Grant Thornton

Technical Accounting Alert

Leasehold makegood / restoration provisions

Introduction

The purpose of this alert is to reinforce that lease makegood / leasehold restoration provisions should be recognised in relation to properties held under operating leases. Such a provision may arise because many property leases contain clauses under which the lessee has to make good dilapidations or other damage which occurs to the property during the course of the lease or restore a property to a specified condition.

Relevant standards

References are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 16 Property, Plant and Equipment	AASB 116 Property, Plant and Equipment
IAS 37 Provisions, Contingent Liabilities and Contingent Assets	AASB 137 Provisions, Contingent Liabilities and Contingent Assets

Overview

Under IAS 37.14, a provision shall be recognised when:

- "An entity has a present obligation (legal or constructive) as a result of a past event;
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- A reliable estimate can be made of the amount of the obligation."

In the case of an owner-occupied property, it is not possible to recognise a provision for repairs and maintenance expenditure, as the owner is under no obligation to incur the expenditure; the owner may choose not to make the repairs or carry out the maintenance and so avoid the expense.

However, many property leases contain clauses under which the lessee has to make good dilapidations or other damage which occurs to the property during the course of the lease. Such situations are different from ones where the property is owner-occupied, as a legal obligation to repair the property may arise from the lease agreement (depending upon its terms and conditions).

If the lease agreement creates an obligation to repair the property a liability should be recognised when an obligating event (being wear and tear, or other damage to the property) occurs. In these circumstances a present obligation exists and it is probable this will result in a transfer of economic benefits. In our view it should also be possible to make a reliable estimate of the obligation in almost all cases. It is not appropriate to recognise a liability before the obligating event (being the damage to the property) occurs because there is no present obligation. Similarly if the lessee continuously maintains the property to the condition required by the lease then no further obligation arises and no provision is recorded.

The following paragraphs explain how these principles apply to a number of common situations.

Obligation to Remove Installed Assets

If a lease contract requires the lessee to remove any assets it has installed in the leased property (such as internal walls or partitions) the removal obligation arises immediately upon installation.

In such a situation, it is appropriate to recognise a liability for the present value of the future cost of removal (sometimes known as dismantlement or reinstatement costs) of the assets at the date they are installed.

This amount is included as part of the cost of the asset in the same way as decommissioning costs are treated under IAS 16 (IAS 16.16(c)). Such a treatment is of course dependent on the installed items meeting the criteria for recognition as property, plant and equipment in accordance with IAS 16.

Requirement to Return the Property to the Lessor at the End of the Lease Term in a Specified Condition

Some lease agreements specify that the property must be maintained by the lessee and returned to the lessor in its original state at the end of the lease. In such scenarios, it is clear that a present obligation arises when wear or tear or damage occurs to the property. For example, if a window is broken or a wall is knocked down then it will be appropriate to recognise a liability for the costs of repairing the property for the damage that has occurred.

The same principle applies to general wear and tear of the property to the extent that this involves the property falling below its specified condition. However, it may in practice be more difficult to determine both when an obligation is triggered and the amount of that obligation.

Whilst it will be clear in some situations that damage has occurred and a liability therefore needs to be recognised, it is less clear when a liability should be recognised for damage which occurs gradually during the course of the lease due to general wear and tear.

In our view, it is not acceptable to recognise a liability based on the simple passage of time as to do so would not comply with IAS 37. Instead, a reliable estimate should be made of the amount that would need to be paid to discharge the obligation that has arisen as at the end of the year. Building up a provision evenly over the term of the lease based on the estimated costs at the end of the lease might nonetheless give a reasonable approximation if wear and tear arises evenly over the course of the lease (and the repair costs are proportionate to the amount of wear and tear) but will not be appropriate in all cases.

Requirement to Replace Items or Purchase New Items

In some situations, the lease may require the lessee to replace items (e.g. carpets) at the end of the term, regardless of the physical state of those existing items. In other situations, the lessee may be required to purchase or construct an asset for the lessor as part of the lease agreement (e.g. the lessee may be required to improve the property by say constructing a road which makes it easier to access the property).

In this instance, the substance of the lessee's obligations should be assessed. In some cases it might be determined that the obligation is in substance a payment for the use of the property asset (rather than a mechanism for maintaining the asset). In such cases, the expenditure effectively comprises part of the minimum lease payments. Under IAS 17.33 lease payments under an operating lease are recognised as an expense on a straight-line basis over the term of the lease unless another systematic basis is more representative of the time pattern of the user's benefit.

The Amount of the Provision

In principle, the amount to be recorded should be the best estimate of the expenditure required to settle the present obligation at the end of the reporting period (IAS 37.36). This amount would reflect:

- The extent of damage and wear and tear at the period end; and
- The time value of money.

Some entities might propose an accounting policy based on building up a provision evenly over the lease term equal to the estimated costs at the end of the lease. This approach is not strictly consistent with IAS 37's measurement requirements. Such an approach might nonetheless give a reasonable approximation if wear and tear arises evenly over the course of the lease (and the repair costs are proportionate to the amount of wear and tear) but will not be appropriate in all cases.

Further Information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au