

# CONSTRUCTION ALERT

The power of industry experience

Issue Two

## FINANCIAL DUE DILIGENCE

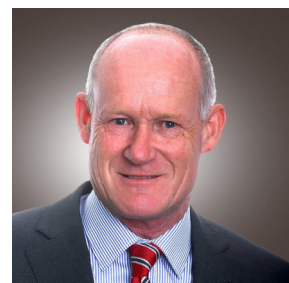
The crest of the wave in the financial cycle for the building industry is the period of heightened financial risk. It is a period when:

- ▶ Staff and skills shortages are at their greatest
- ▶ Cost increases of subcontractors and materials are rampant
- ▶ Staff shift to new employers seeking higher pay
- ▶ Balance sheets and cash flow become stretched by increasing activity and the need to finance higher levels of work in progress, accounts receivable and retentions receivable
- ▶ Both construction companies and subcontractors are committed to completing contracts which were negotiated months ago at tight margins and their cost structures are rising.

Property owners and their consultants have increasingly been requesting references, reviewing financial statements and conducting financial due diligence on construction companies. The information building companies have been prepared to provide has varied with some allowing inspection of their financial statements and others regarding this as highly confidential and sensitive information. Bank references are invariably requested and if a bank reference is provided it gives virtually no information of any real value.

With the changing levels of activity as we ride the crest of the business cycle, the areas of risk move to the financial vulnerability of the subcontractors. A lot happens between tender acceptance and time to start the job with many subcontractors finding that their staff are moving to competitors for higher pay and they are having to replace those staff, if they can, with higher paid staff. The margins on committed jobs are often less than may now be obtainable and with rising costs, margins can be well below expectations.

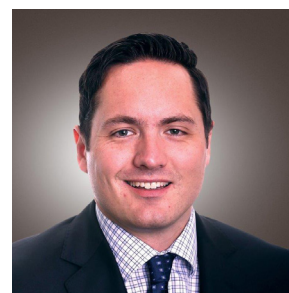
The effect of these factors plus delayed projects and a few bad debts from failures or disputes is that some subcontractors are or will be struggling. A few have closed their businesses, and more will need to. Some have and more will pull out of contractual commitments notwithstanding that there are legal obligations to perform.



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## The required response

It is important for contractors to perform financial due diligence on their subcontractors in a similar way to the due diligence being performed on them. Contractors can ill afford a subcontractor walking off the job or not being able or prepared to start, or worse still, failing during a project.

At a minimum, due diligence should include:

- ▶ Sighting IRD statements to show that both GST and PAYE returns are being filed and payments made when due
- ▶ Credit references from trade suppliers
- ▶ Have your QS do their own calculations so you know their pricing is realistic and do not accept unrealistic prices despite the temptation
- ▶ Who else are they working for and on what jobs

If subcontractors don't want you to sight their IRD statements, use an intermediary such as your accountant to view them so dollar amounts remain confidential.

Watch for other warning signs. These can include:

- ▶ Inability to provide materials due to stop credit or similar problems
- ▶ The grapevine; fellow industry companies are quick to spread stories of companies in difficulty
- ▶ Quoted prices below expected levels or below most other tenderers
- ▶ Poor quality or delayed paperwork on the project
- ▶ Overstretched across their current projects and forecast projects
- ▶ Loss of their key staff

For projects to run smoothly to everyone's economic benefit there is reliance on all parties technical ability and financial strength. A missing financial link in the chain impacts everyone. Proper financial due diligence and transparency is to everyone's benefit.

If you have any further questions, please feel free to get in touch.

All the best,  
James MacQueen

## BDO New Zealand offices



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## Call to action

Contact a member of the construction team or your BDO Advisor if you would like to discuss these issues further

[www.bdo.nz](https://www.bdo.nz)

