Accounting Impacts of 2021 Covid-19 restrictions on Construction Projects

Background

Under the recent 2021 Covid-19 health restrictions, there were several disruptions to construction activity across Greater Sydney, including the Central Coast, Blue Mountains, Wollongong, and Shellharbour. The three events which impacted construction during this time were as follows:

- Event 1: Construction pause, for the period Monday, 19 July until Friday 30 July construction site closures for all of Greater Sydney.
- Event 2: Staged reopening, for the period Saturday 31 July to Tuesday 10 August, eight local government areas where restrictions remained in place, outside of these areas some restrictions still remained.
- Event 3: Reopening with restricted capacity, for the period from Wednesday 11 August to Monday 11 October.

In light of these requirements, agencies will need to consider the impacts of the construction pause in accounting for capital projects. Specifically, additional costs may be incurred due to contractual obligations or to secure worksites, that are not directly attributable to bringing the asset to its intended use. This paper is intended to provide agencies with guidance on the key requirements that should be considered, in determining whether costs should be capitalised or expensed in these specific circumstances.

The Accounting Standards provide some guidance on how costs associated with the 2021 Covid-19 construction pause might be treated. It is likely, in most instances, the costs incurred by agencies during this time are more correctly expensed rather than capitalised. However, to ensure appropriate conclusions are drawn, the detailed steps outlined below need to be followed to consider fully both the facts and the application of the standards.

This guidance provides only a summary of the applicable requirements under *AASB 116 Property, Plant and Equipment (AASB 116)*, *AASB 123 Borrowing Costs (AASB 123) and AASB 137 (Provisions, Contingent Liabilities and Contingent Assets)*. Agencies should also refer to these standards when making their assessment. Additionally, *TPP 06-6 Guidelines for the Capitalisation of Expenditure for Property, Plant and Equipment* and *TPP 21-09 Valuation of Physical Non-Current Assets at Fair Value* provide some guidance on the distinction between capitalising and expensing costs.

Relevant Accounting Standards

<u>AASB 116 *Property, Plant and Equipment*</u>

AASB 116 is the Australian Accounting Standard that that must be applied in assessing whether amounts are part of the cost of property, plant, and equipment. This includes self-constructed assets. *AASB 116* does not provide specific guidance on whether costs can continue to be capitalised during periods of suspension on construction projects. However, it is important to consider what qualifies as the cost of an item of property, plant, and equipment in determining whether an item can be capitalised or not.

Elements of Cost – AASB 116
Under *AASB 116* paragraph, 16 'the cost of an item of property, plant and equipment comprises (emphasis added):

a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
b) any costs **directly attributable** to bringing the asset to the **location and condition necessary** for it to be capable of operating in the manner intended by management.
c) the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.'

AASB 116, paragraph 21 mentions that costs may be incurred in connection with the construction or development of an item of property, plant and equipment, that are not necessary to bring the item to the location and condition necessary for it to be capable of operating in the manner intended by management. These incidental costs may occur before or during construction. For example, income earned using a building site as a carpark until construction starts would be required to be recognised in profit and loss. This is because incidental operations associated with the construction activity are not necessary to bring it to its condition intended by management.

Additionally, in *AASB 116*, paragraph 22 (emphasis added): 'the cost of abnormal amounts of wasted material, labour, or other resources incurred in self-constructing an asset **are not included** in the cost of the asset.'

In issuing IAS 16 (Basis of Conclusions paragraph 5), the IASB acknowledged that judgement may be involved in distinguishing between costs that enhance an asset compared to those that simply maintain an asset. Note, enhance is not defined in IAS 16 or AASB 116, but is generally implied to be adding value or future economic benefit to an asset.

AASB 123 *Borrowing Costs*
AASB 123 applies to Borrowing Costs and is discussed further below. However, the approach to capitalisation of borrowing costs under AASB 123 is consistent with AASB 116. Therefore, reference to AASB 123 when considering non-borrowing costs, during a delay in construction, may be useful.

In particular, *AASB 123* (paragraph 20) requires that if an entity suspends active development of a qualifying asset for an extended period, then it also suspends capitalisation of the borrowing costs for that asset. However, examples in AASB 123 (paragraph 21) indicate that an entity does not normally suspend capitalising borrowing costs during a period when:

- It carries out substantial technical and administrative work; and/or
- A temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. We note that in the example provided, the delay is caused by an event that is common to the specific type of construction project and the geographic location of the construction project.

Please note, NSW Treasury has mandated specific treatment of borrowing costs, this is discussed further below.

The AASB *Conceptual Framework for Financial Reporting*

While the *Conceptual Framework for Financial Reporting* (the Framework) does not specifically apply to public sector or not-for-profit entities[1], it is useful to reference the Framework when interpreting the Australian Accounting Standards. The Framework indicates that historical cost is based on information derived, at least in part, from the price of the transaction (paragraph 6.4) and that the cost of an asset should be based on an event that is a transaction on market terms (paragraphs 6.6, 6.80).

Assessing costs incurred during the 2021 Covid-19 construction pause

In assessing whether costs incurred as a result of the construction pause should be capitalised as part of the cost of property, plant, and equipment, or expensed, agencies should:

a) Apply the core requirements of AASB 116, by considering whether the cost:
   - Is **directly attributable** to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management[2]
   - Is not an **abnormal amount** of wasted material, labour or other resources[3]

b) Consider any other factors that would support/contradict the assessment above, for example whether the costs:
   - Enhance, as opposed to maintain, the asset
   - Would have been considered necessary and common to the type of construction project and/or asset
   - Would be reflected in an arm's length transaction

AASB 116 does not provide definitions of these concepts, so some judgement is involved in determining whether costs should be capitalised. To determine whether a cost is necessary and common, consideration should be given to the intent of management and the circumstances at contract inception. Management would have an expectation of the intended use of an asset and would be expecting the asset to be developed to a particular standard to be fit for purpose. In some circumstances, anticipated costs may be higher due to the environmental, legislative or operational conditions.

The 2021 Covid-19 construction pause was not anticipated across the industry and by the Government and would not be expected to be reflected in an arm's length price for assets prior to the event. Therefore, in most cases costs that are incurred during this specific period are unlikely to meet the requirements to be included in the cost of the relevant assets. Outlined below are some examples of costs incurred and the appropriate accounting treatment.

Examples of Costs

- Where employee costs are required to be paid during the 2021 Covid-19 construction pause, it is likely that these costs should be **expensed**. This assumes that the employees are idle or no longer contributing to the active development of the asset during this period.

- Costs paid to contractors that are still required to be paid during the 2021 Covid-19 construction pause, due to contractual obligations, are likely to be **expensed**. This assumes,

[1] Not-for-profit public sector agencies should apply the *Framework for the Preparation and Presentation of Financial Statements*

[2] AASB 116.16(b)

[3] AASB 116.22

in most cases contractors would be idle or no longer contributing to the active development of the asset.

- If staff are able to be redeployed or carry out substantive technical and administrative work[4] in relation to the development of the asset during this period and are deemed to still be contributing to the development of the asset, these costs may be able to be capitalised.

- Costs of securing a site could include personnel and hire of equipment, e.g., alarms, lights etc. Security costs incurred during the 2021 Covid-19 construction pause are likely to be **expensed**, because:

    - Costs that continue to be incurred during the construction pause, are not directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management, and nor do they enhance the asset.

    - Costs of hiring additional plant and equipment or labour i.e., alarms, cameras to secure site locations, due to the construction pause, are likely to be abnormal amounts of wasted resources that would not have been considered necessary or common to construction projects at that point in time.

  In some instances, costs during construction delays, that are necessary and common, in order to bring the asset to its intended use, may be capitalised.[5] However, similar costs incurred during the 2021 Covid-19 construction pause are unlikely to meet the criteria for capitalising. These costs would not have been factored into the arms-length price for construction projects given that Covid construction pauses were not a common cause of delays at that point in time.

Judgement is required in determining whether a cost should be capitalised or expensed. Agencies may have incurred additional costs as a result of the 2021 Covid-19 construction pause, due to contractual obligations that would otherwise not be incurred. In most cases, these likely would be expensed, because they will be abnormal amounts of wasted resources that do not enhance the asset.

Agencies should consider the following when determining the accounting treatment for a particular cost:

Key decision points:

1. Are the costs directly attributable to bringing the asset to the location and condition necessary for it to be in use?
2. Are the costs adding value or do they enhance the asset?
3. Are the costs incurred otherwise unavoidable and simply the result of contractual obligations?
4. Are the costs not simply for securing premises and maintaining construction sites?
5. Is the interruption to construction activity common for this type of construction?
6. Is the interruption common to the market or business environment at contract inception?

[4] AASB 123.21
[5] AASB 123.21

If agencies are able to answer "**yes**" to the any of the above criteria, then the costs may be able to be capitalised to the related asset. However, in most instances, costs incurred due to the 2021 Covid-19 construction pause will likely be expensed, on the basis that they would not meet the criteria above.

Borrowing Costs

TC20-08 *Mandates of Options and Major Policy Decisions under Australian Accounting Standards*, requires:

- General Government not-for-profit entities must expense borrowing costs;
- For-profit entities must capitalise borrowing costs; and
- Not-for-profit PNFC entities can choose whether to capitalise borrowing costs.

AASB 123, paragraph 20 states that 'an entity shall suspend capitalisation of borrowing costs during extended periods in which it suspends active development of a qualifying asset'.

That is, capitalisation is dependent on there being ongoing 'activities necessary to prepare an asset for its intended use or sale' and the 'costs of holding partially completed assets' should not be capitalised (paragraph 21).

There are some limited circumstances where it is appropriate to capitalise borrowing costs during a delay (paragraph 21). An entity does not have to suspend capitalising borrowing costs in the following circumstances, where a delay relates to:

- when it carries out **substantial technical and administrative** work.
- when a temporary delay is a **necessary part of the process** of getting an asset ready for its intended use or sale.

AASB 123 provides some examples of exceptions, where borrowing costs during a delay in construction can be capitalised. These examples support the principle that borrowing costs would only be capitalised if a delay was necessary and the cause of the delay was common to the construction process. This is consistent with the principle of the cost of an asset being informed by the price in an open market transaction, i.e. what you would normally expect to pay.

The 2021 Covid-19 construction pause was not reasonably anticipated and borrowing costs **would unlikely** be able to be capitalised during this period. In most cases the 2021 construction pause due to Covid-19 would not be perceived to be a typical part of the construction process and therefore would **not be directly attributable** to the cost of an asset. At contract inception, it would be highly unlikely in most circumstances that any covid related delays would have been foreseen. Some examples which further explain the treatment of construction pauses are considered below.

Example of construction pauses common in specific industries

Under AASB 123.21, an entity does not suspend capitalising borrowing costs when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. A temporary delay may be necessary if the cause of the delay is common to the specific type of construction project, geographical location or industry.

Note, the examples included below are not in respect of the 2021 Covid-19 construction pause but have been included for information purposes to highlight the intent of the Accounting Standards in respect of construction pauses.

An entity has entered into a construction contract to build a bridge in an area which is subject to flooding, which is well known upon entering into this market transaction, due to the geographical region that the bridge will be built in. In periods of flooding, where high water levels are a common delay to construction, these costs are considered necessary to the construction process and can **continue to be capitalised**.

An entity purchases a parcel of agricultural land for development of a new sporting facility. A planning application was submitted to Government for the land to be redeveloped. Following a change in government policy this development is deemed to no longer be fit for purpose and the planning application is rejected. Borrowing costs should be **expensed** because the delays caused by a rejected development application are not considered necessary or common to the construction project.

An entity has to place a construction project on hold due to an unforeseen period of political unrest. As this would not have been a common cause for delays when entering into the market transaction, borrowing costs should be **expensed** during this period.

Key decision points:

- Have resources been redirected to perform substantial administrative or technical work or is all activity on pause?
- Can the agency demonstrate the interruption is due to a common external event or is a typical part of the construction process?
- Is the agency simply incurring additional borrowing costs due to contractual obligations required to hold a partially generated asset?

In most cases, it would be unlikely that contractors or staff could be re-deployed to carry out substantial technical and administrative work, due to the nature of the capital projects carried out by Government. Additionally, the pause in construction activity is not due to getting an asset ready for its intended use or sale, it is a result of the Covid-19 pandemic response. As such, in most cases it is expected these exceptions will not be applicable and borrowing costs should be **expensed** in the period of the 2021 Covid-19 construction pause.

Onerous Contracts

An onerous contract may occur due to the 2021 Covid-19 construction pause. An onerous contract is defined in AASB 137, paragraph 10 as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

Agencies should carefully consider any unavoidable costs and care should be taken to include all expected costs to complete or exit a contract. This may include the incremental costs to complete the contract as well as other unavoidable direct costs.

If an agency determines they have an onerous contract, under AASB 137, paragraph 66, the present obligation under the contract must be measured and recognised as a provision immediately. It is expected that a provision for an onerous contract would be measured based on the unavoidable costs of meeting contract obligations.

Examples of unavoidable costs that may result in onerous contracts:

- Increased costs for fulfilling contract due to the Covid-19 interruption, for example, paying contract staff for idle time, additional costs to secure work sites.
- Increased contractual obligations that must be met regardless of whether work can continue. For example, costs for additional plant and equipment, costs for staff working on the project.

Key decision points:

- Do any contracts contain construction pause clauses? The 2021 Covid-19 construction pause may result in construction contracts becoming onerous i.e. that would result in an outflow of resources greater than the future economic benefits.
- Have you determined the financial impact of any obligation associated with an onerous contract, to ensure appropriate measurement of an onerous provision?
- Have you prepared clear and meaningful disclosures about judgements and estimates made in recognising and measuring onerous provisions?

For further information on onerous contracts, please refer to Treasury publication *Guidance on Identifying Onerous Contracts - Natural Disasters and Covid-19.*

Agency Action Required

Agencies should reassess the relevant construction project and borrowing costs to determine whether these should be expensed rather than capitalised. It is likely in most instances, this will result in these costs being expensed during the 2021 Covid-19 construction pause. If costs are assessed to be capitalised, then consideration should be given to the amounts being capitalised as a result of any modifications to contractual obligations.

Note, this guidance has been written in response to the 2021 Covid-19 construction pause. If you have identified other construction delays that were unforeseen, please raise these with our team directly.

Agencies can contact NSW Treasury Accounting Policy team at email accpol@treasury.nsw.gov.au.

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