

# The Purpose of a Contract

An IACCM research report





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The survey attracted input from 575 participants, providing cross-industry and multiple country perspectives. Input was gathered in August / September 2017. For further information on specific findings (e.g. industry or functional variations), please contact [info@iaccm.com](mailto:info@iaccm.com)

## About this report

In a recent survey conducted by the International Association for Contract & Commercial Management (IACCM), participants were asked to evaluate the extent to which a contract should fulfil a selection of eleven possible purposes. They were then asked to assess how successful their contracts actually are in achieving each purpose. On every category, they acknowledged underperformance – with ‘a framework for a mutually successful business outcome’ recording the biggest shortfall. In fact, actual performance was close to desired performance on just one characteristic – that contracts should ‘demonstrate brand and corporate values’.

The idea that contracts should support these values was the least selected purpose (coming in eleventh place) and the evaluation of performance indicates that contracts generally are not a great marketing tool. In a separate question, just over 50% of respondents acknowledge that their contracts are not a source of competitive advantage. Though not unsurprising, this low score is unfortunate given the growing issues around institutional trust and corporate integrity.

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The idea that contracts should support brand and corporate values was the least selected purpose

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### *Executive summary and call to action*

Most contracts underperform. There are many reasons for this, not least the extent of multiple stakeholder interest, but business leaders could take action to increase the chances of success. Key steps would include:

- Ensuring that there is a defined owner of the contracting process with accountability for its quality and integrity;
- Encouraging internal debate over the primary purpose for contracts and the outcomes that executive management expects;
- Supporting investment in the process, in particular with tools and systems that generate the information and data flows that are required to drive performance; and
- Sponsoring reform of contracts to drive simplification, market-based standards and ease of use.

Lawyers and contract managers are split in their opinions about the purpose of contracts – but united in the view that they typically fail to meet their goals. On average, they underperform against expectations by some 27%.

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On average, contracts underperform against expectations by 27%

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### *The purpose of a contract*

What is the purpose of a contract? IACCM's discussions with business people revealed a range of views. Those findings resulted in the research that underlies this report. Eleven distinct ‘purposes’ emerged; in most cases, they are not mutually exclusive and conversations confirmed that most people see multiple purposes.

#### The eleven purposes are:

1. *A record of rights, responsibilities and obligations*
2. *Providing protection and remedies in the event of a dispute*
3. *A framework for a mutually successful business outcome*
4. *A tool for risk apportionment*
5. *Support for a business relationship*
6. *Governance and performance management*
7. *A tool for risk management*
8. *An effective communication tool for those with a need to know*
9. *Providing operational guidance*
10. *An instrument for generating financial benefit*
11. *Demonstrating brand and corporate values*

The depth and extent of purpose varies in accordance with the depth and extent of the relationship. For example, a one-time transactional agreement will not have the same degree of purpose as a ten-year outsourcing contract. However, no matter the type of agreement, many of these characteristics remain valid across all contracts – it is the degree of importance that changes. Cumulatively, they also contribute to the eleventh-placed purpose – demonstrating brand and corporate values. Contracts – and the process through which they are formed – have impact on levels of trust and cooperation.

### The evaluation

Participants were asked to rate each purpose on a scale from 1 to 5, where 1 was a low extent and 5 was a high extent.

Most of the potential purposes achieved a relatively high score, a finding that illustrates the underlying complexity of the contracting process. A contract seeks to fulfil many roles and a glance at the list shows that they are not entirely compatible. This multi-purpose role may be one reason why the results are often disappointing. In addition, the question was posed without asking what types of contract the respondents typically handle and it may be that the nature of the agreement has some impact on the sense of purpose. For example, those who deal primarily with low value commodity contracts are perhaps unlikely to view the purpose in the same way as someone handling a long-term outsourcing arrangement. Whether they are correct in this view is open to question.

### The purpose of a contract

Ranking	To what extent should a contract fulfil the following purposes?	% stating 'to a high extent'	Overall score (scale 1-5)
1	A record of rights, responsibilities and obligations	76	4.71
2	Providing protection and remedies in the event of a dispute	65	4.53
3	A framework for a mutually successful business outcome	61	4.46
4	A tool for risk apportionment	52	4.31
5	Support for a business relationship	48	4.27
6	Governance and performance management	42	4.23
7	A tool for risk management	41	4.1
8	An effective communication tool for those with a need to know	46	4.07
9	Providing operational guidance	30	3.85
10	An instrument for generating financial benefit	26	3.76
11	Demonstrating brand and corporate values	12	3.08

## Many contracts fail to fulfil their purpose

The table below shows the top five areas where respondents feel their contracts fall short of their goals. It compares the rating of effectiveness with the rating of purpose (as shown in the previous table on page 5).

### Top 5 areas where there are 'shortfalls' against purpose

Ranking	To what extent should a contract fulfil the following purposes?	% stating 'to a high extent'	Overall score (scale 1-5)
1	A framework for a mutually successful business outcome	11 / (50)	3.35 / (1.11)
2	Support for a business relationship	15 / (33)	3.35 / (0.92)
3	Effective communication tool for those with a need to know	9 / (37)	3.19 / (0.88)
4	Governance and performance management	15 / (27)	3.38 / (0.85)
5	A tool for risk management	16 / (25)	3.39 / (0.71)

There is acknowledgement by respondents that their contracts typically have weaknesses in two particular areas. One is the extent to which they are effective at providing the information that people need in order to do their job. Just 26% believe that contracts are consistently good at fulfilling this role. The consequences of incomplete information are:

- Potential for claims or disputes
- Potential for increased costs or delays
- Potential for operational inefficiencies and errors

The typical problem here is that those who write contracts aim to create certainty and 'completeness', even though research (such as that by Nobel prize winner Oliver Hart) clearly illustrates the growing impossibility of doing this, especially in today's volatile business conditions. Good contracting practice actually recognizes inevitable uncertainty by focusing on mechanisms and governance standards that support its management, through appropriate reporting, review and escalation procedures.

The second – and related – issue is that almost 70% acknowledge that their contract negotiations do not focus on the topics needed to achieve a mutually successful outcome. In some respects, this may be directly linked to the item above – incomplete information. Negotiations are often bogged down on issues related to protection of assets and remedies, with the result that key issues around on-going governance, performance management and roles and responsibilities are either overlooked or the negotiators run out of time. This finding aligns with the results in IACCM's annual study of 'The Most Negotiated Terms', where respondents acknowledge that the terms that take most time are not those which generate the best results. Specifically, the focus for negotiations is frequently on terms such as limitation of liability, indemnities and liquidated damages (dealing with the consequences of failure), rather than the critical issues of scope and goals, responsibilities of the parties and managing change (the terms that reduce risk likelihood).

## 70% acknowledge that their contract negotiations do not focus on the topics needed to achieve a mutually successful outcome

## Different functions have different views

Overall, each of the functions represented in the survey is positive about the purpose and importance of contracts. On average, lawyers give the highest scores, with operational staff, such as project managers, the least convinced. The response from operational staff appears to show a degree of cynicism about the role of contracts, particularly their failure to give effective operational guidance (see sidebar). Although it may be intended to offer definition of roles and responsibilities and a governance framework, many times the contract is ineffective. That may be because it is incomplete (in particular failing to include effective change management procedures) or perhaps it is simply too complicated to read and understand. Different functions have different views.

## Simplified structure and language does not render a contract unenforceable

This issue is an example of the difficult balancing act in developing and drafting contracts. Those with an eye to potential litigation worry about ‘legal’ language; yet such language renders the agreement hard to understand for many operational staff, thereby increasing the risk of failure to comply. These competing interests require a balancing act – yet with the right approach, they are not incompatible. Simplified structure and language does not render a contract in some way unenforceable.

## Company size has an impact

Popular wisdom suggests that smaller businesses see contracts playing a less important role in their activities. In reality, the overall scores for the conceptual purpose of contracts are mostly very similar. Comparing the results for companies with less than \$100m in sales with those over \$5bn, the former actually see a stronger link between the contract and their brand and its values. They are also more likely to view the contract as a source of operational guidance and a tool for risk management (rather than apportionment). This latter finding may be a reflection of comparative negotiating power.

It is when we compare the effectiveness of contracts that significant gaps appear, with smaller businesses more likely to find that they fulfil their purpose. The table on the right illustrates the extent of the difference.

## “Contracts aren’t much use to me”

This project manager spoke for many of the operational staff who participated, reflecting a degree of cynicism about the role and purpose of contracts. In his experience, contracts often fail to give effective operational guidance. Although its intent may be to offer definition of roles and responsibilities and a governance framework, many times the contract is ineffective. That may be because it is incomplete, or perhaps simply too complicated to read and understand.

In fact, many of those responding from Legal or Contract Management roles do not entirely disagree. They too acknowledge a substantial gap between aspiration and reality. One question in the survey asks whether a contract should provide the framework for a mutually successful business outcome. While over 60% strongly agree that it should, only 11% feel that is what actually happens.

So unfortunately, our project manager is right to be disappointed. But doesn’t he deserve better and could we not do more to make our contracts truly ‘fit for purpose’?

### Percent selecting ‘very effective’

To what extent are your contracts effective at fulfilling their purpose?	Revenue under \$100m	Revenue over \$5bn
A mutually successful business outcome	19%	4%
Support for a business relationship	22%	10%
Providing operational guidance	16%	5%
Effective communication tool for those with need to know	16%	6%
Demonstrating brand & corporate values	11%	2%

Why might this happen? One reason appears to be the number of stakeholders whose views have to be reconciled within large businesses, leading to more complex procedures (56% in large businesses are dissatisfied with the contracting process and the extent to which it supports business and personal performance). This combines with greater emphasis on the role of contracts in allocating risk and ensuring control and compliance, rather than assisting operational performance (50% of those in big business do not find their contracts easy to understand or explain; only 25% find them consistently helpful in performing their job).

In the table on the previous page, it is notable that the major areas of difference are related to softer and more practical values of communication, guidance and relationships. The impact on successful outcomes is a natural consequence of those factors, certainly in more complicated or longer term engagements.

## Industry matters

We all know that individual people have different views about the purpose and value of contracts. But what about industries - do they also have distinct perspectives?

The answer appears to be yes. And for any negotiator – especially when working across industry borders – those variations are important to understand. There is only one area in which there is unanimity of purpose – and that is in defining rights, responsibilities and obligations.

### Top 5 areas where there are 'shortfalls' against purpose

	Lowest score (Scale 1-5)	Highest score
Providing protection and remedies in the event of a dispute	4.1 - Outsourcing / Consulting	4.8 – Eng'g & Construction
A framework for a mutually successful business outcome	4.1 – Retail	4.8 – Aerospace & Defense
A tool for risk apportionment	3.9 – Outsourcing / Consulting	4.6 – Technology
Support for a business relationship	4.1 – Eng'g & Construction	4.5 – Outsourcing / Consulting
Governance and performance management	4.0 – Technology	4.5 – Outsourcing / Consulting
A tool for risk management	3.4 – Retail	4.4 – Technology
An effective communication tool for those with a need to know	3.7 – Aerospace & Defense	4.5 – Eng'g & Construction
Providing operational guidance	3.4 – Aerospace & Defense	4.2 – Eng'g & Construction
An instrument for generating financial benefit	3.5 – Public Sector	3.9 – Technology
Demonstrating brand and corporate values	2.5 – Aerospace & Defense	3.5 – Outsourcing / Consulting

Reviewing the overall score, those in Engineering and Construction and Outsourcing and Consulting place the highest overall value on contracts; those in Retail and Aerospace and Defense place the least. Why might that be?

- The Engineering and Construction industry has a long history of fractious relationships. The contract is of major importance in communicating roles and responsibilities (including definition of scope). And given the traditional adversarial relationships, it also scores very high for its role in apportioning risks.
- In the world of outsourcing and consulting, there is no tangible product, so the contract takes on a far more significant role in defining the business relationship, governance and performance management. People in this industry are also more likely to see the contract having a role in promoting their brand and its values, providing an instrument that generates trust.
- Those in Aerospace and Defense do not view the contract as unimportant, but they are more selective in the areas where they see a strong purpose. In particular, they rate its role in supporting communication, risk management and operational guidance significantly lower than those in other industries. One reason may be because the industry is in transition from the traditional sale of products to a new world of services and outcomes. In many cases, contract models and commercial skills are still catching up with this change.
- Retail is perhaps no surprise; in general, retailers are working with suppliers who are considerably less powerful and in many cases the retailers place limited value on the relationship. Contracts are primarily focused on risk allocation and the rights of the customer.

## Geographic variations

Few will be surprised by the fact that there are variations in geographic views about the purpose of contracting. Traditions over the use of contracts vary substantially – so in fact we might expect greater divergence than the survey reveals. All regions place a relatively high rating on the purpose of contracts – an average that ranges from a low of 3.9 to a high of 4.3. In part, this relative consistency is likely to be due to the nature of those responding, since they are drawn from people who are familiar with the use of contracts.

As the sidebar indicates, Australia emerges as the region where contracts have the lowest overall rating of purpose and effectiveness. There are factors to explain this. Rather more significantly, Europe shows the next lowest rating, with contract effectiveness some 10% below that for

North America. However, this average masks significant country variations within Europe. Contracting traditions vary significantly and are also impacted by the legal system. While employees of multi-national organizations show a relatively high level of consistency in their views, those in more nationally focused companies and the public sector are more likely to reflect traditional cultural attitudes to the role and importance of contracts.

### Compared to other world regions, Australians see less purpose in contracts

In every category, respondents from Australia rate the performance of their contracts lower than other geographies, by an average of almost 20%. The only areas where the sense of purpose is close to the worldwide 'norm' are:

- defining rights, responsibilities and obligations. Australia is in line with the global average for purpose, but 8% below average for results.
- governance and performance management. Australia is again in line with the global average for purpose, but 14% below average for results.
- a framework for a mutually successful business outcome. Australia is slightly below the global average for purpose and 18% below average for results.

Write-in comments show a divide between views of the contract as a legal instrument, as opposed to an operational tool. Among those who work for large multi-nationals, the contract fails because of a lack of authority – contract terms and models are imposed from elsewhere. Some comments also reflect concern about the role of lawyers, especially in making the contract an effective communication tool or operational guide (each being a category where effectiveness is rated especially low).

Australia is among the most innovative in contracting - its focus on alliances and collaboration goes back 20 years and there has been great success in raising the quality of performance management. Its inclination towards collaboration is often frustrated by external forces. Limited empowerment reduces the effectiveness of the contract and gives it a reduced purpose. This is especially notable when it comes to the role of the contract in supporting the brand and corporate values: for Australians, that certainly is not something that their contracts achieve.

Overall, while the geographic comparisons are interesting, more research would be needed to validate the findings. Our data tends to reflect the views of a relatively mature and experienced audience, a majority of whom work in multi-national companies. Therefore, the results for regions such as Asia, Africa and Latin America in particular seem unlikely to be fully representative.

### *Is ownership the problem?*

The variability of purpose is mirrored by the variability of ownership. As the chart demonstrates, there is no consistency in 'who owns the contracting process'. Indeed, almost half of the respondents acknowledge that there is no owner, or they do not know who it is. Many confuse overall process ownership with ownership or responsibility for specific agreements or transactions.

However, even at this transactional (individual contract) level, there is rarely clarity: the largest proportion – some 36% - say that responsibility is collective (see chart).

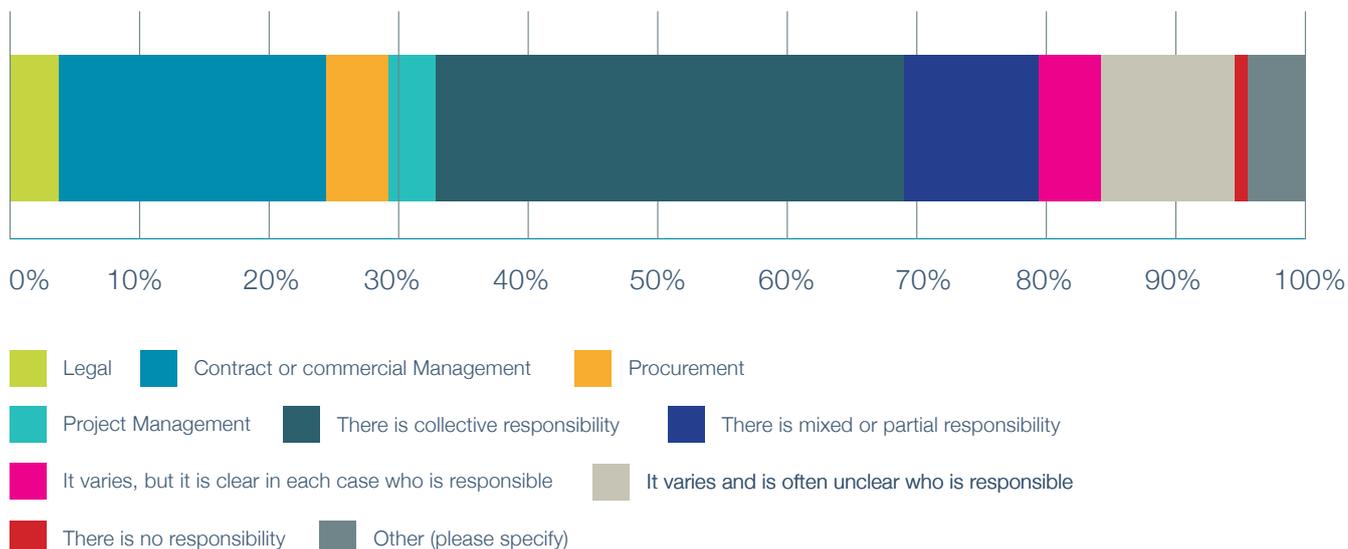
The answers illustrate the point that in a majority of organizations contracting is not viewed as a process. This is reflected in other IACCM surveys, such as our April 2017 report on the state of contract management automation, which revealed major challenges with system adoption, data flows and user satisfaction. Essentially, contracts 'emerge' from a fragmented range of activities, conducted by functions and individuals who are motivated more by functional interests than by overall business results and where a lack of measurement means that the underlying flaws are not recorded or addressed.

Given this failure to drive quality into the process, it is not surprising that responsibility and accountability for individual agreements is also confused. The level of confusion operates in inverse ratio to the level of complexity. In other words, simple forms of agreement – such as in retail – actually have clearer ownership than complex or strategic contracts. Again, this is a reflection of the numbers of stakeholders who become involved and this tendency towards 'collective responsibility', which ultimately means that everyone can blame someone else for whatever goes wrong.

*Is there a defined owner of the contracting process (someone fully accountable for ensuring its quality) within your organization and if so, who is that?*

Supply Chain Chief Project Manager Contracts Department  
Counsel VP Contracts Contract Administrator  
Lead Legal Contracting Officer Commercial  
Contract Owner Contract Manager CEO  
Procurement Governance Director  
Contract Analyst Responsibility Strategic Sourcing  
Business Function Senior Contract Specialist

*Which group or function is responsible for ensuring that a contract fulfils its purpose?*



## Conclusions

The chart shows the areas of relative weakness in current performance. However, this is based on the evaluations of the importance of purpose. Are these correct? IACCM takes the view that the last two items – regarding financial benefit and corporate values – should be significantly higher on the list no matter what the type of contract.

	Extent to which contract should fulfil this purpose	Extent to which contract does fulfil this purpose
A record of rights, responsibilities and obligations	4.71	4.14
Providing protection and remedies in the event of a dispute	4.53	3.96
A framework for a mutually successful business outcome	4.46	3.35
A tool for risk apportionment	4.31	3.65
Support for a business relationship	4.27	3.35
Governance and performance management	4.23	3.38
A tool for risk management	4.1	3.39
An effective communication tool for those with a need to know	4.07	3.19
Providing operational guidance	3.85	3.16
An instrument for generating financial benefit	3.76	3.18
Demonstrating brand and corporate values	3.08	2.62

Each organization needs to discuss priorities and determine the importance of these shortfalls in the context of their markets. The problem is that this debate rarely occurs – in large part because no one feels responsible to lead the discussion.

A key purpose of this report is to prompt those internal discussions and to support them with firm data that illustrates the opportunity to drive substantial improvements. Contracts are often complicated instruments, needing to reflect and balance the interests and goals of many different stakeholders – that is, individuals who are measured on specific areas, such as savings or revenues; internal business functions, such as Finance, Risk Management, Legal, Project Management and Operations; related groups, such as the Board and shareholders; the counter-party to the contract (and all their stakeholders); and broader society, in the context of regulatory authorities and potentially the media.

The pressures on the quality of corporate governance and integrity continue to grow. The vast majority of high profile governance issues are related to a failure to ensure transparency in contracts and contracting practices. The financial collapse, the multiple bribery and corruption cases, the focus on sales practices can all be traced to poor contracts and contracting practices. For any organization that cares about its business results and market reputation, a thorough review of the purpose of its contracts should be at the top of their priorities.





## Who we are

IACCM is a not for profit association active in over 160 countries. It is dedicated to raising individual, organizational and institutional capabilities in contracting and commercial management, providing research, benchmarking, learning, certification and advisory services to a worldwide, cross-industry audience of practitioners, executives and government.

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