

Head Office Overheads Revisited



Prof. Indrawansa Samaratunga

“Head Office Overheads” is not an expression that is found in FIDIC Forms of contract, resulting in frequent debate as to why a prolongation cost claim (especially under FIDIC Forms of contracts) should include a Head Office Overheads element. Typical expressions such as “off the Site overhead charges” (FIDIC–4th 1.1(g)(i), FIDIC–1999 1.1.4.3) and “Contractor’s general overhead costs” (FIDIC–4th 52.3) found in FIDIC Forms of contract are generally construed to mean Head Office Overheads. Whilst in some parts of the world they are referred to as “Home Office Overheads”, an accountant would use the expression “General and Administrative (“G & A”) expenses of the company” in referring to the Head Office Overheads.

In the books of accounts of a Contractor’s Head Office, the Overheads (G&A expenses) are generally recorded under the following heads (which vary from company to company):-

- Executive and administrative salaries, allowances & recruitment costs etc.	- Insurance.
- Head Office rent and maintenance.	- Travel.
- Utilities, phone/data/fax, postal and bank charges.	- Bad debts.
- Depreciation of company assets.	- Entertainment.
- Furniture and equipment.	- Pantry expenses.
- Stationary and printing.	- Contributions.
- Professional fees.	- Sponsorship fees.
- Auditing expenses.	- Idle resources.
- Advertising and marketing (including tendering costs).	- Training.
- Interest on company borrowings.	

delay claim. There is no reason, for example, why the Employer of the delayed project should bear a part of a bad debt related to another project of the Contractor. Similarly, the Employer of the delayed project has no liability to bear any part of a claims consultant’s fees paid for the preparation of a claim for another project of the Contractor. Therefore, during an audit of the books of accounts of the Contractor’s Head Office by the Engineer or the Employer’s other Contract Administrators (or by the Contractor’s Contract Administrators in auditing a Subcontractor’s books of accounts) in order to verify whether the Contractor (or the Subcontractor) has calculated the Head Office Overheads element of a prolongation cost claim in a fair and reasonable manner, the following should be given due consideration:

Though the total of all these expenses (taken as a percentage of the company revenue) is usually considered as a suitable basis for the pricing of tenders and building-up new rates / prices, some of these expenses are inappropriate for inclusion in the prolongation cost calculations of a

- (a) Capital expenditure (building extensions, new furniture etc) should be appropriately depreciated.
- (b) One-off annual/quarterly expenditure (advertising costs, audit fees etc.) should be distributed over the year/quarter and the cost of bulk printing etc.

- should be distributed over the relevant period.
- (c) Insurance costs and financing costs of projects should not be included in the Head Office Overheads account. (They should be in the project accounts).
 - (d) Claims consultancy fees should not be included in the Professional Fees head.
 - (e) Any bad debts written-off under the Head Office Overheads should be completely removed from the calculations.
 - (f) Cost of idle resources should be in the project accounts and not in the Head Office Overheads account. (It is permissible to allow the cost of some idle resources such as the asphalt plant of a road works contractor to be in the Head Office Overheads account).
 - (g) Cost of an employee (such as a Commercial Manager) whose time is totally dedicated to a project/projects, should not be in the Head Office Overhead account, despite being stationed at the Head Office.
 - (h) Sponsorship fee/parent company fee paid as an annual/monthly sum of money or as a percentage of the revenue could be a Head Office Overhead, but not if it is a portion/percentage of the profit.

Once the Head Office Overheads account is rationalized in the above manner (let's call it the "Rationalized" account), it would be suitable for prolongation cost calculations.

Where a project completion had been delayed, it is not difficult for a Contractor to demonstrate (using daily records, photographs, correspondence etc.) that the cost of his Site Overheads increased due to the necessity of:-

- supervision staff to stay longer on Site
- site huts to be maintained for a longer period
- tower crane to be retained on Site longer than previously planned
- performance security, insurance etc. to be extended
- etc.

The prolongation of these Site Overheads are manifest and therefore this part of the claim generally receives few challenges, but when it comes to the matter of Head Office Overheads, the impact thereof on the site/project costs is not so obvious and therefore Engineers and Employers often have the following questions, as to:-

- why should there be an increase in the Head Office Overheads when the project completion is delayed?

- why should any Head Office Overheads be an additional cost under the contract?
- why should a formula be used (whereas the Contractor should demonstrate all costs using records)?

Moreover (unlike for Site Overheads), there are no site records that can be produced (other than the Head Office books of accounts) to support this part of the claim.

The answers are found in the explanation of how the Contractor sustains his Head Office. Since the Head Office does not have an individual income/revenue, the cost of sustaining the Head Office has to be borne by all the projects of the Contractor, by contributing a proportional sum every month from their project revenue, in order to meet the Head Office Overheads. Therefore such contribution is a cost incurred in the execution of the Works (not different to paying authority fees, taxes, subcontract/supplier payments, and any other project expense).

The resources deployed in the project were expected to generate revenue and pay to the Contractor's Head Office a sum of money (to fund the Head Office Overheads) for the duration of the Time for Completion, following which the same resources were expected to be deployed in other projects to generate revenue in order to contribute further money to fund the continuing Head Office Overheads beyond the aforesaid Time for Completion, which was prevented by the Employer by delaying the project completion, requiring the said resources to be retained on Site for a prolonged period of time, resulting in the need to contribute more money from the delayed project to sustain the Head Office, which is an unforeseen additional cost, which is the answer to the second question.

The answer to the first question is that, it is not an increase in the Head Office Overheads but an increase in the contribution required from the delayed project to fund the continuing Head Office Overheads (though such Overheads may not have increased) for the prolonged period, because the resources were not released to generate such contribution from other projects.

Since there are adequate provisions in FIDIC Forms of contract entitling the Contractor to additional payment in respect of costs incurred as a result of a delay caused

by the Employer or by those for whom the Employer is responsible or by an event for which the Employer assumed the monetary risk, and since Head Office Overheads contribution is part of such cost, the Contractor would be in a position to successfully argue his Head Office Overheads claim, provided that it is quantified in an appropriate manner.

Where both parties are agreeable to use an existing formula such as Hudson, Emden, Eichleay or Hank Laan (see the Schedule at the end of this article), quantifying the Head Office Overheads claim would be quite simple, but where there is disagreement, such formulae cannot be used with FIDIC Forms of contract and most bespoke forms of contract (or with claims for damages for breach of contract) due to the necessity to deal with the actual (but fair and reasonable) costs incurred or to be incurred, in addition to other limitations/weaknesses found in such formulae.

It is ideal (but may not be convenient) to have a transparent method to apportion the Rationalized Head Office Overheads of a Contractor to all his projects and to recover monthly from each project, its due contribution, neither based on the revenue (as is being practised by some contractors) nor based on the overall expenditure (as practiced by the others), but based on the limited cost of staff, workers and equipment deployed on the projects (or in other words, based on the cost of those resources that a Contractor moves from one project to another and from which he generates revenue). If this is practised by Contractors, there would be no need of formulae to establish the quantum of Head Office Overheads element of the claim. The Contractor can simply produce proof of the contribution made by the delayed project towards the Head Office Overheads, during the delay period. But the general practice among Contractors (mainly due to administrative convenience) is to use either the revenue or the overall expenditure as the basis for the apportionment, thus necessitating the use of a formula to later assess (for the purpose of a claim) what a fair and reasonable Head Office Overheads contribution should have been, because the actual contribution made was disproportionate (and therefore not fair and reasonable). Moreover, a Contractor is at liberty to collect from any of his projects whatever level of contribution that he prefers, in order to fund the Head Office Overheads (which is the contribution that would be recorded in the project accounts), but an Employer is required to reimburse only what the project

should have contributed fairly and reasonably, and not what was actually contributed. Such fair and reasonable contribution could either be lower or higher than such actual (but unfair and unreasonable) contribution, and can only be assessed by using a formula, which is the answer to the third and final question, and therefore the use of an appropriate formula in the assessment of the Head Office Overheads element of a claim should neither be questioned nor rejected.

Where a necessity arises for the use of a formula, which is free of those shortcomings referred to in the Schedule given at the end of this article, the following formula developed by the author is available, which is currently being used successfully by Contractors and Consultants in the construction industry:-

$H \quad X \quad \frac{CP}{SCP} = \text{Additional Payment due}$
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where:

- H** = Actual total overhead costs (G&A expenses) of the Contractor's Head Office during the period of EOT of the delayed project (Rationalized).
- CP** = "Contract Price of the delayed project divided by its original Time for Completion, and multiplied by the period of EOT"
- SCP** = Sum total of "Contract Price of each concurrent project divided by its original Time for Completion, and multiplied by the whole or part period of EOT (of the delayed project) through which it was in progress", taking into consideration all projects in progress at the time, including the delayed project.

The application of the formula to a project and its claim, would demonstrate that the Contractor is not attempting to recover (from the Employer of the delayed project), all or most of its Head Office Overheads incurred during the relevant period, but only a fair and reasonable portion of it, which is the transparency that an Employer would expect. (Such transparency does not exist when using Hudson or Emden Formulae). It would also be transparent to the Contractor that he is not under-recovering on the reimbursement of the contribution, fairly due from the delayed project. Since the pace of the

project (fast track, slow paced etc.) has been factorized through the CP component, a fast-track project (where it is very likely that the Contractor's highest paid Project Director and most of the brand new equipment are deployed) would need to contribute proportionally higher than a slow-paced project, which is a fair distribution of Head Office Overheads that cannot be criticized. Also a weighting has been introduced (to multiply by the full or part period of EOT through which a concurrent project was in progress) in order to avoid unfair apportionment to a project which was not concurrent through the full period of EOT. (Such factorization and/or weighting to ensure a fair apportionment cannot be found in Hudson, Emden, Eichleay or Hank Laan Formulae). Since actual costs are taken into consideration, this Formula can be used in claims under FIDIC Forms of contract and since a transparent method of fair apportionment is used, this Formula would be acceptable to both Contractors and Employers. For the same reasons, this formula should still be acceptable as a means of assessment of Head Office Overheads element of a prolongation cost claim at arbitrations and litigations even where the Form of contract is not FIDIC, and also where a claim is for damages for breach of contract.

One would wonder why the Author's Formula takes into consideration the period of Extension of Time (EOT) rather than the period through which the delaying event continued. (It is not all the monetary aspects of the delay claim that should be calculated for the period of actual delay! Cost of prolongation of the Site Overheads for instance, should be calculated for the period of actual delay whereas financing charges in respect of reduced revenue should be for the period when the Contractor actually suffers from such reduction (i.e. probably after 2 months of the occurrence of the actual delay, given 28 days for certification and 28 days for payment. Likewise, financing charges for the late release of first moiety of Retention Money should be for the period from original date for completion to the end of the EOT, whereas in respect of the second moiety it should be a year later. Thus each kind of prolongation cost is incurred during a different period of the project time line). Head Office Overheads element should be calculated for the period when the Contractor was unable to generate revenue from other projects using his resources which were unforeseeably retained in the delayed project, which is the same period for which EOT was determined.

A refined version of the formula could be developed by using an S-Curve distribution instead of the linear distribution adopted for the CP factor but the necessity to use calculus and probable non-availability and/or unacceptability of the information required by such a version may pose administrative difficulties/impossibilities in its application for most projects. For this reason, parties to contracts consider the linear distribution to be adequate in order to arrive at a fair assessment of the Contractor's Head Office Overheads contribution that should be reimbursed as part of a prolongation cost claim.

Schedule

HUDSON FORMULA:-

$$\frac{\text{HO/P}}{100} \times \frac{\text{Contract Sum}}{\text{Contract Period (Weeks)}} \times \text{Period of Delay (weeks)}$$

where :

HO/P = the percentage of head office overhead cost and profit allowed in the Tender

Author's Comments:-

- (a) This formula does not comply with the actual cost requirement of FIDIC Forms of contract (or of claims for damages for breach of contract) due to the following reasons:-
 - The actual Head Office Overheads percentage could either be more or less (at the time of delay/EOT) than that included in the Tender.
 - The average-per-week interim assessment is a departure from the actual.
- (b) There is no transparency as to:-
 - whether the Contractor is attempting to recover all or most of the Head Office Overheads from the Employer of the delayed project.
 - whether the other concurrent projects of the Contractor are also sharing the Head Office Overheads in a fair and reasonable manner.
 - whether the Contractor is over-recovering/under-recovering on the Head Office Overheads contribution of the delayed project.

EMDEN FORMULA:-

$$\frac{H}{100} \times \frac{C}{CP} \times PD$$

where :

h = head office percentage arrived at by dividing the total overhead cost and profit of the Contractor's organization as a whole, by the total turnover.

c = contract sum

cp = contract period in weeks

pd = period of delay in weeks

Author's Comments:-

- (a) This formula does not comply with the actual cost requirement of FIDIC Forms of contract (or of claims for damages for breach of contract) due to the average-per-week interim assessment.
- (b) There is no transparency as to:-
 - whether the other concurrent projects of the Contractor are also sharing the Head Office Overheads in a fair and reasonable manner.
 - whether the Contractor is over-recovering/under-recovering on the Head Office Overheads contribution of the delayed project.

EICHLEAY FORMULA:-

Step 1.

$$\frac{\text{Contract Billings}}{\text{Total Contract Billings for Contract Period}} \times \frac{\text{Total Head Office Overheads for Contract Period}}{\text{Contract Period}} = \text{Allocable Overhead}$$

Step 2.

$$\frac{\text{Allocable Overhead}}{\text{Days Of Performance}} = \text{Daily Contract Head Office Overhead}$$

Step 3.

$$\text{Daily Contract Head Office Overhead} \times \text{Days of Compensable Delay} = \text{Additional Payment due}$$

Author's Comments:-

- (a) This formula does not comply with the actual cost requirement of FIDIC Forms of contract (or of claims for damages for breach of contract) due to the average-per-day interim assessment.
- (b) Where the value of billings of other projects of the Contractor is low, the delayed project would attract most of the Head Office Overheads, which would not be acceptable to an Employer.

HANK LAAN FORMULA:-

$$\frac{\text{Contract Billings}}{\text{Total Company Billings}} \times \text{Total Head Office Overheads (during the period of delay)} = \text{Additional Payment due}$$

Author's Comments:-

- (a) The actual cost requirement of FIDIC Forms of contract (or of claims for damages for breach of contract) are satisfied to some extent by this Formula but the method of apportionment used in this formula would not be acceptable to an Employer for the reason stated in comment (b) under Eichleay Formula above.
- (b) Author's Formula is a development off this formula in search of a fair apportionment acceptable to both the Contractor and the Employer.

(Editorial Comment – Samaratunga Formula was first published in 2001, in his Doctoral Thesis "Contract Administration in the Middle East under FIDIC-4th ", and later became a popular topic in his Sound Contract Administration training trilogy)