UNIT III

ORGANIZING HUMAN RESOURCES AND CONTRACTING

Topic 5: Contracts

What is a contract in project management?

In project management, the contract outlines the agreement made by a buyer and a seller or supplier. The contract the buyer and seller sign dictates all aspects of their business transaction. According to the Project Management Institute, a contract between parties can be oral or written and is a legally binding agreement that defines their relationship. Any use of PMI's registered mark or mark of the project in your services or products has to include the proper trademark symbols.

Within the category of contracts for project management, there are various types of contracts. These include Fixed Price Contracts, Time and Material Contracts and Cost Reimbursable Contracts. The contract dictates the timeframe within which the deal or transaction takes place, what payment will be and when the payment is due.

Why are contracts important in project management?

Having a proper contract for a project provides a legal framework for the job that reduces any uncertainty about timelines and payment details. The contract dictates what work is required, who is responsible for completing the specified tasks, when the deadline for the project is, and how payment will be received. Having a legally binding contract for a project helps facilitate a positive relationship between buyer and supplier by creating trust that the task will be completed on time and payment will be received in the agreed upon amount.

Types of Contract:

1. Fixed Price Contract (FP)
2. Time and Material Contract (T&M)
3. Cost Reimbursable Contract (CR)

Fixed Price Contracts:

These are also known as Lump Sum contracts. The seller and the buyer agree on a fixed price for the project. The seller often accepts a high level of risk in this type of contract. The buyer is in the least risk category since the price the seller agreed to is fixed. Be sure this type of contract has fully detailed specifications, checklists, and project scope statements from the seller's side, which the buyer will use.

With this type of contract, sellers may try to cut the scope to deliver the projects on time and within budget. If the project is finished on time with the desired quality, the project is over for that contract. However, if the project is delayed and there are cost overruns, then the seller will absorb all the extra costs.

Below are a few types of fixed-price contracts:

- ### Fixed Price Incentive Fee (FPIF):

  Although the price is fixed, the seller is offered a performance-based incentive. The incentive can be dependent upon one or more project metrics such as performance, cost, or time.

- **Fixed Price Award Fee (FPAF)**

  If the performance of the seller exceeds expectations, an additional amount (i.e., 10% of the total price) will be paid to the seller.

- **Fixed Price Economic Price Adjustment (FPEPA):**

  The fixed price can be re-determined depending on the market pricing rate.

Time and Material Contracts or Unit Price Contracts:

Unit price contracts are what we usually call hourly rate contracts. This type of contract is a hybrid of a cost-reimbursable and fixed-price contract. For example, if the seller spends 1,200 hours on a project at $100 an hour, the seller will be paid $120,000 by the buyer. This type of contract is common for freelancers, and the main advantage of this contract type is that the seller makes money for every hour spent working on the project.

Cost Reimbursable Contracts:

What do you do when the scope of the work is not clear? A fixed-price contract is out of the question since you are not sure what the project will require. Here's where you'd use a cost-reimbursable contract.

A cost-reimbursable contract also known as a cost disbursable contract—is used when the project scope is uncertain, or the project is high risk. The buyer pays all costs, so the buyer bears all the risk. Under a cost-reimbursable contract, the seller works for a fixed time period and raises the bill after finishing the work—a fee that represents the profits for the contract. The fee may be dependent on selected project performance or other metrics.

A major drawback of this type of contract is that the seller can raise an unlimited or unknown amount which the buyer is compelled to pay. This is why cost reimbursable contracts are rarely used. Below are a few types of cost-reimbursable contracts:

- **Cost Plus Fee (CPF) or Cost Plus Percentage of Costs (CPPC):**

  The seller will get the total cost they incurred during the project plus a percentage of the fee over cost; this is always beneficial for the seller.

- **Cost Plus Fixed Fee (CPFF):**

  The seller is paid a fixed amount that is agreed upon before work commences. The cost incurred on the project is reimbursed on top of this, regardless of project performance.

- **Cost Plus Incentive Fee (CPIF):**

  A performance-based incentive fee will be paid to the seller over and above the actual cost they have incurred on the projects. With this type of contract, the incentive is a motivating factor for the seller to meet or exceed the project's performance metrics.

- **Cost Plus Award Fee (CPAF):**

  The seller will get a bonus amount (the award fee) plus the actual cost incurred on the projects; this type of contract is very similar to a CPIF contract.