

The Calculation of Head Office Overheads

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One of the principal elements of a claim for reimbursement of the costs of the prolongation of the time for completion of the works, is a claim for the costs of head office overheads.

However such a claim, and the basis upon which it is made, is often misunderstood. In simple terms a contractor may seek reimbursement of its head office costs in one of two alternative ways:

- As lost opportunity costs; or
- As additional overheads actually expended as a result of the delay.

An opportunity costs claim is based on the premise that because of the delay the contractor's organisation is free unable to move on to another project and earn the combined profit and head office overheads of which it is reasonably capable, i.e. the opportunity to earn elsewhere is lost.

This is the normal basis of claims for head office overheads, firstly because it is the easiest to calculate as it adopts a simple formula such as the Hudson formula or the Emdem formula, and secondly because it tends to generate large sums of money.

In order to pursue a claim on the opportunity costs approach if is necessary for the contractor to prove the following:

- That the overhead represents a reasonable one by reference to audited accounts for the appropriate period. This is generally not a problem provided contractors are able to provide copies of their audited accounts.
- That work of the same level of overhead recovery was available during the period of delay. This can be proved by production of tender enquiries and publications (such as the Government

Gazette) indicating the level of construction activity during the period of delay.

- That the method of working of the Contractor was suitable for this approach. This can be proved by showing that the Contractor is actively seeking extra work during the period of delay, and by providing details of tenders which it has submitted. Difficulties can arise where economic conditions are such as to restrict the number of tendering opportunities available.
- That the Contractor was prevented from taking on further works as a result of delay. This is the real difficulty. Few contractors in Hong Kong actually turn work away due to delays on a single contract. They are more likely to either increase their resources by subcontracting works out or by employing extra staff. Of course this may have the effect of increasing a contractors tender prices and making it less competitive, but to prove that this has denied the contractor the opportunity to carry out work elsewhere is very difficult. The best a contractor can do is to be aware of the need for such evidence and ensure that records of how delays are affecting management decisions are kept by minutes of directors meeting, memos, internal directives and of course letters to the appropriate employer advising of the position.

Whilst the opportunity costs approach provides a straightforward and easy method of calculation, and whilst it is probably easy in principle to prove an entitlement to opportunity costs, the reality is that evidence will be far from easy to provide.

Indeed in the mid 1980s comments made by the judge in the non construction case of *Tate & Lyle v. Greater London Council* led many to believe that the courts would no longer accept claims for head office overheads made on the opportunity costs approach at all.

However, in the more recent construction case, of *Alfred McAlpine Homes North v. Property and Land Contractors* (1995), the court affirmed that there was no objection in principle to a claim for head office overheads made on the opportunity costs approach, and further that there was no objection in principle to such a claim being calculated by reference to a formula. It should be noted however that in this case the court in fact refused to adopt such an approach principally because it was the contractor's working arrangement that they only ever undertook one construction project at a time and did not undertake another until the project was complete. It was therefore inappropriate to use opportunity costs as the basis of calculation.

The second method of calculating a head office overheads claim is the actual costs approach. The basis of this claim is that the prolongation has resulted in the contractor allocating more overhead expenditure to the project than was originally contemplated at the date of the contract.

This is traditionally a less popular approach due to the fact that the records necessary to support the claim are seldom available, because few contractors require their head office staff to fill in time sheets detailing the

time spent on each contract. Also the amounts of money generated by this approach are generally significantly less.

However, hope may be in sight for contractors who find it difficult to satisfy the requirements of an opportunity costs claim, and who do not keep sufficiently detailed records for an actual costs claim.

In the above mentioned case of *Alfred McAlpine Homes North v. Property and Land Contractors* (1995), and also in the *Amec Building Ltd v. Cadmus Investments Co Ltd* (June 1996), the courts accepted a claim for head office overheads, based on the actual costs approach but using a formula to calculate the amount attributable to the particular contract.

The court simply calculated the contractor's average weekly overhead costs (by reference to the company's accounts), multiplied this by the number of weeks delay and then allocated them to the particular contract by means of a pro rata calculation based upon the value of the work carried out on the site during the overrun period and the value of all the works being carried out by the contractor during the overrun period.

This method may at last provide contractors with a simple and acceptable method of calculating head office overheads for inclusion in a prolongation costs claim.

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