple projects at any one time, each of which involve a significant number of subcontractors, often in the hundreds.

The following two graphs (figures 10 and 11) show the response from payers and payees to the survey questions in respect of enquiries and inspections of trust funds. We have distinguished enquires from inspection as they have are two distinct types of requests. The first graph shows responses to questions regarding how often payees enquire with payers as to whether funds are held on trust and conversely how often these requests are received from payers by payees.

Figure 10: Payees enquiring about trust

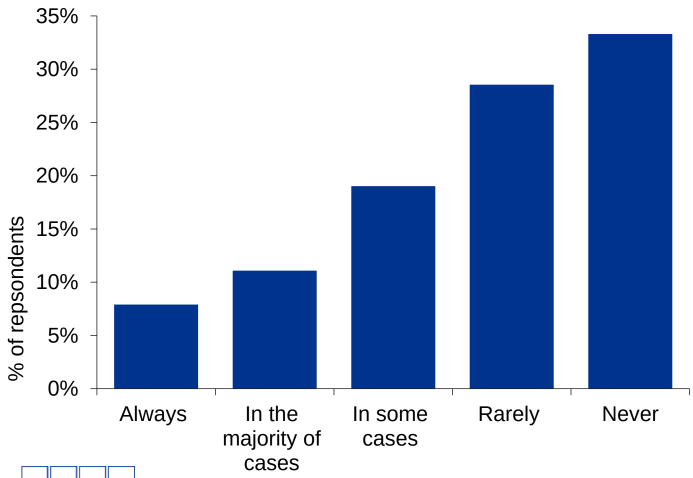
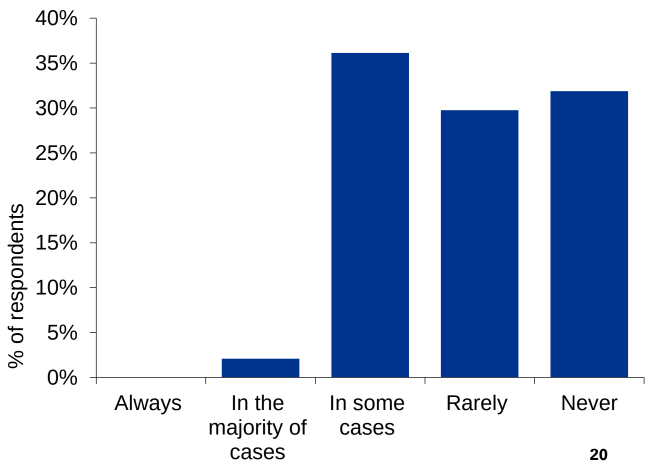


Figure 11: Trust enquiries received by payers



The next two graphs (figures 12 and 13) show the response from survey participants to the question on how often payees make a request to inspect the accounting records of payers and conversely how often payers receive such requests from payees.

Figure 12: Payees request inspection of records

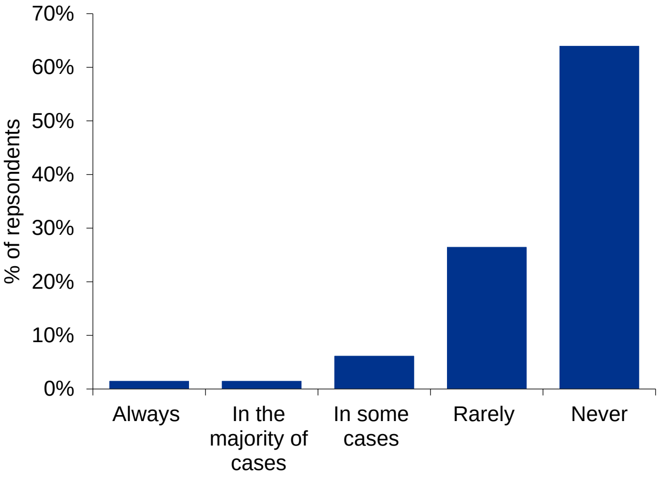
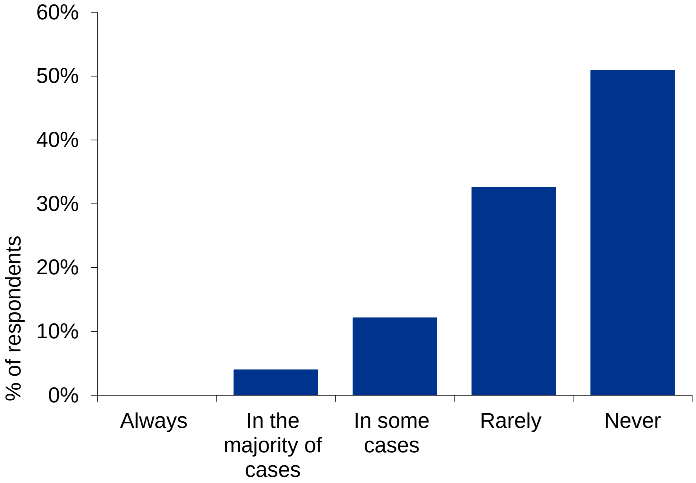


Figure 13: Payers receive request to inspect records



The survey did not provide detail on what was provided when these requests were made so we used the interviews and focus groups to establish the types of responses that were provided by payers or received by payees. The following four types of responses were reported:

- Records of retentions held from the accounting system and a bank statement detailing funds held in a retentions trust account;
- A written response confirming funds were held on trust. The nature of the responses varied, with some parties detailing amounts held and the bank account, to some that only provided a positive confirmation with neither supporting documentation nor confirmation of the amount of retentions held;
- A defensive response wanting to understand why the request was being made; or
- No response.

When an insufficient response was received, payees typically did not have an appetite to follow it up due to the perceived risk of impacting their relationship with the payer or reprioritised the request and often forgetting to follow up.

KPMG have been provided with examples of responses that subcontractors have received from contractors, which illustrate the variation in responses and the potential inadequacy of some to comply with the legislation.

Record keeping

Given the ability to inspect accounting records of payers is rarely used, it is hard to draw a conclusion regarding the quality of record keeping, and whether they are prepared in accordance with generally accepted accounting practices and are auditable. KPMG however asked payers how they were complying with the record keeping provisions in the regime as part of the interview process. The common methodologies for compliance included;

- Recording retention payables in the accounting system, in most cases confirming the party for which the retention was held, the amount and the date due for payment. Some accounting systems included functionality which allowed the payer to distinguish the retentions associated with contracts entered pre and post implementation of the regime, otherwise manual spreadsheets were used to make the distinction; and
- Monthly reconciliation of the retentions payable balance (for post implementation contracts) with the funds on trust (which most often were held in a separate bank account);

In some cases funds were monitored through the month to ensure that there was always sufficient funds to cover the total retentions balance, or a buffer was held.

KPMG note that depending on how contractors distinguished between contracts pre and post 31 March 2017, this could result in some subcontractors' retentions not being properly withheld on trust. For example, one head contractor only retained retentions on trust for subcontractors when the contract with the principal was on or after 31 March 2017, as oppose to date of the subcontract.

5.3.3 Adjudicators reinforcing the intent of the Retention Regime

KPMG asked interview participants if they had been involved in adjudication in relation to retentions since the introduction of the legislation and what their experience of this was. In addition, adjudicators were spoken with.

KPMG was advised of one adjudication in which the Retention Regime was raised (one party wanted the head-contractor to change their reporting processes to positively report on retentions withheld). However, no further evidence was provided regarding adjudications involving the Retention Regime. Interviewees advised that it is unlikely the provisions would be addressed in an adjudication, as adjudications tended to focus on issues concerning contract interpretation, defective work, and time related costs. When adjudications concerned retentions, the focus was on release of them or quantum due.

All interview respondents confirmed that they had no cases with adjudicators in relation to retention disputes.

5.3.4 Insolvency practitioners enforcing intent of legislation

Since the introduction of the Retention Regime, there have been a number of construction firm insolvencies, the highest profile being Ebert and Arrow.

From interviews with insolvency practitioners involved in these and other matters, it appears there is generally strong knowledge across the profession of the Retention Regime. The industry body, the Restructuring, Insolvency and Turnaround Association of New Zealand has run a number of sessions on this topic.

The only high profile instance of Court directions being requested on how to handle retention monies is in the case of Ebert, the outcome of which is highly publicised. Some other matters have been dealt with without requesting Court directions. All the insolvency practitioners we spoke with had investigated whether there was a retention account or liquid assets held on trust. Where funds have been held in a separate bank account, insolvency practitioners are administering the funds for the benefit of payees.

Further information on the retentions position in insolvencies, including the actual or likely outcome for retention creditors, is detailed within the subsequent sections of this report.

5.3.5 Directors ensuring that their firms are complying with the Retention Regime

It was evident amongst the contractor and most of the principal group that we interviewed, that compliance was either initiated or monitored by the directors or the governance body and this was a key driver for compliance (noted below). In addition, the majority of the responding group to the survey were director or senior executive level, and given the high level of compliance identified, this would support that directors are ensuring compliance with the regime.

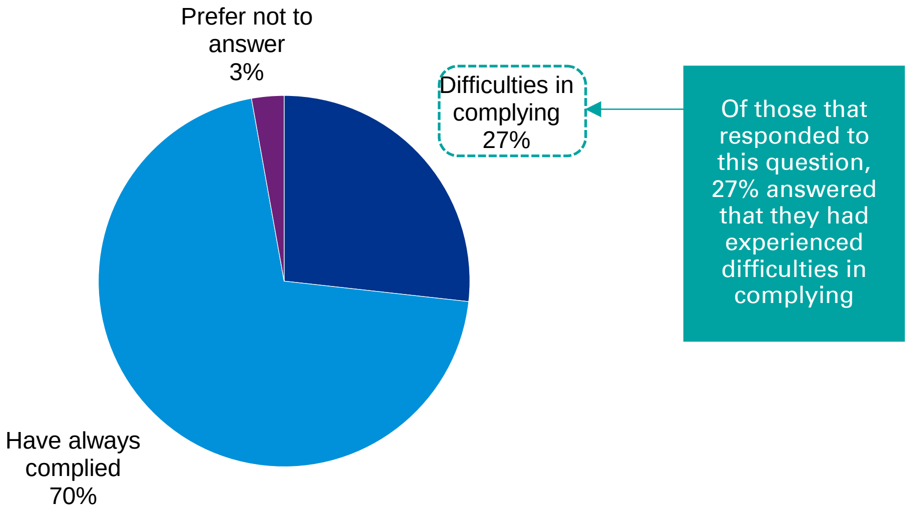
5.3.6 Barriers to compliance

KPMG identified barriers to compliance through:

- asking survey respondents if at any point they had difficulties in complying with the Retention Regime, and what caused the difficulties; and
- asking interviewees and focus groups what barriers may exist for compliance.

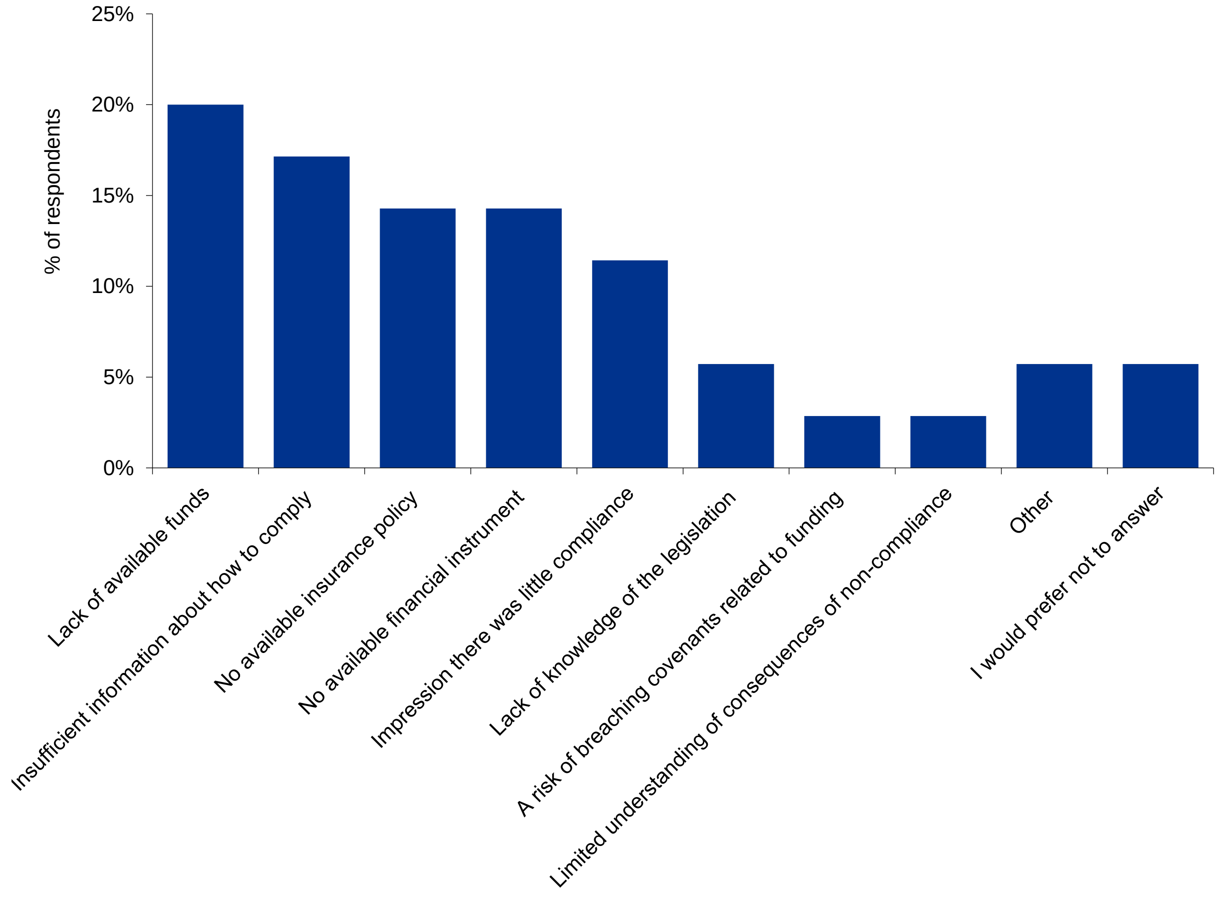
Refer to Figures 14 and 15 below for summary responses from respondents regarding whether they have had difficulties in complying with the regime and the reasons for their difficulties.

Figure 14: Whether respondents have had difficulties in complying with the Retention Regime



The results of this question indicate that 27% of respondents who hold retentions have at some point in time had difficulties with complying.

Figure 15: Reasons respondents have had difficulties in complying with the Retention Regime



The reasons for difficulties are varied but the most common reason cited was that a lack of available funds inhibited compliance. 42% of respondents who indicated they have had difficulties selected multiple answers, indicating there was no single factor that caused non-compliance.

When KPMG asked what barriers may exist for compliance in the interviews and focus groups, similar responses to the survey were identified. The barriers encountered primarily related to:

- Lack of funding/working capital;
- Insufficient information/knowledge of how to comply;
- Impression there was limited compliance;
- A lack of maturity of the corporate governance function; and
- Lack of insurance or financial instrument products.

KPMG noted in the interviews that there was an increased weighting towards the lack of penalties for non-compliance in the legislation being the main reason for non-compliance. However, this response was primarily received from subcontractors, who in a number of cases perceived there was non-compliance but did not have evidence to support this. Rather than being a barrier, a lack of penalties may reduce the incentives to comply. A number of interviewees commented that if a successful claim is pursued against directors of a failed business for non-compliance, then this would likely act as a driver for compliance.

KPMG further considered insolvency outcomes (supported by interview evidence), and it became apparent that there may be unintended non-compliance or difficulties in complying as a result of the following:

- It is common practice for a retentions account to only be reconciled once a month. Where this happens there can be a difference in timing between when retentions are deducted from a party and when the funds are deposited into the retention trust account. For example payments to subcontractors are made on the 22nd of the month and the retentions account is reconciled on the 31st of the month;
- insufficient records held to determine the exact amount of retention funds that should be held on trust. KPMG are aware of a number of businesses running manual spreadsheets of retentions which can lead to errors;
- contracts with subcontractors not correctly identified in the accounting system as being entered into on or after 31 March 2017; or
- a lump sum being held on trust has not been topped up to match the exact amount required to be held under the Retention Regime.

The above feedback indicates that even when entities have an intent to comply, there may not be full compliance with the legislation at certain points in time. This point is substantiated by what has been seen in some recent insolvencies. For example, in Ebert the funds not transferred to the retention trust account included:

- Retentions in the month prior to receivership that were calculated but not transferred; and
- Retentions incorrectly classified as related to pre 31 March 2017 contracts.

This report examines the position of retentions in insolvencies in more detail in the subsequent sections of this report.

5.3.7 Drivers for compliance

We note a number of drivers for compliance are the inverse of barriers for compliance and therefore the barriers section provides evidence to support the drivers. In addition, interviewees were asked what the drivers for compliance are, many of whom confirmed the inverse relationship to barriers.

Consistent drivers identified included the following:

- Businesses were adequately capitalised or had parent company support so compliance was not seen as a significant drain on cash flow and, therefore, compliance simply formed part of the general compliance framework for the business;

- Directors requiring compliance and regular reporting of compliance to them. This is especially true of larger businesses who have independent directors on their boards;
- A desire to show good corporate governance and protect reputation of the business;
- To demonstrate sector leadership;
- Banks requesting that customers comply and in some instances insisting a separate retentions account is set up; and
- Principals requesting confirmation of how head-contractors are complying and examining compliance as part of their procurement processes.

6 Behaviour change

6.1 Key findings

- Banks have changed their behaviours as a result of the Retention Regime and some are positively encouraging compliance across the construction sector.
- While construction firms have an appetite to use a complying financial instrument, there have been limited products available and uptake in the market.
- Where there have been clearly identified retention accounts, insolvency practitioners have taken steps to administer these accounts to enable subcontractors to recover retention funds due.
- The Ebert decision has highlighted a number of issues with the Act, some of these issues may be addressed over time through case law. One of the key issues highlighted is that the Act does not reference the insolvency provisions within the Companies Act 1993 and Receiverships Act 1993 and, therefore, does not provide appropriate mechanisms to administer the retention account on insolvency. The costs of the Ebert Court process has been funded from the retention account and therefore reduced the funds available for subcontractors.
- The most noticeable change in behaviour of payers is the actions they have taken to comply with the regime. At a contracting stage there have been some changes observed, with some construction companies seeking confirmation of compliance before entering a contract. Beyond this, there were minimal behavioural changes observed for payers and payees that can be attributed to the Retention Regime.
- Boards have generally driven compliance with the Retention Regime as part of their corporate governance practices. Larger more sophisticated business have amended their policies and procedures to specifically address the risks arising from the Retention Regime.

6.2 Overview

The third area of this review is gather evidence on the behavioural change that has occurred since the introduction of the Retention Regime, focussing on the changes in attitude and behaviour of payers, payees, directors, accountants, liquidators, banks and insurance providers.

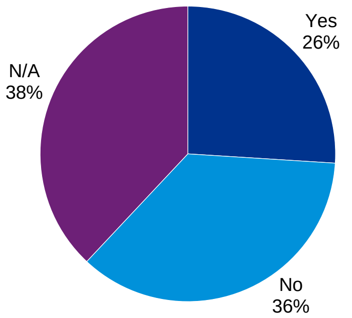
The Retention Regime was introduced, in part, to change behaviours in the construction sector relating to undercapitalisation and low price-tendering, which were considered to be supported by the use of retention money as working capital.

6.3 Results

6.3.1 Behaviour changes from banks

In the survey, KPMG asked respondents whether the Retention Regime had impacted bank covenants, or other agreements related to funding, with 26% of survey respondents observing an impact on their funding and/or covenants. Banks are generally reluctant funders to the construction sector, but do provide performance bonds and bonds in lieu of retentions which are supported by the construction company's balance sheet. The Retention Regime is expected to impact funding and covenants, given the reduction in cash available. Interviewees remarked that banks are tightening lending criteria to the sector, but this was not due to the regime and was driven by the current industry risk profile.

Figure 16: Whether respondents have observed an impact on bank covenants or other agreements related to funding



In order to understand what changes banks were making to covenants or funding and how they were responding to the Retention Regime, KPMG interviewed a range of staff from four banks. While KPMG spoke with a range of staff, due to the size and complexity of each banking organisation, the views expressed may not capture all the activities the banks are undertaking in response to the Retention Regime. The staff primarily engaged with were from property finance teams who provided development funding to principals. While these staff had significant insight into the overall construction sector, some of these staff were not lending direct to contractors or subcontractors so were unable to comprehensively comment on levels of compliance or means of compliance for these parties.

Banks were generally concerned about not wanting to assume any risk as a constructive trustee under the regime or otherwise have imputed knowledge of non-compliance. This risk impacted what steps the banks were taking with regards to the compliance of their customers. This potential risk was highlighted by legal firms during the interviews as well.

Overall, the evidence obtained indicates that banks are considering compliance with the Retention Regime as part of their lending decisions to the sector, with some banks taking a more pro-active role to encourage compliance. While banks are taking some steps to encourage compliance, they are generally not actively monitoring compliance for their customers, in order to avoid taking on any constructive trustee role.

Where banks are funding any property development projects, they are seeking some evidence from principals and head contractors to confirm compliance with the regime. The level of evidence requested varied from bank to bank. Some of the banks interviewed sought representations and warranties from contractors and clients before any draw downs, in some instances this included from representations regarding general compliance with all laws and obligations. Another bank's policy was to use the project quantity surveyor to undertake spot checks to confirm retentions are being held on trust.

Two banks took more active steps with construction clients (including principals), by requesting their clients open a separate bank account or use a solicitors' trust account for any retention funds to be paid into.

KPMG also noted a range of other behaviours, as follows:

- In two instances, clients were actively encouraged by their bank to comply prior to becoming insolvent;
- In one instance a bank became aware of a client transferring funds from a retention trust account to a subsidiary. The transaction had the effect of creating a receivable balance from the subsidiary to the parent, which the client considered fulfilled the requirements of a liquid asset under the Act. However, the bank intervened in this transaction and required the subsidiary to return the funds to the retention trust account;
- Banks are sometimes asked to provide confirmation that funds are being held on trust and the banks are providing this confirmation; and
- In the Ebert case, the bank initially funded the application for directions by the Receivers.

In most instances, retention trust balances are not being specifically excluded from the banks' security, except where the borrower has requested this from the bank for which there were some examples. However, the banks KPMG spoke with recognised that any specifically identified retention funds that are in a separate account will sit outside their security. As an example, in the case of Ebert, the bank has a secured claim of $6.1m and the retention trust fund of $3.68m has been recognised as belonging to subcontractors.

However, a number of interviewees expressed concerns that where there is comingling of trust monies and general trading funds, there may be difficulty establishing who has priority over these funds and there is no case addressing this in the context of the retention regime. To date, KPMG is not aware of any instances where a dispute has arisen between an insolvency practitioner and a bank in relation to the entitlement to funds. As such the Courts have yet to consider this issue and no case law has been established.

6.3.2 Behaviour changes from insurers

From our desktop research, there are only two insurers that offered complying instruments in accordance with the Act, one of who was CBL Insurance Limited (in Liquidation) ("CBL"). At the time its liquidation, KPMG understand CBL had written a number of policies into the market.

While there is another retentions product in the market and there have been requests to the insurer to provide insurance, to date the insurer has not written a policy because they cannot rely on the financial stability of those requesting the policy.

There are concerns that the requirements for a complying financial instrument impose a significant administrative burden (relating to adding parties to the policy and ensuring each retention was covered) which may be a barrier to utilising an instrument.

Another insurer is in the late stages of developing an insurance product to respond to the Retention Regime. A number of participants KPMG spoke to in the construction market were interested in being able to utilise an insurance product to manage their retentions balance. This would allow the release of any cash in the retention trust fund to better support the working capital requirements of the business.

6.3.3 Behaviour changes from insolvency practitioners

From our research, KPMG only identified a limited number of insolvencies (less than 10) where the insolvent company was required to withhold retentions, with Ebert and Arrow being high profile examples. Based on Companies Office data, between January 2017 and February 2019, 4,265[12] companies entered an insolvency process. Of these companies, 2,277 (equivalent to 53% of the insolvencies) provided a business industry code ("BIC"). Of the 2,277 companies with a BIC, 586 had a construction related BIC (equivalent to 26% of companies). Given the number of construction company insolvencies, there may be further examples where retention money was required to be held.

To consider the behaviour of insolvency practitioners in cases involving retention funds, KPMG interviewed a number of those appointed as receivers, voluntary administrators or liquidators and reviewed their reports issued to creditors.

Ebert Insolvency

On 31 July 2018, the Bank of New Zealand appointed Lara Bennett, John Fisk and Michael Longman of PwC as receivers of Ebert, pursuant to the powers under a general security agreement. At the date of receivership, Ebert had withheld $4,466,071 of retentions for contracts entered into on or after 31 March 2017, which were categorised as follows:

- $3,678,833 for retentions that were reconciled and transferred into a retentions account, including $68,902 of retentions which were 'released' within its financial accounts but not paid;
- $170,340 of retentions not withheld due to the subcontracts being wrongly classified as being pre 31 March 2017;
- $475,000 for retentions that were calculated but not transferred for work completed during June 2018; and
- $380,000 for retentions that were not calculated or transferred for work completed during July 2018 (i.e work completed during the month of receivership).

KPMG also note a further $4.858m of retentions were withheld for contracts entered into prior to 31 March 2017, for which there was no requirement to withhold these retentions on trust in addition to unsecured trade creditor claims of $24.52m at the date of receivership.

The receivers of Ebert applied to Court for directions due to uncertainties regarding whether the receivers could administer the fund, pay their fees and expenses in managing the fund, and who had entitlements to the fund. The receivers sought directions to: seek appointment as receivers to manage and distribute the fund; confirm which

[12] These numbers are overstated, as the data counts the number of insolvency events during the period. This results in a company that entered receivership and liquidation being counted twice.

subcontractors have a claim on the fund; and confirm how to distribute the fund. In the absence of a Court order, the receivers would not have been able to administer the fund or deduct their costs in managing and distributing the fund.

The Court made an order appointing the Ms Bennett, Mr Fisk and Mr Longman to be receivers of the retention trust fund and allowing them to deduct their fees and expenses in administering the fund. The Court decided that only the retentions that were properly reconciled and transferred were held on trust for subcontractors. As a consequence, subcontractors with retentions totalling $856,141 did not have an interest in the funds in the retention account.

In the Ebert case, subcontractors are due to receive $3,678,833 (excl GST), subject to the fees and expenses of the receivership. The regime has therefore resulted in a return to subcontractors for most of the calculated retentions, whereas normally there would have been no return to subcontractors. As of 11 May 2019, the receivers had made an interim distribution totalling $2,309,601 (incl GST) to eligible subcontractors.

Arrow Insolvency

On 28 February 2019, Andrew Bethell, Andrew McKay and Colin Gower of BDO were appointed joint and several administrators of Arrow by board resolution. Mr Bethell, Mr McKay and Mr Gower were subsequently appointed liquidators at the watershed meeting held on 6 June 2019.

According to the liquidators' first report, Arrow held $4.53m in a separate bank account which represents all amounts required to be withheld by Arrow for contracts entered into on or after 31 March 2017. We understand the liquidators are administering the retention fund as agents of the Company and are not seeking a Court order to support this.

Corbel Insolvency

On 3 December 2018, Andrew Oorschot of Ashton Wheelans was appointed liquidator of Corbel Construction Limited (in Liquidation) ("Corbel") by special resolution of the shareholders. Corbel was holding $110k in a retention account. At the date of liquidation, Corbel had withheld $333k of retentions for contracts entered into on or after 31 March 2017, which were categorised as follows:

- $110k for retentions that were reconciled and transferred into a retentions account;
- $106k for retentions not withheld due to the subcontracts being wrongly classified as being pre 31 March 2017; and
- $117k for retentions that were calculated but not transferred for work completed prior to liquidation.

The liquidator believes the directors have an obligation to make good the shortfall in the retention account of $223k and is pursuing the directors for this amount[13]. No legal action has yet been commenced in relation to this claim.

The liquidator will additionally be making an application to Court for confirmation of entitlement and authority to administer the funds in the retention trust account. Recovery for subcontractors will therefore be impacted by the costs of this process.

Other insolvencies

KPMG is aware of a number of other insolvencies where construction companies who had entered into contracts on or after 31 March 2017, but the companies have not withheld retention money on trust. Some of the non-compliance has been attributed to transition issues (i.e whether the contract is post 31 March 2017 and therefore captured). In one instance, while retentions were not correctly withheld, because of defects in workmanship from subcontractors, the retentions were considered to be unlikely to be payable to the subcontractors.

General comments

All the insolvency practitioners KPMG spoke with were aware of the requirements of the Act and had investigated whether there was a retention account or liquid assets held on trust.

As the regime is relatively new, there remains uncertainty from insolvency practitioners around entitlement to act, whether they are entitled to fees and expenses for administering the fund, and the impact on directors of non-compliance. As case law develops, some of this uncertainty may be addressed. Some of the issues encountered in current insolvencies are driven by transition issues (with not all retentions required to be withheld on trust), which should reduce over time once all construction contracts are subject to the Retention Regime,

[13] Ashton Wheelans *Corbel Construction Limited (in Liquidation) Liquidators Six Monthly Progress Report for the Period 3 December 2018 to 2 June 2019* (New Zealand Companies Office, July 2019).

While the liquidator of Corbel is pursuing the directors of a construction company for not withholding retentions on trust, KPMG is not aware of any other insolvency practitioners considering actions against directors for non-compliance with the Act.

The Ebert case highlighted a number of issues with the Act, including the following:

- Uncertainty as to who can administer the trust and whether fees and expenses can be paid from the retention account. Some of this uncertainty has been addressed by the Ebert court decision;
- While it was intended that the regime would create 'deemed trusts', this was rejected by the Court and payers needed to take positive steps to create the trust;
- In order to create the trust and provide protection for subcontractors, retention monies need to be withheld and where no payment is made, there can be nothing withheld on trust;
- Deficiencies in the accounting or record keeping processes of payers may impact who has entitlement to the retention account;
- The retention account was funded on a GST exclusive basis, but retention payments to payees are made on a GST inclusive basis. The receiver in Ebert was able to reach an arrangement with the IRD to manage the GST impact by recovering the GST portion from Inland Revenue as a GST refund. However, only receivers, liquidators or voluntary administrators (as agents of the insolvent company) would be able to receive GST refunds from Inland Revenue. Therefore, if a third party was to administer the retention account, they would not be able to receive GST refunds and pay a GST inclusive amount to subcontractors (unless the retention account was funded on a GST inclusive basis); and
- Uncertainty as to who has entitlement to any interest earned on the retention trust fund post insolvency.

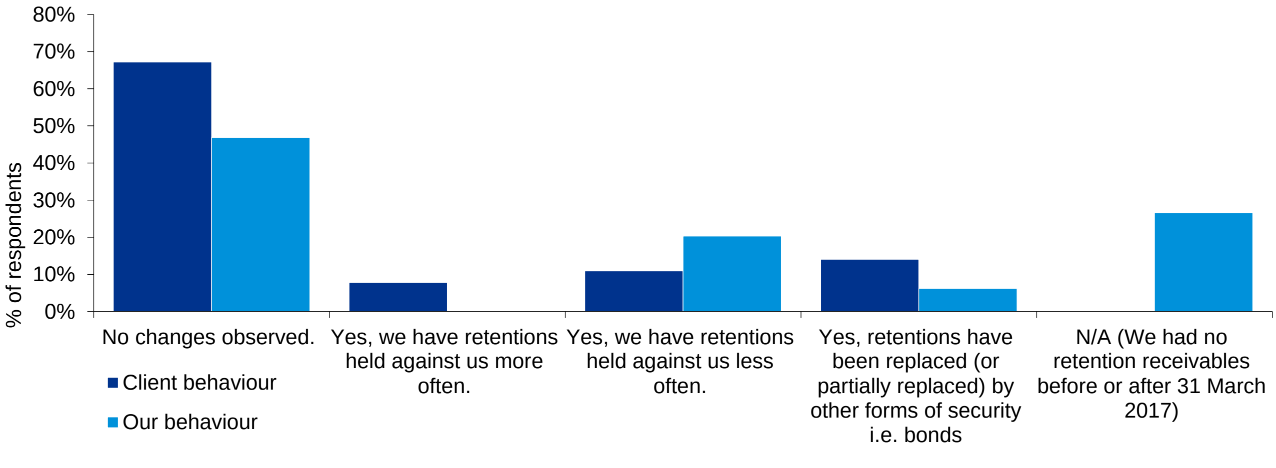
A further issue that has been highlighted during interviews is that there are no mechanics in the Act for addressing what happens to the retention fund when the head contract is either cancelled early or is assigned to a new contractor.

6.3.4 Behaviour changes from payers and payees

The Retention Regime has required construction companies and principals that withhold retentions to hold these retentions on trust for the benefit of head contractors and subcontractors. Based on our survey, BDO's survey[14] and insolvency evidence to date (see section 5.3.1 above), a high proportion of companies have changed their behaviour to comply with the requirements of the Act.

In the survey, KPMG asked participants whether clients or head-contractors had changed policies or behaviours towards the levels of retentions held, or whether they had changed internal policies or behaviours towards the levels of retentions held against subcontractors. The survey evidence is consistent with information provided during interviews.

Figure 17: Whether respondents have observed a change in the levels of retentions held



[14] BDO *The BDO 2019 Construction Survey Report* (BDO, 2019).

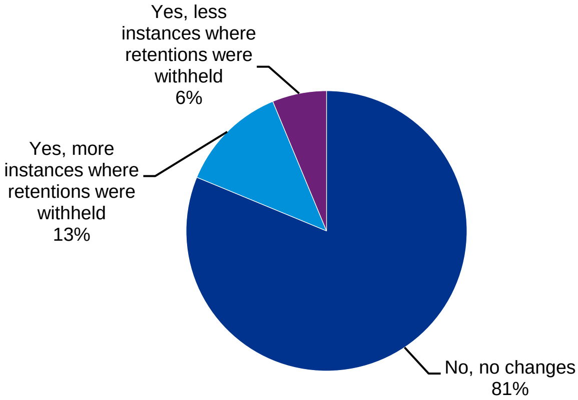
While the survey has indicated there has been some change in behaviour regarding levels of retentions withheld, KPMG notes that some of these changes may not be attributable to the retention regime. In interviews with industry participants, subcontractors advised they have been able to contract out of retentions, but these subcontractors tended to be in trades where retentions were not consistent with the work being performed (i.e pre-cast concrete) or where there was less subcontractor competition and, therefore, the subcontractor had greater bargaining power. They did not attribute the changes in retentions held to the Retention Regime.

Many interview participants noted that subcontractors were more aware of contractual rights which meant retentions were given more focus in contractual negotiations. However, retentions are a small aspect of overall contractual negotiations compared with larger issues relating to: penalties for time delays; price; and management of certain construction risk and assumption of risks existing already (i.e. geotech). Also because the balance of power tends to reside with contractors, retentions still tend to be included in contracts. Accordingly, while there may be some behavioural change around contracting behaviours, it appears unlikely that this is attributable to the regime and is driven by market conditions.

KPMG also notes the findings in the Pye Tait Consulting report that in England there is limited evidence of widespread use of alternative mechanisms to retentions to manage risk and that only few of the alternative mechanisms have potential for standalone sector-wide alternatives to retentions[15]. On this basis, the Retention Regime appears unlikely to significantly reduce the use of retentions, given the lack of standalone sector-wide alternatives.

KPMG sought information on whether participants had noticed a change in the number of instances of retentions being withheld and not paid to them post the introduction of the regime with 81% of respondents advising they had not noticed any change in behaviour.

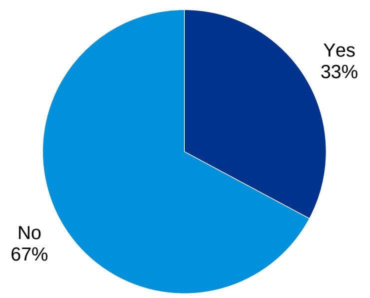
Figure 18: Respondents' view on whether the number of instances of retentions being withheld and not paid to them has changed



33% of respondents, including both head-contractors and subcontractors, had changed behaviour to seek confirmation of compliance with the regime prior to entering a contract. During interviews, limited number of interviewees confirmed this was part of their normal practice. KPMG was not provided with details of what form this confirmation took.

[15] Pye Tait Consulting *Retentions in the Construction Industry* (United Kingdom Department for Business, Energy & Industrial Strategy, BEIS Research Paper 17, October 2017). Alternatives discussed were Project Bank Accounts, retention bonds, performance bonds, escrow stakeholder accounts, parent company guarantees and retentions held in trust funds. We note retention and performance bonds are used in addition to retentions in New Zealand.

Figure 19: Whether respondents request confirmation of compliance with the regime from clients or head contractors before contracting



During interviews some instances of other behavioural changes were identified, as follows:

- A principal was seeking to cancel a construction contract with a construction company, with non-compliance with the regime cited as a partial reason for cancellation of the contract; and
- One client sought to include terms in its contract regarding how and when a construction company could request records relating to the retentions withheld.

Our analysis and findings relating to: speed and certainty of payment; warnings of financial distress; and efficiency and productivity are covered in section 7 (Early Impact) of our report.

6.3.5 Behaviour changes from directors

Interview participants noted that compliance was generally driven by the board of directors as part of their corporate governance processes with many boards seeking legal advice to confirm the appropriate approach for compliance. A few key examples were identified that demonstrated behavioural changes from directors, as follows:

- Boards amending their monthly board reporting processes to include details regarding compliance with the Retention Regime;
- Boards implementing policies and procedures for dealing with retentions on trust from subcontractors;
- Directors advised that the regime focussed their attention more on cashflow and in some cases had improved their cashflow monitoring and, for one party, this highlighted solvency issues earlier;
- One principal's board requested that as part of any tender process, contractors had to provide confirmation they were complying with the regime. The same board also requested an internal audit to confirm they were adequately complying with the Retention Regime.

The impacts above may not be reflective of all of the industry and in the main have been observed in larger more sophisticated businesses who have a formal board of directors.

6.3.6 Behaviour changes from accountants

KPMG has received limited input regarding changes from accountants, other than some participants noting their accountants had suggested they seek confirmation from payers as to compliance with the regime as part of their annual financial reporting processes.

There have been changes made to accounting systems and monitoring processes, including monthly reconciliation processes and reporting of pre and post legislation contracts, to address the requirements of the Retention Regime.

7 Early impacts

7.1 Key findings

- Cashflow for payers has been negatively impacted, and has reduced the cash buffer available for businesses to withstand any shocks, noting that the additional cash retained on trust does not support general trading activities.
- The cash impact of the regime is continuing to be felt as businesses build up the retention account balance.
- In order to fund the regime, shareholders have recapitalised their businesses, retained profits, provided funding or increased debt facilities with their banks.
- The reduced cash available in the businesses has also impacted bonding in certain instances, which may further constrain the industry.
- To date, there are limited improvements to the speed and certainty for payments of retentions but there were indications there may be some improvements over time.
- The regime has generally not provided any earlier warnings of financial distress, but has focussed boards on cashflow management and potential cashflow issues.
- The regime has provided significant protection to subcontractors from insolvency, resulting in returns to subcontractors that would not have otherwise occurred in a number of high profile insolvencies. However, there are other insolvency cases where the regime has not provided any protection because of non-compliance. Some of the non-compliance may be due to transition issues.
- There was no strong evidence of changes to the health, efficiency and productivity of the sector, but KPMG notes the impacts on working capital, bonding and protection on insolvency which may impact the health and efficiency of the sector.
- There is some evidence of unintended consequences being observed in the sector by respondents, regarding bonding, the sale of a construction business and the insolvency of another. Some of these consequences may not continue long term, given retention funds are anticipated to be fully funded in the next year.

7.2 Overview

The final area of this review is seeking insights into the intended and unintended consequences of the legislation for solvent and insolvent firms and the health of the commercial construction sector. As part of this review, we have considered the following key questions:

- In what context has there been reduced use of retention money as working capital by firms?;
- What is the current situation and trends so far for faster and more certain payment of retentions to subcontractors?;
- What is the current situation and trends so far for earlier warning of financial issues (including insolvency) in firms?;
- What is the current situation and trends so far for improved efficiency and productivity in the construction sector and can this be attributed to implementing the retentions provisions?; and
- What is the sectors view on the unintended consequences of the retentions provisions on the health of the construction sector, and are these likely to continue?

7.3 Results

7.3.1 Working capital

Based on interview evidence, retentions held against subcontractors tend to represent approximately 3%–6% of annual turnover for larger contractors and up to 10% for smaller contractors (for example, refer to the Ebert decision[16] in which Ebert was holding approximately 5.5% of retentions relative to forecast turnover). Therefore, based on the interview

[16] *Bennett & Ors v Ebert Construction Limited (in receivership and liquidation)* [2018] NZHC 2934

evidence provided, for a $100m business, it would be expected that the business would require liquid assets totalling between $3m–$6m to be held on trust to comply with the Retention Regime. In addition, the same contractor would have retentions being withheld against it, typically of a lesser value (due to the sliding scale for calculating retentions and caps on total retentions). The large majority of contractors withholding retentions that were complying, were holding cash in a separate account. The level of cash required to be withheld to comply with the regime is significant relative to profitability in the sector[17].

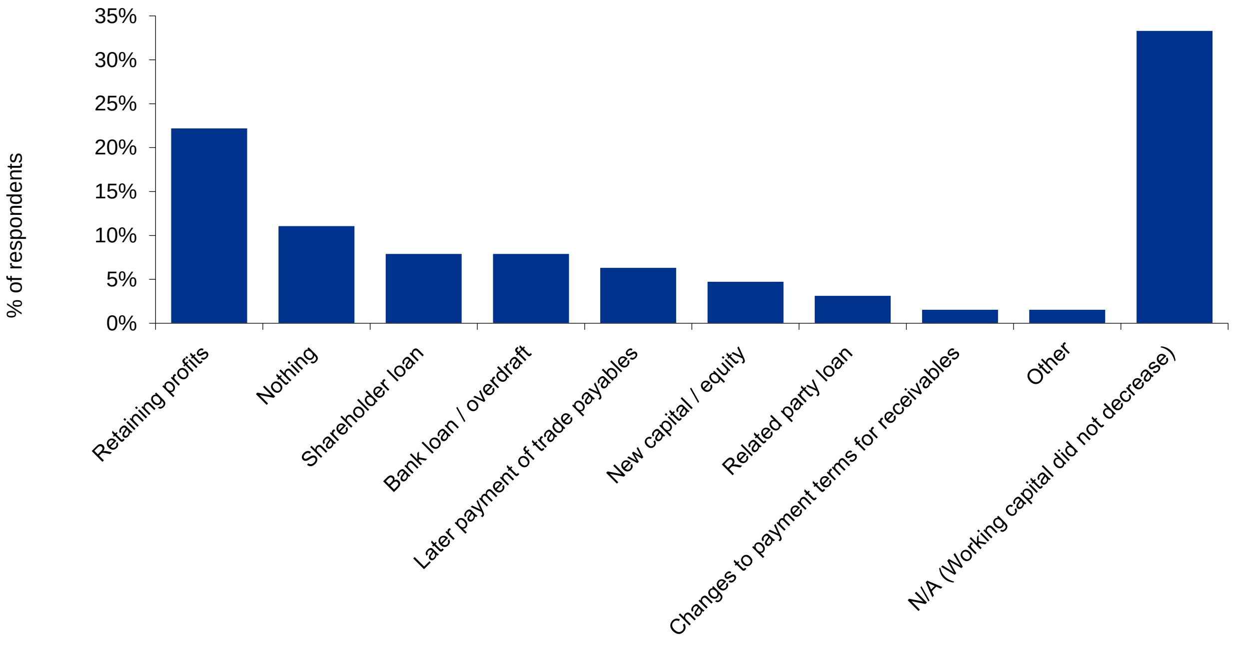
The contractors KPMG spoke with were still working though contracts that were not subject to the Retention Regime, therefore the retention trust balance was still progressively being built up. Contractors estimated that the current retention trust fund balance was between 50% - 80% of the forecast total retention value. Once the retentions trust balance has been fully funded, which is anticipated to be next year, the cashflow impact will have largely been incurred (assuming the business is stable).

In the survey, KPMG asked respondents whether there had been any change in working capital since the introduction of the regime. After removing survey respondents that were not withholding retentions and any responses that were inconsistent with other survey evidence (relating to how they addressed the working capital impact on the business), 50% of respondents had noticed a decrease in working capital. During interviews, the majority of interviewees confirmed the Retention Regime had a noticeable negative impact on cashflow, with some experiencing a significant impact on cashflow.

In order to comply with the Retention Regime, some contractors were able to utilise existing cash (see graph below). By utilising existing cash reserves, some businesses had reduced their cash buffer and, therefore, their ability to withstand one-off shocks or project losses.

Other businesses were unable to comply with existing levels of working capital and had to recapitalise, retain profits or forego dividends, while some have had to use additional debt funding. These findings were consistent with our interviews, with a number of interviewees confirming they retained profits as a means to fund the Retention Regime.

Figure 20: What measures respondents have taken to fund required amounts if working capital has decreased



[17] Based on interview evidence and existing knowledge, head contractors often bid at margins of between 3%–8% and after accounting for overheads, this left an EBITDA profit in the best case of between 1% - 4% (compare this to EY's UK 2015 construction report which indicated the top 25 UK construction companies delivered an EBITDA margin of 2.6%).

While construction businesses have recapitalised or retained profits to meet their obligations under the Retention Regime, this increased capital does not support general trading as this capital is only available to meet retention payments, remedy non-performance or provide protection in the event of failure.

There is a general industry view that contractors need to be more financially resilient to withstand one off project losses. Additionally, procurers are putting more emphasis on the financial position of potential construction providers including engaging third party experts to undertake financial due diligence. As a result, construction businesses are having to take steps to strengthen their financial position generally as well as to meet the demands of the Retention Regime.

A major contracting constraint is the level of bonding facilities available from banks. Most vertical contractors KPMG spoke with were constrained by bonding facility limits. For any bank funded developments, banks require a bank issued bond which are subject to varying facility agreements, based on either a multiple of equity, cash backed bonds or tangible assets provided as security (in some instances backed by assets outside of the contracting group). For those contractors subject to a total asset or a cash backed bonding facility, the Retention Regime has in some instances constrained their bonding capacity and ability to tender for certain contracts (unless further capital has been introduced, profits retained, or bonding is supported from assets outside of the group).

7.3.2 Speed and certainty of payment

In our survey KPMG asked respondents a range of questions relating to whether there has been a change to the speed or certainty of payment. While the majority of respondents indicated that there has been no change (see graphs below), there was some evidence of change with 15% of head contractors advising they administered payments to subcontractors faster and 19% of respondents advising there was more certainty of payment. In the event of insolvency, there is much greater certainty of payment if retentions are held on trust. The added protection from head-contractor insolvency is discussed in further detail below.

Interview participants advised that in some instances subcontractors never asked for retention monies to be repaid, leading to retentions being retained for the benefit of the contractor. In England, evidence indicates that a large portion of retentions were never paid to subcontractors because either the subcontractor never asked for the money or they initially asked for it, but did not pursue it[18].

During interviews, some contractors advised they were now likely to pay out retentions earlier as a result of the Retention Regime, given the retentions were being held on trust (under the Act, retentions on trust can only be withdrawn to remedy defects or pay the subcontractor) and there was no financial incentive to withhold retentions.

In practice, subcontractor retentions are often linked to the head contractor's practical completion and defects liability period, so that even when the subcontractor has fulfilled their obligations (including remedying any defects), the retentions were not being paid because the head contractor had not fulfilled its obligations under the head contract.

[18] Pye Tait Consulting *Retentions in the Construction Industry* (United Kingdom Department for Business, Energy & Industrial Strategy, BEIS Research Paper 17, October 2017). In Pye Tait's survey, 33% of tier 1 contractors advised that subcontractors did not ask for retentions at practical completion and 19% at the end of the defects liability period. Tier 2 and 3 contractors advised that approximately 25% of subcontractors initially asked for money, but did not pursue this.

Figure 21: Whether payers consider they administer faster payment to payees

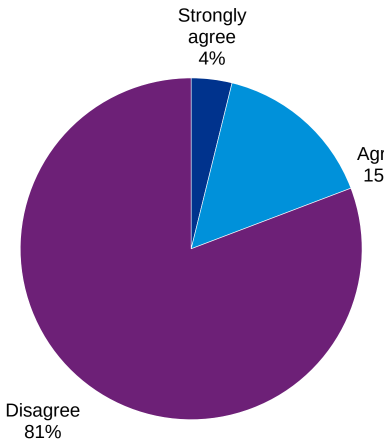


Figure 22: Whether payees consider they receive faster payment from payers

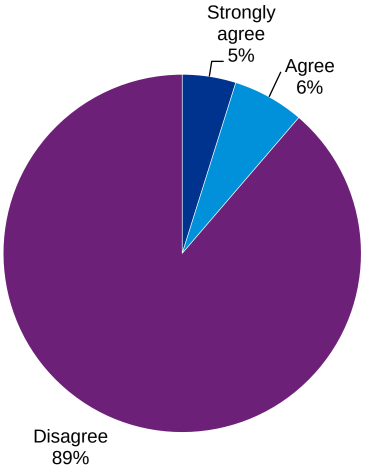
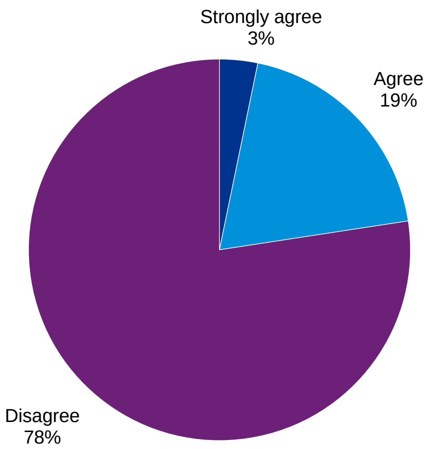


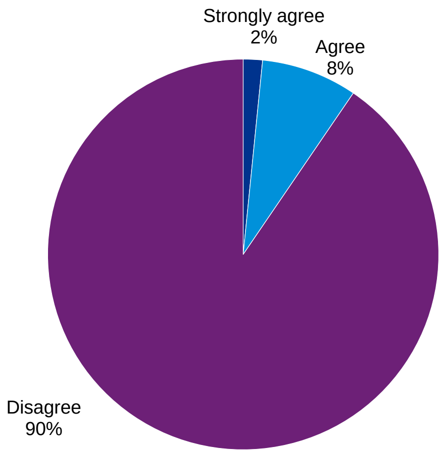
Figure 23: Whether payees consider they have more certainty of payments from payers



7.3.3 Warnings of financial distress

Survey respondents and interviewees largely advised that the Retention Regime had not provided any earlier warnings of financial issues.

Figure 24: Whether respondents consider there are now earlier warnings of financial distress



While regular requests to inspect accounting records regarding compliance with the regime could potentially indicate financial issues of clients or contractors, there has been limited use of the inspection rights and, to the extent inspection rights are utilised, it is sporadic (see section 5.3.12 above). Additionally, the information provided may not necessarily indicate financial distress (see Ebert and Arrow as examples of Companies that held retention funds on trust that became insolvent for which inspection may not have highlighted any issues). Subcontractors indicated that a more reliable indicator of distress was the slow or non-payment of monthly progress claims or industry gossip.

However, one interviewee advised the retention regime brought underlying cashflow issues to their attention earlier, this impacted their decision to appoint insolvency practitioners to the company. In some instances, contractors were more aware of their cashflow position. In our experience, better cashflow management supports decision making and provides earlier warnings of distress to all stakeholders.

Due diligence procedures for principals consider compliance with the Retention Regime as part of the procedures and non-compliance is a red flag around financial strength when considering whether to engage with head contractors.

7.3.4 Protection in the case of insolvency

Based on the evidence to date, the regime has provided better protection for subcontractors in the event of contractor failure. Cases where there has been protection are summarised below:

- In the case of Ebert, it was holding $3.68m (excl GST) in a separate bank account. As at May 2019, the receivers had paid eligible subcontractors $2.3m of initial entitlements.
- In the case of Arrow, it was holding $4.53m in trust.
- In the case of Corbel, there are $110k of funds available for subcontractors along with the prospect of further recoveries from directors.
- On 31 July 2018, Andrew Oorschot of Ashton Wheelans was appointed liquidator of Maven Interiors Limited (in Liquidation) ("Maven") by special resolution of the shareholders. At the date of liquidation, Maven was holding $30k in a retention account.

In each of the above instances, if the Retention Regime had not been in place, the retention funds would not likely have been available for subcontractors. Even if the same level of cash had remained in the business at the date of insolvency, it appears likely the money would have been subject to claims from secured creditors and therefore would not be available for subcontractors.

While the above cases illustrate the Retention Regime has provided some protection in the case of insolvency, it does not provide any protection against the larger losses suffered by subcontractors, namely the 1–2 months of unpaid claims or work in progress that is almost always not recoverable.

As noted in section 6.3.3, there are other insolvency cases where no retentions have been withheld. In these instances, the regime has not provided any protection for subcontractors. However, it is yet to be seen if any claims will be brought against the directors of these companies. If case law is established for the consequences of non-compliance and the financial implications or penalties for directors are sufficient to provide motivation for compliance, this may result in increased protection in the future.

7.3.5 Efficiency, productivity and health of the sector

Based on the survey responses, only 3% of respondents considered that post implementation there was an improvement in the efficiency and productivity of the sector. Similarly only 8% considered that post implementation there was an improvement in the health of the sector. This is consistent with the interview evidence. KPMG notes its comments in sections 7.3.1 – 7.3.4 regarding the impacts on working capital, bonding and protection to subcontractors on insolvency, as these factors all impact the efficiency, productivity and health of the sector. Furthermore, as highlighted in section 3.7.6, given the significant changes the sector has experienced over the implementation period, separating out the impacts of the Retention Regime and overall sector performance is difficult.

Figure 25: Whether respondents consider the sector is more efficient and productive

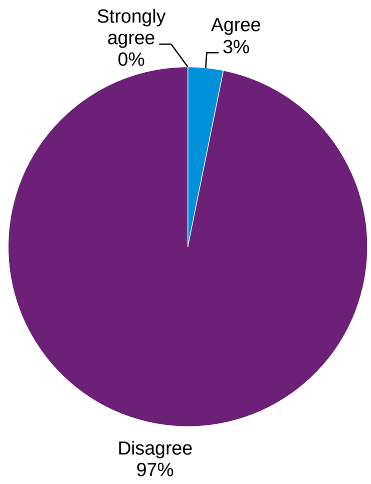
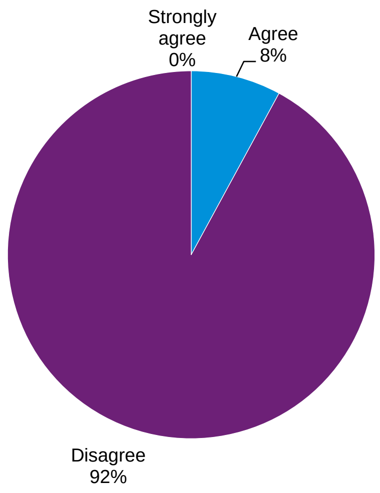


Figure 26: Whether respondents consider there is an improvement in the financial health of the sector



7.3.6 Unintended consequences

The purpose of the regime was to protect subcontractors, improve capitalisation and change certain behaviours in the sector, such as using retentions as working capital and low-price tendering[19]. Accordingly, it was envisaged that the Act would impact the working capital of construction companies and the viability of certain businesses. Parliament amended the original drafting of the Act so that it only applied to contracts entered into post implementation of the Retention Regime, allowing a period of transition so the payers could build up their capital base as the Act was implemented decreasing the risk of non-compliance and viability.

Parliament intended that companies would build up their capital base to prepare for the implementation of the Act.

Our findings concerning the intended consequences are addressed earlier in the report. KPMG has also been asked to investigate the sector's view of the unintended consequences. Prior to the implementation of the regime, various potential unintended consequences were identified [20], including the following:

- Increased construction costs to cover higher funding costs;
- Restricting the capacity of the sector to deliver construction projects;
- Shareholders choosing to discontinue their business, rather than putting any additional capital at risk;
- Use of creative payment structuring to avoid retentions, i.e milestone contracts; and

[19] Cabinet Paper "Legislative solutions to issues relating to the use of retentions in the construction market" (7 August 2014).

[20] KPMG *Contract Retentions* (KPMG, 10 October 2016); PwC "Submission to Construction Contract Amendment Act 2015, subpart 2A – Retention Money" (3 June 2016).

- Increased use of bonds and guarantees, impacting the ability of subcontractors to compete for work.

KPMG questioned interviewees regarding potential unintended consequences and notes the following:

- While interviewees confirmed there has been an increased funding and administration cost for complying, this cost has not yet been passed on into the supply chain;
- Bonding capacity is generally constrained at present and banks are tightening lending criteria to the sector (not due to the regime). The regime reduces the cash available for businesses and this constrains bonding capacity (where bonding facilities are linked to assets or cash and trust funds are excluded for calculation purposes). Generally this constraint had led some head contractors to be more cautious about which contracts they were prepared to tender for, so as to avoid tying up bonding capacity;
- The Administration and subsequent liquidation of the Arrow group of companies was partly attributed to the retentions rules reducing working capital[21] (along with high industry competition, funding an Australian company, a large loss making project amongst other issues);
- The management of a construction company advised the sale of the business by the shareholder was partially attributed to the impact of the Retention Regime;
- KPMG was advised there has been a growing use of bonds in lieu of retentions between clients and contractors, but is only aware of one instance in which this was driven by the Retention Regime. There was limited evidence of more bonds in lieu of retentions being requested by contractors. However we are aware of a number of customers in the infrastructure sector that use bonds (or global bonds for all contractors) instead of retentions, not on top of retentions; and
- While KPMG has not been made aware of any increased use of milestone contracts, one client was considering using such a contract in the future or negotiating different payment schedules to advance cashflow.

As noted previously, for stable businesses the cashflow impact will largely have been worn once retention accounts are fully funded. Therefore, it is anticipated that the cashflow and bonding impact may not have a long term impact.

It should be noted that the unintended consequences referenced above are the views of the sector based on the interviews KPMG undertook.

[21] Chris Hutching "Arrow debts rise to $40m - administrators advise liquidation" (4 June 2019) Stuff <www.stuff.co.nz>.

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