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## Purchase order, contract or purchase agreement: Which is best for your procurement strategy?

Procuring equipment, materials and services are very important to a project's financial success. Extensive effort is focused on achieving quality purchases in a timely fashion at the best possible price. Most major companies procure materials and services globally. Therefore, a broad spectrum of sellers and external factors must be considered. To ensure that the supplies of products and services are consistent with what has been agreed to, purchase orders (POs), contracts and purchase agreements are widely used in the procurement process. Each of these approaches has its benefits and challenges. Sometimes a combination of these documents is used. This article describes each document type and highlights key differences and major factors influencing document selection.

The task of procuring equipment, materials and services generally represents one of the most influential responsibilities on a project regarding the team's ability to financially stay on track. Minimizing financial risk is at the heart of executing projects, so there is a large procurement focus on having safeguards in place to limit exposure. All of this creates a lot of attention on choosing the best and most comprehensive procurement documents when making project purchases.

POs, contracts and purchase agreements, both at the local site and at the global level, are the document options most often considered in executing the procurement process. Project success requires tight controls on purchases to maintain quality, budget and schedule. Using the proper procurement docu-

ments and the related processes can ensure that these goals are met. Project specifics should be considered in determining the right document for the application to avoid overkill and to also provide adequate risk protection. In the end, utilizing the right procurement document and the appropriate process will go a long way to achieve project success.

**Definitions.** Before discussing which document is the optimum choice for procuring goods or services, it is best to understand each. Following are definitions of each document type.

**PO.** This is a commercial document that usually originates, with a purchase requisition, outside of the procurement department. A person outside of the procurement department, who is often in engineering or project management, has a request for materials, equipment or services to support a project and, therefore, completes a requisition. The process is generally supported through an enterprise resource planning (ERP) platform. To adequately depict the item(s) being purchased, the requisitioner includes drawings and/or specifications and may also recommend preferred vendors. Sometimes, early in a project, a prequalification phase is conducted, and, for these projects, only "accepted" vendors are considered. The PO needs to include specifications, descriptions, quantities, prices and estimated receipt dates. The ideal PO includes payment terms and conditions, as well. Many companies have their own standard terms and conditions with clauses that cover

such items as confidentiality, guarantees, termination, dispute resolution, liabilities, insurance and consequential damages. The PO can also refer to additional terms and conditions specific to equipment, materials or services, which can make it as detailed as a purchase agreement. A PO is issued before there is agreement between parties. A PO is accepted when the seller accepts the terms of procurement by signing the PO or otherwise by acknowledging acceptance in writing. Another way a PO becomes a binding contract is by the seller providing the ordered goods.

**Contract.** This is a legal document that details the materials, equipment or services being sold or purchased. Contracts set the agreed-upon prices, define the scope of work and detail the terms and conditions of the purchase. Details may also be displayed as addenda or exhibits at the end of the document. The terms and conditions are typically more specific in contracts than in POs. With a contract, the parties have worked out their agreement, and both parties must sign it before it is issued. A contract will typically contain all the information that would be in a PO, but this document is often longer and more detailed. These documents are often developed and reviewed by the company's lawyers or by external lawyers. Typically, a contract will contain contract sums, change order processes (i.e., changes in the work and depicting the manner in which they will be handled), payment terms, billing terms, general provisions, dispute resolutions and insurance requirements. POs become contracts once the vendor

accepts them after issuance, but not every contract is a PO. Therefore, contracts are sometimes used in conjunction with POs so that both legal and commercial aspects of the purchases are addressed.

**Purchase agreement.** This document is essentially a contract, and it contains the same information as previously discussed. Generally, local and global sites try to use common equipment, materials or services, which are driven by a corporate group. In real estate transactions, the terminology of a purchase agreement is used in creating a binding contract. The document used to purchase services is often called a contract or service agreement. For materials or equipment, the document is typically called a contract. As with a contract, a purchase agreement becomes binding between the buyer and seller as soon as it is signed and before issuing. This document also has a specific start and expiration date.

**Key considerations.** There is no simple rule that determines whether to use a PO or a contract. The choice depends on the nature of the transaction and on the relationship between the buyer and seller. The following are some important considerations.

**Commodities vs. services.** Commodities (e.g., steel, pipe and concrete) are well defined in terms of size, shape and materials. Prices for commodities from various suppliers can be easily compared. The purchase of these materials is routine and entails little risk. Therefore, POs with standard terms and conditions are appropriate for this type of purchase, especially if it is a one-time transaction. For repeat purchases, a blanket PO is used to expedite the transaction. A blanket PO often contains discount pricing based on volume. This kind of arrangement is good for both the buyer and seller.

Conversely, services tend to be unique and are typically site specific. The scope, complexity and duration are influenced by conditions at the site. A good example is a site maintenance agreement. Therefore, the transaction is more complex and open-ended. A contract is more useful in these situations to cover price, warranty, insurance, *force majeure*, liability and termination stated in the general terms and conditions document.

**Short-term vs. long-term agreements.** POs are typically used for single business transactions, although blanket POs are commonly used for repeat orders.

Contracts and purchase agreements are used for the long-term agreement between the buyer and vendor. Contracts may also include renewal options. For multiple-year contracts and purchase agreements, there are generally provisions to allow for agreed price increases for future years that are generally pegged to a mutually agreed-upon benchmark or index.

**Risk.** Price is usually at the forefront of people's minds when making a purchase. However, equally important is the risk associated with quality and schedule. Getting a low price may not constitute success if the delivery of the product or service is delayed or if the quality is subpar. The main components of a construction contract have been described in literature.<sup>1</sup> The important risks are associated with an event that could not have been foreseen (such as acts of God, floods, hurricanes or fire). It may be important to include language in terms of limits of liability and liquidated damages. In these situations, a contract, which is legally binding, would likely be appropriate. To minimize risk, many contractors carry bid bonds and performance bonds, which guarantee the bid and performance of the work.

**Dollar value.** The absolute magnitude of the transaction needs to be considered in relation to the cost of developing a contract. For example, if the transaction for a grassroots petrochemicals plant is worth millions of dollars, it is certainly worth creating a detailed contract and developing the necessary legal paperwork by using external professional legal services or company lawyers. If the transaction is a routine purchase of office supplies that can be obtained from other suppliers in a worst-case scenario, then a PO may suffice.

**Ease of use.** It is a good idea to minimize paperwork and contractual documents, given the nature of the transaction. Paperwork does not add value to either party, and it is in the interest of both parties to keep it simple, while protecting their individual interests. Having a sound and robust ERP platform and an electronic document management system certainly helps.

**Relationship.** A PO or contract is helpful to both the buyer and seller. It defines the transaction precisely on paper, thereby removing uncertainty, reducing risks and creating a certain level of comfort. If the buyer and seller have a long-standing relationship based on mutual trust built on positive prior experiences, the paperwork

can be simplified. Paperwork is needed to resolve conflict if something goes wrong. If the transaction proceeds smoothly and both parties are satisfied, the paperwork is usually redundant and sits in a file. Very rarely do conflicts get escalated to a court of law. However, it does happen when the right strategy is not adopted and followed correctly.

**International vs. domestic procurement.** Depending on the local costs of materials and labor, international procurement can save money. When purchases are just as likely to be made internationally as they are domestically, it is important to be extra vigilant regarding foreign purchases and logistics, as well as shipping and customs complexities (e.g., import taxes). More specific contract language is usually warranted with international purchases to keep the process on track. Therefore, a contract is preferred over a PO with standard terms and conditions.

Governing regulations vary from country to country, so it is important to explicitly spell out procurement requirements. There should even be a discussion of dispute resolution if the process reaches log-headers. This may involve the courts in a neutral location. Extra effort is needed to understand local codes and custom duties. Time differences, along with culture and language differences, can also add complexities to the procurement process. Very often, it is desirable to use a combination of the approaches previously described.

**Using a combination of approaches.** There may be instances where it is prudent to use both a contract and PO(s). An example is the case where multiple purchases of different commodities and/or services will be made from a given vendor through the course of a project. A contract can be used to define overall requirements with specific terms and conditions. Then, each purchase with this vendor can be made with a simplified PO. Another reason for a contract with a PO is to highlight the importance of project requirements. For example, if a process plant or a skid unit is engineered and partially fabricated at a different location or country, and if the balance of work is required to be completed at the buyer's site, using local materials and services, then such a combination approach can be taken. Again, the devil is in the details, and the project scope must be written clearly and also understood and agreed upon by both par-

ties. This is particularly important with complex projects or in cases where delivery requirements are unique and critical.

**Limitations of each approach.** The limitations of each procurement document may be obvious from this article. However, to reiterate, a PO is the simplest document used in making a project purchase, but it may not be sufficiently detailed enough with respect to the contract requirements. A PO does not become a contract until it is accepted by the seller. Conversely, a contract ensures an early agreement between the buyer and seller. Additionally, contracts tend to be more comprehensive—entailing risks, schedules, scopes, etc.—and may be viewed as cumbersome for simple purchases.

**Takeaway.** Project procurement is generally the major factor determining whether a project stays on track financially. The lowest price is important for the buyer; however, factors such as quality and timely delivery are very critical, and all details must be holistically considered. The challenge is to

select a procurement document that provides the necessary protection but that is not overly burdensome or complicated for the buyer and seller. By applying the guidelines presented here regarding the selection of a PO, contract or purchase agreement, the strong points of each document are clear and there is an understanding of any limitations. At the end of the day, procurement is not the only driver for a successful project, but it certainly is a key activity influencing project metrics. A sound strategy that is executed properly will eventually help a company develop a good vendor relationship, with a fruitful win-win partnership for both the parties. **HP**

#### LITERATURE CITED

<sup>1</sup> Shahani, G. and J. Berg, "The ins and outs of construction contracts," *Hydrocarbon Processing*, December 2019.

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