Accounting Policy

Capitalisation of Labour Costs

July 2020

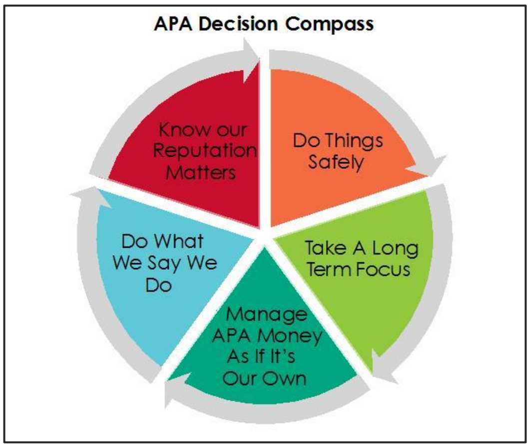
Document type	Policy
Effective from	1 July 2020
Key contact	Manager – Accounting & Financial Reporting
Document owner	Finance
Next review date	30 June 2023
Review cycles	Every 3 years
Legend	N/A
Version Control	Version V1 July 2020

Contents

1 Purpose

The purpose of this policy is to provide guidance in respect of the determination of when and which categories of internal labour costs may be capitalised.

2 Decision Compass



APA is committed to designing and implementing effective and optimal structures, internal systems and processes to ensure we protect our Values and Code of Conduct and enable delivery of APA's financial, customer, people and community objectives. A strong internal control framework is fundamental to achieving these goals.

Effective application of the Accounting Policy – 'Capitalisation of Labour costs' supports decision making as part of the APA Decision Compass under the segment "Know our Reputation Matters".

3 Scope

This Policy applies to APA Group and all staff of APA Group entities who process, code, journal or authorise transactions for accounting purposes, or who cause accounting transactions to be initiated.

4 Objectives

The objectives of the Policy are to set out:

- Principles to apply when determining internal labour costs that are directly attributable to the self-construction of assets.
- APA's Policy and procedure for approval to capitalise internal labour costs.

5 Definitions

The definitions of this Policy are the same definitions outlined in AASB 116 Property, Plant and Equipment ("AASB 116"), the AASB Framework for the Preparation and Presentation of Financial Statements, and other applicable standards.

6 Accounting Principles

In determining whether to capitalise or expense costs associated with any project, it must first be determined whether or not the project meets the definition of an asset.

6.1 Asset Definition

AASB Framework for the Preparation and Presentation of Financial Statements, paragraph 49, defines an asset as:

always powering ahead

- a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

6.2 Asset Recognition

Costs that meet the definition of an asset must also meet the recognition criteria before an asset can be recorded in the balance sheet. The recognition criteria states that assets should be included in the balance sheet when:

- it is probable that the future economic benefits will flow to the entity; and
- the asset has a cost or value that can be measured reliably

  (AASB Framework for the Preparation and Presentation of Financial Statements (paragraph 83 and 89), AASB 116 Property, plant and equipment (paragraph 7) and AASB 138 Intangible Assets (paragraph 21)).

The concept of 'probable', included in the recognition criteria above, is not defined in Australian Accounting Standards. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared (AASB Framework paragraph 85).

The term 'probable' is considered to mean being more likely rather than less likely, i.e. there is a greater than 50% chance that the future economic benefits will occur. Appropriate supporting evidence must be available to support the recognition criteria.

The concept of the term 'economic benefit' includes:

- Revenue contracts entered into which underwrite the capital expenditure to be incurred;
- Work which substantially reduces future operating costs, such as maintenance costs;
- Work that improves the quality and/or quantity of the output of the asset;
- Replacement components or units which extend the service life of the existing asset beyond its expected service life on construction; and
- Replacement/enhancement which increases the efficiency, capacity or functionality of the existing asset.

Probability of expected future economic benefits should be assessed using reasonable and supportable assumptions that represent management's best estimate of the economic conditions that will exist over the useful life of the asset.

An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the income statement (AASB Framework for the Preparation and Presentation of Financial Statements paragraph 90).

Expenditure that is capitalised in the balance sheet must therefore provide future economic benefits beyond the current accounting period or the following 12 months.

6.2.1 *Costs that should be capitalised*

The cost of a self-constructed asset is the aggregate of the cost of material, labour and other inputs used in its construction. Cost is defined as "….the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction or, where applicable, the amount attributed to that asset when initially recognised in accordance with the specific requirements of other Australian Accounting Standards, for example, AASB 2 Share-based Payment." (AASB 116 paragraph 6).

The cost of an item of property, plant and equipment includes:

- the purchase price, including non-refundable purchase taxes less any trade discounts and rebates;
- direct construction costs;
- any other costs that are 'directly attributable' in bringing the asset to a location and condition necessary for it to be capable of operating in the manner intended by management; and
- the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located.

  (AASB 116 paragraph 16, AASB 138 paragraph 27).

'Directly attributable' costs are costs that, if not incurred, would result in the asset not being able to be used in the manner intended by management and therefore not being able to provide future economic benefits to the entity.

AASB 116 (paragraph 17) and AASB 138 (paragraph 28) detail examples of 'directly attributable' costs which include:

- cost of employee benefits (all forms of consideration given by an entity in exchange for services rendered by employees);
- cost of site preparation;
- initial delivery and handling costs of materials for the capital works project;
- installation and assembly costs;
- costs of testing that the asset is functioning properly; and
- professional fees (including contractor fees).

Recognition of costs in the carrying amount of an item of property, plant and equipment or intangible asset cease when the item is in the location and condition necessary for it to be capable of operating in the manner intended by management (AASB 116 paragraph 20 and AASB 138 paragraph 30).

Costs incurred for performing regular major inspections for faults over the useful life of an asset and made to allow the continued use of the asset (e.g. costs aimed at reducing future maintenance expenses, and optimising the useful life of the asset) may be permitted to be capitalised if the recognition criteria as outlined in paragraph 4.2 is satisfied (AASB 116 paragraph 14). The proportion of cost of the major inspection capitalised is identified separately and depreciated over the period to the next major inspection date. At the time of the next major inspection, any capitalised cost remaining from the previous major inspection is de-recognised once the cost of the new major inspection has been capitalised.

The costs of day-to-day servicing of an item do not meet the recognition criteria and would therefore be expensed as incurred.

6.2.2 *Costs that should not be capitalised*

Costs that are not eligible to be capitalised are:

- research costs;
- administration costs and general overhead costs - unless this expenditure can be directly attributed to preparing the asset for use;
- training costs specifically required for general & operational purposes;
- operating costs such as repairs and maintenance, insurance costs.

Other examples of costs that are not costs of an item of property, plant and equipment are (AASB 116 - Property, Plant and Equipment (paragraph 19) and AASB 138 – Intangible 138 (paragraph 67 and 69):

- costs of opening a new facility;
- costs of introducing a new product or service;
- costs of conducting business in a new location or with a new class of customer; and
- costs of identified inefficiencies and initial operating losses incurred before the asset achieves planned performance.

These costs are expensed as they do not increase the future economic benefit of capital projects.

7 Accounting Policy

The Accounting Policy detailed below relates to labour costs incurred in relation to projects which are capitalised in the balance sheet. Any costs incurred for operational and maintenance activities are expensed to the profit and loss when incurred. The cost of a self-constructed asset is determined using the same principles as for acquired assets.

'Directly attributable' costs are costs that would have been avoided if the asset had not been constructed. As APA Group regularly constructs assets, an element of apparently 'fixed' costs may also be directly attributable to bringing an asset to working condition. In such circumstances, consideration should be given to which costs would have been avoided if none of those assets had been constructed.

In summary, the following principles apply to capitalisation of labour costs:

- Direct labour costs

  Where an employee is engaged to work directly on a capital project, the employee costs are controllable by the respective project manager. The employee time is charged to the project by way of timesheet and the employee costs are included in the project cost report and capitalised to the respective project. Refer paragraph 7.1.2 below.

- Indirect labour costs

  Where a department or employee provides services to support the project team and capital activities, these costs are recorded in the respective departments. To the extent that the labour costs qualify as "directly attributable" the costs are recharged and capitalised to the respective capital project by way of an "allocation of capital costs". Refer paragraphs 7.1.2 and 7.1.4 below.

7.1 Acquired and-self constructed capital works and other assets

The capitalisation of labour costs is permitted to the extent that labour costs are directly attributed to specific assets. Only those directly attributable labour costs that relate to the time spent by employees on construction, bringing the asset to working condition or acquiring the specific asset should be capitalised.

Where labour costs are not directly attributable to assets, the cost of labour cannot be capitalised (e.g. costs that would have been incurred regardless of whether the asset was constructed, such as general and administration costs).

Capitalisation of labour costs shall cease once the project is completed and the asset is ready for use in the manner intended by management. At this point the asset should be transferred from capital work in progress to the fixed assets register.

7.1.1 Labour Costs

Labour costs represent the cost of employee benefits provided in exchange for the services rendered by the employee and include:

- employee benefits such as salaries and wages (cash and packaged items) and bonuses (where there is a constructive obligation);
- post–employment benefits such as superannuation benefits (where there is a constructive obligation); and
- on costs, which include all costs that are a consequence of the employment relationship, such as payroll tax and workers compensation.

7.1.2 Labour Costs permitted to be capitalised

Only labour costs that are 'directly attributable' may be capitalised. Labour costs that are eligible for capitalisation include:

- employees who are actively involved and who specifically have been engaged for the purposes of being directly involved in the construction/development/Stay-in-Business ("SIB") capex projects process of assets (e.g. project managers, supervisors, construction, engineering and design staff);
- time allocations by way of timesheets (i.e. number of hours spent on the project multiplied by the applicable charge out rate (typically referred to as the OTL rate or Oracle Time and Labour rate); and
- departments or employees providing services to support the project team and capital activities to bring the assets to working condition. Refer paragraph 7.1.4 below for further detail.

Labour costs of employees who are directly involved in the construction of assets are capitalised on the basis that if their labour costs were not incurred this would directly result in the asset not being constructed and therefore not providing future economic benefits to the entity.

Labour costs of employees who are indirectly involved in the construction of assets, are capitalised on the basis that these costs would have been avoided if APA did not self-construct assets. Refer paragraph 7.1.4 below for further detail.

always powering ahead

Please note that not all personnel may be involved in the construction of assets, and therefore labour costs relating to those employees not involved in construction related activities will not be permitted to be capitalised.

7.1.3 Labour Costs not permitted to be capitalised

Labour costs that are not eligible for capitalisation include:

- management or departmental costs that would have been incurred regardless of the existence of the capital project (i.e. non-incremental costs of the asset), and not directly attributable to construction of an asset;
- work not directly related to the development or construction of the asset (e.g. Commercial Department);
- administrative support;
- training costs specifically required for general and operational purposes; and
- general overhead costs that would have been incurred without the capital project or general capital project activity.

Labour costs of employees who are not directly involved in the construction of assets and labour costs which are ongoing expenses that would have been incurred regardless of the existence of the capital project will not be permitted to be capitalised.

It is important to note that there may be instances where employees may provide services which relate to the construction of assets. As the services provided are however incidental to their work, the labour costs are not deemed directly attributable to the construction of the assets and would therefore not be permitted to be capitalised.

7.1.4 Indirect Labour Costs

As APA Group regularly constructs new growth assets and SIB assets, an element of apparently 'fixed' costs may also be directly attributable to bringing an asset to working condition. In determining the costs that would be eligible for capitalisation, consideration is given to which costs would have been avoided if none of those assets had been constructed.

In determining the indirect labour costs that would be eligible for capitalisation, an assessment of the activities and time spent on capital activities is required.

As noted above under paragraph 7.1.3, it is important to note that the time spent should not be incidental to the employee's work - i.e. regardless of whether such labour costs are incurred, the asset will be constructed - therefore these costs are not directly attributable to the construction of the asset.

An assessment of the activities performed within APA's cost centres are conducted periodically. From this assessment, cost centres are identified where labour costs are incurred which could have been avoided if no assets were constructed by APA. For each cost centre, an estimate of the cost driver of proportion of construction related activities is made which is used as the basis upon which indirect labour costs are allocated to capital projects. The estimate will be reassessed on an annual basis, and will be adjusted as appropriate.

8 Conclusion

The accounting treatment of internal labour costs, whether to capitalise or expense costs, is dependent upon the probability of APA receiving future economic benefits and the nature of the project.

Where it is probable that projects will proceed resulting in the construction/development of an asset, which is to be recorded as part of property, plant and equipment/intangible assets and thereby providing future economic benefits to APA, then internal labour costs directly attributed to the construction process are to be capitalised (i.e. the incremental costs to the entity that would have been avoided only if the asset had not been constructed).

As APA Group regularly constructs assets, an element of apparently 'fixed' costs may also be directly attributable to bringing an asset to working condition. In determining the costs that would be eligible for capitalisation, consideration is given to which costs would have been avoided if none of those assets had been constructed.

Any internal labour costs which are not directly attributable to the construction of an asset, are not permitted to be capitalised, and must be expensed immediately.

9 References

AASB Framework for the Preparation and Presentation of Financial Statements (Issue date: December 2007)

AASB 3 – Business Combinations
(Issue date: December 2012)

AASB 116 – Property, Plant and Equipment
(Issue date: September 2012)

AASB 119 – Employee Benefits
(Issue date: September 2011)

AASB 132 - AASB 132 Financial Instruments: Presentation
(Issue date: September 2011)

AASB 138 – Intangible Assets
(Issue date: June 2009)

AASB 139 Financial Instruments: Recognition and Measurement
(Issue date: October 2010)