



# FUNDAMENTALS OF CONTRACT AND COMMERCIAL MANAGEMENT



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# Fundamentals of Contract and Commercial Management



## Colophon

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# Foreword

Study the headlines from around the world and you will rapidly grasp the significance of contract management. Stories abound of multi-billion losses in whatever currency you choose to name—\$30bn from weaknesses in US defense contracts, €140bn from failed European software projects, £300 million each year on UK Government service contracts. Cancelled projects, failed development initiatives, even losses of human life are increasingly attributed to poor contracts.

However, the real failing is not the contract, but rather it is poor contracting practices. It is people who decide on the form, structure or terms of a contract and the way it will be managed. As business people we all have a role in ensuring that contracts are designed, developed, negotiated and managed in a way that is ‘fit for purpose’.

Today’s trading relationships are in many ways more complex than those of the past. Factors such as globalization, increased regulation, innovative technologies, and the speed of change have all contributed to an environment in which it is often difficult to define and manage the many factors involved in a successful contract. This has led many organizations to see the contract primarily as an instrument of control, where rigid standards are imposed and negotiation is restricted to specialists. Unfortunately, this thinking has led to many business people stepping away from their role in the process, viewing the contract as a purely legal or procedural requirement. The consequences of this are reflected in the headline losses mentioned above.

This book seeks to provide insight to the good contracting practices that will contribute to business success. As a simple introductory example, let’s look briefly at the way that today’s sales and purchasing practices have contributed to poor contracts and resulted in avoidable losses.

Procurement organizations have been tasked with saving money. They perceive suppliers trying to undermine these efforts through specific techniques:

- Forming relationships with the business people and thereby working around Procurement.
- Exaggerating product or service performance to justify a higher price.
- ‘Bundling’ products or services into ‘solutions’ that make competitive price comparisons difficult.
- Offering a low initial contract price, but with contracting practices that mask incremental charges or expensive change procedures.

Procurement has developed a variety of methods to protect against these techniques:

- Controlling or forbidding direct conversation with the business people
- Onerous performance penalties in the form of damages, service level credits and other ‘penalties’
- An approach known as ‘commoditization’, which seeks to unbundle a supplier’s offering to allow direct competitive comparison.
- Growing insistence on the use of their own standard terms and conditions, leading to a low-value ‘battle of the forms’.
- A more adversarial approach in post-award performance management to restrict price or charge increases and overruns.

The combination of these techniques and methods has a negative impact on contract formation and the results achieved. This can be avoided only through patiently forming a positive, multi-tiered relationship that includes developing the right contract structure and terms. A supplier must help its customers appreciate that constraints on conversation, imposition of ill-suited standard contracts or the unbundling of genuine added-value solutions is detrimental to their own interests, but this can be done only by tackling these issues at the right levels, with the right experts and at the right time.

# Introduction

Why do I need to know anything about contracts?

That's a question many people ask and which this book will answer. Contracts are fundamental to a business and its value. Just think for a moment how much you would be willing to pay for a business that had no contracts? Or why it is that investors flee from companies that show themselves unable to manage or enforce their contracts?

Most adults have managed a contract without even realizing it. Take the example of a man looking out of the front window of his house on a snowy day. He sees a young man walking by with a snow shovel. The young man sees him in the window and raises his shovel with a quizzical look on his face. The older man reaches into his pocket and pulls out his hand with money in it. The young man holds up ten fingers. The older man nods, steps away from the window, and the young man shovels the walk. After the young man finishes the walk and rings the bell, the older man opens the door, surveys the walk, and pays him ten dollars.

Expending minimal effort and time, these two men have completed a business transaction and actually managed a very simple contract from initiation to completion without the use of a single word or piece of paper. Business transactions demand more formal communication and record-keeping, but most commerce in our world follows that same process. Understanding the process and how to facilitate its important elements is fundamental to driving business objectives and success.

Making and managing contracts can be hard work, or it can be easy. A goal of this book is to combine commercial process knowledge with an understanding of the roles in the buyer/seller relationship to make contracting both efficient and effective.

Even the simple example of the snow shoveler highlights the fundamental questions that all business people have about any transaction:

- Is it clear what is wanted, and when?
- Will it be at an acceptable price?
- Can what is promised be delivered?

As the situation becomes more complex, so do the questions we ask:

- Is what is promised what the customer thinks they're going to get?
- Does the contract offer an acceptable return?
- Does the contract make the best use of available resources?
- Do I understand the risks involved and my part in managing them?
- When things change, what happens?
- If it all goes horribly wrong, what are the consequences?

Most business people ask these basic questions routinely. Asking, answering, and documenting these questions is the most fundamental level of contract and commercial management, and it is this that makes almost everyone a contract manager, whether consciously or unconsciously.

Beyond this statement is the professional reality that contract or commercial management is often one of the least defined positions in the corporate hierarchy. Consequently, individuals with many different titles perform some or all of the elements of the process we will talk about within this book as the commercial transaction process. Whether the reader's job title is Managing Director or Accounting Clerk, that position touches the transaction process, and understanding the value added by the contract manager enables each to function more effectively. It also means we have a collective responsibility to make the contracts in our organization contribute to its success rather than become a source of poor performance and loss.

Readers can work through each chapter of this book in sequence or select individual chapters of interest that relate to a specific job function. This is not designed to be an operational guide or give detailed instructions in the duties of contract management. Its purpose



is to provide a broad commercial audience with an overview of the fundamental functions of contract management, the unique perspective and skills that dedicated professionals can bring to the transaction process. It is also designed to challenge the reader to facilitate business through understanding the process and improving its function as individual abilities and situations permit.

**Part One: Essentials** provides a general overview of the transaction process and the types of relationships encountered; the main elements of a contract; cost, pricing and payment; and negotiation principles. This Part concludes with an overview of the commercial transaction process. These early chapters contain checklists and questions the reader can use to identify key issues.

**Part Two: The contract management lifecycle** takes the reader through each of the five phases of the lifecycle, starting with initiation of a project, bidding, developing and negotiating a contract. The remaining chapters in this Part address the Manage phase: contract implementation, managing day-to-day performance and issues that must be addressed to move the project forward to a successful completion rather than a costly dispute. Questions and checklists have again been provided to aid in issue identification.

Case studies are included throughout the text to demonstrate the real-world application of the issues. Appendices are included that contain relevant supplementary information.

Each step of the commercial transaction process is covered, including a description of the step and the critical duties that must be performed. Perhaps more important is a discussion of the reason why the step is important to the business and the value that a professional can add to the process.

This book will enable readers to approach this process with greater knowledge, confidence and understanding, providing them with the edge to improve performance.



# ***PART 1***

## ***ESSENTIALS***



# CHAPTER 1

## COMMERCIAL RELATIONSHIPS: BUILDING A FOUNDATION

*Business is not just doing deals; business is having great products, doing great engineering, and providing tremendous service to customers. Finally, business is a cobweb of human relationships.*

**Ross Perot**

## 1.1 *The relationship continuum*

The business world is full of relationships, with the most pervasive or critical being the one between buyer and seller. Every individual, regardless of title or other duties, is at some point involved with or affected by these relationships. Career and business success or failure can often be attributed to these interactions

Business relationships reside in a complex universe with infinite variables. While many have tried to document these, there is no global standard that applies across industries, geographies and types of product or service. One way to express this is as a continuum in terms of relative depth and complexity (Figure 1.1).

At the far left side of the continuum is the purchase or sale of a commodity item, which is generally executed with a simple transaction that may be repetitive. At the far right side of the continuum is the purchase or sale of products, systems, or services that are critical to business performance. These sales are generally the result of a relationship that is built and developed through several transactions between the buyer and seller.

Business efficiency demands that the right amounts of effort and resources are invested in each transaction. Understanding the big



Figure 1.1 The relationship continuum