



## **LATE PAYMENT ISSUES OF SUBCONTRACTORS IN MALAYSIAN CONSTRUCTION INDUSTRY**

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### **Abstract**

The practice of efficient and timely payment in construction projects is a major factor that can contribute to the success of a project. Delays in payment to subcontractor(s) by main contractor and client on construction projects in the Malaysian construction industry is considered to be a significant factor of concern. It causes severe cash flow problems to subcontractor(s) and this condition may lead to a devastating impact to the contractual payment chain. Withholding or delaying payment creates financial hardship for the construction companies and its impacts are sometimes so harsh that some companies have to close down their services. The research methodology adopted was the questionnaire survey analysis based on thirty (37) respondents from selected main contractors and sub-contractors in Gombak, Selangor. The data and information were also gathered from interviews analysis. From the research findings, among the factor of late payment from the client is payment withhold by the client. Meanwhile, the factor of late payment from the main contractor is when the term of “pay when paid” is applied. To improve the payment situation, the findings of this study suggest that there must be dedicated enforcing provisions for payment delay in contracts. This is proposed by introducing the standard form of contract clause regarding payment between the main contractor and domestic subcontractor which include levying charges on overdue payments.

**Keywords:** domestic contractor, construction, late payment

## **INTRODUCTION**

Payment is about money. Generally, money is an instrument used to achieve one's goals and desire through the transaction that involves some amount of money. Parallel in the construction industry, the money survived through the return on investment from the project management that proved the profit from the construction works as been presented by Shiner (2013). Adds on, Rahman (2012) argues that the construction industry is among the profitable ones differ to other industry. It is commonly one of the main objectives for contractors to ensure their company is keeping on survive for a long term. For instance, payment becomes more crucial as they need to cover their next project and to increase their performance to be in the top ranking in construction industry. Therefore, payment has been used as an associate indicator of their output as they are reflecting the worth of contractors. Late or delayed in payment is one of the most serious crisis, which can cause the dispute between parties, bankruptcy, abandon projects and others.

The issue of late payment becomes more critical when it involves sub-contractor who new in the construction industry and did not have strong financial stability to rotate the money. Al-Hammad (1993) states that most of the contractor that win the tender has absorbed around 70% of the construction work to the subcontractor. This situation gives advantages to the main contractors where the absorb of the work allows the main contractor to pay attention to other projects. The relationship between parties generates the ideas that payment should be secured to prevent any disputes arise in the project through good communication, good schedule planning, understand the contract agreement and etc. (Metri, 2005). This ambience further proved the essential role performed by the subcontractor in completing the construction project (Ng, 2006).

According to The Association General Contractor of America (AGCA), domestic sub-contractor can be defined as the independent contractor who performs the works, normally for a portion of the work. Domestic subcontractor in Malaysia plays a significant role in activating the construction industry as the result of sub-contracting the work by the general contractor. Normally, the provision is extremely vital in the construction project as it will stand for the fairness and justice in construction work such as the provision between the main contractor and their client. Unfortunately, in construction industry, there is poor contract binding for the domestic contractor in reacting to the main contractor. There is no specific provision that allocated specifically for the use of domestic subcontractor.

This paper reports on a study of factors on late payment faced among domestic sub contractor in Malaysia construction industry, either the client or main contractor is the main contribution to this issue. This paper scrutinises the strategy adopted by domestic sub-contractor to overcome late payment issues.

This paper is structured into five sections which including the introduction to an overview of late payment issues faced by domestic sub contractor. This is followed by a review of a factors contributing to late payment issues. In the subsequent section, an extensive of the strategies adopted by domestic sub-contractor to overcome late payment issues would be conducted. Finally, the paper provides a conclusion highlighting the key findings from the study.

## **RESEARCH BACKGROUND**

Payment has been said lifeblood to construction industry which essential things to the process of construction and it also the reason of any problem arises. Although there are various rubrics given in numerous standard forms of contract regarding the payment from client to contractor, contractor to sub-contractor and others. The late payment still becomes the crucial issue in Malaysia construction industry (Din & Ismail, 2014). The issue becomes more complicated when there is no contractual binding between main contractor and subcontractor in standard form of contract Public Work Department (PWD) or Persatuan Arkitek Malaysia (PAM) for domestic subcontractor. There is no obligation that explains what the punishment is if late payment occurs between them. Standard form of contract is a pre-prepared contract which legally binding between two parties, the Employer and the Contractor. All the terms and conditions in the contract has been created earlier and consider as non-negotiated contract. (Zolkafli et al., 2011).

In addition, according to the Construction Industry Working Group on Payment (2007), problem related to the payment has become top of hierarchy and affects the cash flow to all chain in contract. Supardi, Adnan & Mohammad (2010), stated that the nature of dispute consists of payment (51%), delay (19%), termination (18%), variation (13%), damages (11%), performance bond (8%), default (8%), and defect (1%). Delay in payment timeliness for construction area is likely to happen most of the time that jeopardize the effectiveness of the construction work as it failed to meet the timeline schedule. Delay can be specified as time overrun in getting completion of work that already stated in a contract, or beyond the date agreed by other parties. There is provision in PWD Form 203A (1/2010) which stated within 44 days from the valuation, the government shall make the payment to contractor. Unavailability to follow the payment timeliness affects the payment to another chain, especially to subcontractor. Since the payment has been recognised as a dominant factor for the dispute, the reason of late payment issue commonly arises from poor financial management, the phenomena of pay when paid concept, negative attitude, error in submitting claim and others (Ansah, 2011 ; Azman, et al., 2014 ; Teku, 2015).

Construction industry gets high tendency to be exposed with any shortcoming and obstacles during the construction work. Among the tough hurdles deal by the contractor is the problem in payment that leads to great loss.

In Malaysia, the issue of subcontractors who do not receive the payment on time has become one of the serious causes that contributes to project delays in this country (Sambasivan & Soon (2007). According to Malaysian National Agency News (BERNAMA) (2005), there are a huge number of subcontractors in government project dismissed due to financial problem. Suhaini (2005) stated that in their finding, it is about 16, 000 of grade G1 contractors that suffered bankruptcy when other contractors failed to make payment for rural road project, although the client completed full payment to the main contractor. Therefore, it created financial hardship to the affected parties in this case. Hence, it is an obligation to main contractor to make payment for work that has been done by their subcontractor (Danuri, Munaaim, Rahman & Hanid (2006). Along these lines, one of the possibility elements to recuperate this problem is through introducing the specific management system for the payment throughout the process of the construction work.

This research will be focusing on three main parties in Malaysia's construction industry which are contractor, subcontractor, and client. Contractor and client were chosen because they conveyed the large categories on the construction industry team player. They were chosen because they are the paymaster to the subcontractor in most of the construction projects and they are the reason, contributor of late payment to subcontractor. Both parties are equally important in getting the right information in this research. They work hand in hand within any construction project and often payments problems occur between these parties. The study will also be focusing on the factor of late payment face by lower grade contractor namely G1, G2 and G3 that contributed by client and main contractor, the seriousness degree of late payment problem as well as the strategy by them to overcome this issue.

Obviously, there are various strategy has been taken to overcome this serious dilemma of late payment facing by subcontractor in construction work. However, this problem is stressfully blend in Malaysia culture as Ye & Rahman (2010) said in their finding, most of contractor considered that, a few days of delay is acceptable. However, there are several potential strategies that will be highlighted in the research such as arbitration, litigation and enhancement of communication between parties. (She, 2011).

### **OVERVIEW PAYMENT IN CONSTRUCTION INDUSTRY**

Payment means a sum of money paid from one party to another. In term of construction, payment defined as money paid to a person or company who is hired to perform work. In other word, contractor or sub-contractor received their payment after work is successfully done (Longworth Consulting, 2009). For an illustration, payment been considered as the value of any work, materials or goods comprised in the contract. Formally known, payment needs to be paid fully and promptly except there are circumstances that delay the process. The payment is

divided by two types, which are interim payment and final payment in construction contract. Therefore, the payment requires a proper acknowledgment and certification by the Contract Administrator, Architect and Engineer. Based on Clauses Regarding Payment under PAM Contract 2 (2006), a contractor must fulfill his obligation as it confirmed early in construction contract to carry out all the works. On the other side, the client must keep his promise to pay the works done by contractors.

Since the payment is prime obligations to be fulfilled as stated in the contracts between parties, hence the failure to settle the payment can be regarded as breach of the contract. It acts as a core indicator and consideration to the performance of contractor in the construction project. Likewise, the smooth payment transaction in every procedure of work will lead to an outstanding construction project as it eases the contractor to hire the labour, buy the top brand materials and amongst others.

## **STAGES OF PAYMENT**

- i. **Advance Payment:** This type of payment is only used and available for government projects. The reason of having advance payment is to assist the contractor in term of finance to start up their projects (Palliyaguru et al., 2006). According to PWD 203A clause 69 stated that, the value of advance payment that contractor should pay is 25% from the Builder's work. However, the nominated subcontractor and supplier are not entitled to pay the advance payment. Without advance payment from client, contractor will face difficulty which is insufficient money to commence the work in the beginning of the project. Good example is the contractor experiences insufficient capital to purchase the material, transportation for labours and plants, construction of site office and any other preliminaries requirement.
- ii. **Progress Payment:** Early stage of payment starts after the contractor has commences the works on site. After the work has been done, the quantity surveyor will be responsible to evaluate the progress of the construction work on the site and attain the contractor application of payment. After the valuation of works from quantity surveyor, architect must issue the interim certificate that prepared by quantity surveyor to the contractor and client. Client has to make payment to the contractor in the period of time based the standard form used to the project. To conclude, progress payment is a sum payable to the contractor on a regular basis for the progress of work done, which has been completed include material supplied on site

- and any other eligible items accounted by the contract (Ismail, 2008).
- iii. **Payment Upon Completion:** Minimal contractual formalities can be recognizing through payment upon completion of the work. It is normal for small-scale domestic to experience this kind of payment. It is familiar in construction industry to tolerate the total number of payments that have been settled upon completion of work. It will work based on plain letter of agreement, as there is no inclusive and formal contract agreement. The client will review the full payment receipt after the project is perfectly achieved.
  - iv. **Payment Upon Handing Over:** As construction industry is dynamic in reality, hence the development project especially at the outranked rural area is highly possible adapting the payment upon handing over style. It is more likely “build now pay later” program or credit financing of contract. It is because of the limitation in financial resources and small number of financial assistants by the government. However, due to attractive deal by the contractor that possibly been chosen by the indigent government to handle the project in that rural area.
  - v. **Final Payment:** Final payment is the final certificate that produces by the architect or the superintending officer (S.O), for the construction contract. The final payment as an appropriate amount received by the client after all the contract price adjustment is done (Ismail, 2008). It is normally issued after the defect liability period or after the contractor completes the works and any defect works. The final payment will show the amount that should be paid as the complete of the project and the contract. It also means that the architect and the engineer are satisfied and approved the contractors works based on the contract.

### **SUBCONTRACTOR IN MALAYSIA CONSTRUCTION INDUSTRY**

According to Construction Industry Development Board (CIDB) (2013), subcontracting practices can be defined as agreement between two parties that resulting business to business relationship that commonly be found in construction industry. Subcontracting practice is most of the strategic business plan by main contractor in dealing with uncertainty in market flow and minimize the operating cost as it been transfer by subcontractor. The nature of construction project involves larger number of expertise working together (Fahada and Razak, 2013). It can be proved through the research in South African, where 70% of building project were subcontracted to other parties (Construction Industry Development Board (CIDB), 2013). Tayeh (2009) stated that, subcontract plays a vital strategy in construction to ensure the project is successful as up to 90% of

the total project values are assigned to several subcontracting firm. It is extremely essential for the general contractor to have subcontractor in their construction work as it will save the cost and time, decrease the burden of construction work and the specialty skills or advance own by the subcontractor in certain area of construction work (Badroldin et al., 2016). Unfortunately, the construction industry scenario in Malaysia proved that the catastrophe of operating subcontractor as the result of bankruptcy due to failure of the general contractor to compensate the sufficient amount spend by the subcontractor.

Among the important reason of the main contractors hire sub-subcontractor(s) as part of their work is to accelerate the projects duration. As the construction becomes more complicated, and the specialist is needed to handle some works which are not in main contractor expertise. It becomes a norm for contractor to give part of their works to others rather than handling the large workforce themselves. Enshassi, Arain & Tayeh (2012) stated that, about 80% to 90% of construction work performed by subcontractors. The presence of sub-subcontractor(s) gives a huge opportunity to contractor to undertake and handle more complex projects (Chiang, 2009).

- i. **Cost Reduction:** Cost is one of the vital concerns by the main contractor. Thus, the subcontracting practice is one of the strategic ways in reducing the cost of construction as some general contractor did not manage to afford some amount for the cost of skillful worker in construction project.
- ii. **Risk Reduction:** One of the reasons that lead to the subcontracting practices among main contractor is to reduce risk in terms of financial instability, economic fluctuations and completion risk of the project. Throughout the subcontract practices, the risk is being split to the subcontractor, as the subcontractor is play solely or full responsible towards the completion of the project.
- iii. **Time consuming:** The idea of fast-tracking construction nowadays requires the smart time management in finishing the project. Henceforth, the step taken by main contractor in maximising the progress within the day given is through delegating the project to the subcontractor.
- iv. **Build Relationship:** Domestic subcontractor secured the project by having good relationship with their main contractor. Commonly, the main contractor will guarantee more project to the subcontractor if only they are in a great binding relationship. Also, subcontractor needs to maintain the best connection with the main contractor to prevent any dispute arises especially during the project execution, i.e. providing specialised skills need, in which they will provide the expertise and special skills needed by main contractor in construction work. For an illustration, plumbing work that demands

an expertise from subcontractor in that area since the main contractor has a limited knowledge in the field. Therefore, this trend of subcontracting will speed up the construction work and reduced the duration for completion of project.

Further, according to condition of contract in PWD (PWD), there is specific provision that describes the payment matters in construction project between clients to main contractor, client to nominated subcontractor and general contractor to nominated subcontractor. As stated in clause 60.0 of PWD 203A (Rev. 1/2010), contractor is wholly responsible over Nominated Subcontractor (NSC), he can terminate the NSC anytime with consent from Superintendent Officer (SO) with several acceptable reasons and new NSC may be appointed without extra cost to the government.

Conversely, there is no specific allocation of provision between main contractor to domestic subcontractor in standard form of contract. The only available contract between both parties is drafted by main contractor, prior to Model Terms of Construction Contract for Subcontract Work presented by CIDB, as an alternative to the provision in September 2006. Also, there is studies from Chong (2006) who absolutely agrees that the main issue that occur between subcontractor and main contractor is poor contract term due to zero standard form of contract for domestic subcontractor. The provision of payment timeliness in standard form of contract showed that the importance of prompt payment between client, main contractor and nominated subcontractor in order to guarantee the payment obligation for further chain is not affected (Arditi, & Chotibhongs, 2005). Disturbance of cash flow caused by late payment from the other parties will affect the performance of small business in daily operations in term of financial stability (Odeyinka & Kaka, 2005). Promptness in completing the payment is important to ensure the smooth construction operations, so that it will not interrupt the daily basis of small business operation.

#### **FACTORS OF LATE PAYMENT**

According to Amoako (2011), it is clearly mentioned that the contractors suffered financial hardship when their payment is delayed. The mistake or faulty by main contractor not just burden himself but at the same time it will be shifted to another chain which is subcontractor. Similarly, it also creates financial hardship to the subcontractor.

#### **Fieldwork**

This research was conducted by using mix qualitative and quantitative research. For the case of illustration, this research will provide the respondent with several sets of questionnaires which including numerical answer for the qualitative method while qualitative method been derived from the set of interview

questions. The rich quality data were collected, analysed, summarised and presented in Table 1 – 4, accordingly.

**Table 1** Payment Due to Sub Contractor

When do subcontractors receive their payment?	Both		Main Contractor		Sub-contractor	
	f	%	f	%	f	%
Completion of work	13	35	6	30	7	41
After received payment from client	16	43	10	50	6	35
Progressive Payment every month	8	22	4	20	4	24
Total	37	100	20	100	17	100

**Table 2** Late Payment Issues

Factors Contributing to Late Payment & Overcoming Late Payment Issues		Both		Main Contractor		Sub-contractor	
		M	R	M	R	M	R
Factors of Late Payment caused by Client	Client Poor Financial Management	3.4	3	3.3	4	3.5	3
	Client Withhold the Payment	4.3	1	4.2	1	4.4	1
	Failure to implement good governance in business operation	3.3	4	3.4	3	3.2	5
	Poor understanding of the contract	2.8	7	2.6	6	3.1	7
	Poor communication among parties involved	3.3	5	3.1	5	3.5	4
	Local culture and attitude	3.1	6	3.1	5	3.2	6
	Delay in Certification	4.2	2	4.0	2	4.3	2
Factors of Late Payment caused by Main Contractor	Delay and error in submitting claim	3.8	4	3.7	3	4.0	3
	Bid low price at tender stage	3.5	6	3.3	6	3.7	5
	Contractors failure to agree to the valuation of work	3.5	7	3.4	5	3.5	6
	Contractor Withhold the Payment	3.9	3	4.1	2	3.8	4
	Local culture / attitude of contractor	3.6	5	3.5	4	3.7	5
	The use of pay when paid.	4.3	1	4.4	1	4.2	1
	Poor communication among parties involved	3.2	9	3.0	8	3.4	7
Over-coming Late Payment Problem by Subcontractors	No formal contract agreement	4.1	2	4.1	2	4.1	2
	Contractor failure to understand the contract agreement	3.2	8	3.2	7	3.2	8
	Avoid accepting subcontract from financially-weak contractors	4.7	1	4.6	1	4.8	1
Over-coming Late Payment Problem by Subcontractors	Propose suitable and reasonable prices	4.1	5	4.0	3	4.1	3
	Communicate with the contractor effectively	4.2	3	4.0	4	4.4	2
	Suspend the construction process until payment is received	3.9	6	3.9	5	4.0	4
	Slow down construction work at site until payment is received	4.1	4	4.0	6	4.2	3
	Sending notice letter to client regarding contractor problem	4.4	2	4.4	2	4.4	2
	Initiate arbitration or litigation	3.7	7	3.5	7	3.9	5
	None, just ignore and continue with next month claim	1.5	8	1.7	8	1.4	6

M = mean; R = rank

## Discussion of the Results

Based on Table 1, it is shown that most of the subcontractor got their payment after main contractor received the payment from client. The term of “pay when paid” was applied. It could be due to the late payment and non-payment issue especially to sub-contractor. This clause is applicable when the client did not pay to the main contractor that definitely led to the late payment to the subcontractor. Meanwhile, some respondents claimed that the payment was made after the work is completely done. Should there were any problem due to unavoidable

shortcoming or non-completion of work, the payment will be delayed. This indicates that late payment issue dealt by the subcontractor is the critical issues that should be tackled seriously by scrutinising the factors that induce the late payment in construction area. For an example, when those people in construction industry get used to the pay when paid concept, eventually it will cause the late payment to the subcontractor. Indirectly, this issue becomes more serious in the future.

Based on Table 2, it is shown that the factor of late payment contributed by the client. As the aim of the observation, the three highest factors selected by both parties, i.e. main contractor and subcontractor which are “client withhold the payment”, “client delay in certification” and “client poor financial management” by having overall mean 4.25, 4.15 and 3.42, respectively. Based on the highest response, the client withholds the payment is the most preferred. Most of the employer intent to hold the money from giving to main contractor for several reasons such as Non-Compliance Record (NCR) by contractor not dissolve, incomplete documentation for claim and etc. Some of the main contractor faced hard time to survived to roll their money before getting the payment from client. The concept of Other People Money (OPS) mostly used by main contractors in their business sometimes failed due to client withhold the payment. Also, client has higher tendency to hold the payment in several cases namely, any defective in the construction work, or failure to fulfil the specification require stipulated in the contract and disputes arise between parties. Henceforth, this factors also contributed to the late payment crisis to the sub-contractor. The second highest selected factor was delay in certificate. According to PWD standard form of contract that has been used for the government project, the certificate of payment should be released in 14 days to the contractor. Meanwhile, in PAM standard form of contract, it is stated that the certificate of payment should be released 21 days after the application of payment by contractor. Most of the client did not take this situation seriously and indirectly will contribute to the late payment issue. The third highest factors voted by the respondent is client poor financial management is part of the reason that influences the delay in payment to the subcontractor. This tends to happen if the client is too demanding in specification manufacturing but have insufficient amount of money to pay the main contractor. This situation proves that client fails to provide the payment wisely due to their demand.

Nevertheless, based on the Table 3 the factor of late payment contributed by the main contractor is tabulated. The three highest factors selected by both side main contractor and subcontractor which are “the use of pay when paid”, “no formal contract agreement” and “contractor withhold the payment” by having overall mean 4.30, 4.09 and 3.91, respectively. Based on the highest response, the use of pay when paid is the most preferred factor by main contractor to pay for the subcontractor. It is because the procedure is simpler rather than

payment based on progress as everything were done at once a time. However, this will give chance to the main contractor to drag the payment which cause the late payment to the subcontractor. The second highest factor of late payment from main contractor was no formal contract agreement. As explained previously, there is no specific allocation of provision between main contractors to domestic subcontractor in standard form of contract. The purpose of the contract is to attain fairness for both parties. Without contract, many problems will occur especially in payment process. This situation gives advantage to the main contractor to maximise their opportunity in regulatory subcontractor. The other factor from main contractor that provided by respondent was numerous project coverage by main contractor. This condition occurred when the main contractor has insufficient staff to handle various project and some of them only focus on the specific project which contribute to the higher profit. Therefore, this state of affairs will drive the main contractor to the indecorous management, wherefore the late payment issue tends to come out in the construction project.

Table 4 tabulated above shown the strategy by subcontractor to improve the situation and performance due to late payment problems. The three highest strategies were selected by both parties which are “avoid accepting subcontract from financially-weak main contractors”, “sending notice letter to client regarding contractor problem” and “communicate with the contractor effectively” by having overall mean 4.71, 4.35 and 4.15, respectively. “Avoid accepting subcontract from financially weak main contractors” was the highest selected strategies from the respondents. This is an indication that, most of the respondent prefers to take early precaution before accepting any jobs. The evaluation of contractor should be done in term of financial to prevent any upcoming risk. Meanwhile, the second highest of strategy that been selected by respondents was sending notice letter to client regarding contractor problem. This is done by the subcontractor by reporting any misconduct or problem regarding the main contractor. Usually, sub-contractor will issue the notice letter to the client in order to seek for urgent response from the client side towards their main contractor. There are three respondents whom provide the other strategy to overcome the late payment problem which the answer is out of the questionnaire. Based on the factor stated above, every business must be registered by Suruhanjaya Syarikat Malaysia (SSM) that is provided by government. Furthermore, the contractor also must have certification of Pusat Khidmat Kontraktor (PKK) which is fundamental requirement to involved in any government project. These strategies have been suggested in order to ensure that the contractor is qualified in handling the project based on their capability. The second strategy provided by respondent was to propose the standard form of contract clause regarding payment between main contractor and domestic subcontractor. There must be specific allocation penalties in the clause especially in term of late payment cases such as blacklist the contractor’s name, levy charge

for payment overdue and other penalties for those involve in late payment. Indeed, this clause will be referred and be the guideline if there are any dispute occurs among of them. Thirdly, the subcontractor recommends the main contractor to use their own money instead of waiting the payment from clients. To avoid any distraction in progress of works, main contractor needs to spend their money first to pay the subcontractor.

### **CONCLUSION**

The paper reported on a study of the factor affecting late payments to domestic sub-contractor. The results show the respondents are strongly agreed that late payment issue affect the financial stability, performance, and quality of construction of subcontractor. The result concludes that, late payment culture in Malaysia construction industry is becoming a norm and habit for those in that area to deal with, whether it comes from government or private sector. This situation is getting worse and inferior when it involves the client from government. This crucial issue will be more devastating if there is no serious prevention action taken by authorities which may deteriorate the image of Malaysia.

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