

# Formulae to Formulate the “Head Office Overheads”



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## 1. Introduction

A losses and/or expenses contract clause commonly exists in the frequently-used Conditions of Contract in Hong Kong. For losses and/or expenses claims, heads of claims generally include site overheads, head office overheads (“HO OH”), loss of profits, and finance charges. Assessors of HO OH usually look at the loss of opportunity (“LOO”) approach (the “formula approach”) or the actual cost approach. In this article, I shall focus only on the LOO approach.

In the LOO approach, it is assumed that because of the delay, the contractor’s organization is unable to move on to another project (i.e., another opportunity) and earn the combined profit and HO OH, of which it is reasonably capable. The saying goes that “the opportunity to earn elsewhere is lost”. Sir William Stabb, QC,<sup>1</sup> said:

*It is generally accepted that, on principle, a contractor who is delayed in completing a contract due to the default of his employer, may properly have a claim for head office overheads during the period of delay, on the basis that the work-force might have had the opportunity of being employed on another contract which would have had the effect of funding the overheads during the overrun period.*

## 2. Hudson’s Formula

This formula was published in the book, **Hudson’s Building and Engineering Contracts**, as follows:

$$\frac{\text{HO OH Percentage in the Contract}}{100} \times \frac{\text{Contract Sum}}{\text{Contract Period}} \times \text{Period of Delay}$$

It was accepted in several court cases, but all of them occurred many years ago. More recently, the formula has been criticized for using the HO OH percentage from the contract as the factor to calculate those costs that may bear little or no relation to the actual HO OH costs for the contractor during the extended/delayed period.

## 3. Emden’s Formula

In order to try to improve Hudson’s Formula, another formula emerged from the book, **Emden’s Building Contracts and Practice**. This was Emden’s Formula:

$$\frac{\text{HO OH Percentage}^2}{100} \times \frac{\text{Contract Sum}}{\text{Contract Period}} \times \text{Period of Delay}$$

Unlike Hudson’s Formula, Emden’s Formula has the advantage of extracting the contractor’s actual HO OH percentage from the audited account(s) of the contractors to assess the HO OH costs. Thus, it has received plenty of recent judiciary support.<sup>3</sup>

I find Emden’s Formula quite useful and have used it in several of my assessments of the HO OH of the prolongation costs, provided that the contractor could prove a loss of HO OH and/or profits due to a delay by the employer.

1. J.F. Finnegan, Ltd. v Sheffield City Council (1988)  
2. Emden arrived at this result by dividing the total overhead cost of the contractor’s organization as a whole by the total amount of turnover in the audited accounts.  
3.

**4. Eichleay's Formula**

Someone may argue that if the LOO cannot be proved, then both of the above formulae cannot be used. I am of the opinion that this is quite right. As a result, the third formula below may be used to assess the HO OH under this scenario, which someone claims is likely based on "actual costs" instead.

Eichleay's Formula:

$$\text{HO OH Allocated to the Contract ("A")} = \frac{\text{Value of work during contract period}}{\text{Total value of work for the company as a whole during the contract period}} \times \text{Total HO OH during the contract period}$$

$$\text{Total HO OH assessed} = A \times \frac{\text{Period of Delay}}{\text{Contract Period}}$$

I recently used this formula to assess the HO OH for the prolongation costs, as applied by the contractors, and found it to be very useful. In my opinion, this formula fairly and reasonably assesses the HO OH, since it compares the value of the works carried out in the contract for the project, for which the contractor claimed the prolongation cost, to the total value of the works carried out by the contractor as a whole during the above contract period. Usually, the consultant quantity surveyor can advise on the value of the works carried out in the contract (from, say, the final account prepared) to claim a prolongation cost, whilst both the total value of the works for the company and the total HO OH can be found in the contractor's audited accounts.

Moreover, the audited accounts of the contractors referred to should be included at least one year (preferably two years) before and include the contract period<sup>4</sup> for that particular

project, so as to average out the irregularities and include the information for the relevant years, as advised by the court.<sup>5</sup>

Hon Reyes J.

*Here I accept Mr. Molloy (Mr. John Molloy)'s reasoning. He chose a 4 year average of head office overhead/turnover percentage to obtain a more balanced overhead percentage. Mr. Molloy reasoned that, while the contract period was covered by the years 2003 and 2004, the Contractor would have most likely based its tender on the 2 years preceding the contract period" (bracket added by the author).* ■

3. For instance, *Beechwood Development Co. (Scotland), Ltd. v Stuart Mitchell* (2001); *Global Bright Engineering, Ltd. v CWF Piling & Civil Engineering Co., Ltd.* (2006).

4. For instance, if the contract period was from 2009 to 2010, then it should be better to select audited accounts for the years 2007, 2008, 2009, and 2010 for assessment/averaging.

5. *Hsin Chong Construction (Asia), Ltd. v Henble, Ltd.* (2006).