Grant Thornton

Technical Accounting Alert

Onerous operating leases

Introduction

The purpose of this alert is to provide guidance on:

- Determining when a lessee's operating lease is an onerous contract;
- Recording provisions for onerous operating leases, including:
  - Income available for sub-letting;
  - The distinction between onerous contracts and future operating leases; and
  - The relationship between onerous contracts and asset impairment.

Lease categories and onerous contracts
This TA Alert discusses the application of IAS 37 to onerous operating leases for the lessee. Other categories of lease may also result in non-recoverable costs or assets but IAS 37 is not applied. The relevant requirements for other lease categories are:

- Finance leases - lessee: the leased asset is assessed for impairment in accordance with IAS 36
- Operating leases - lessor: the lessor-owned asset is assessed for impairment in accordance with IAS 36
- Finance leases - lessor: the finance lease receivable is assessed for impairment in accordance with IAS 39

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 17 Leases	AASB 117 Leases
IAS 36 Impairment of Assets	AASB 136 Impairment of Assets
IAS 37 Provisions, Contingent Liabilities and Contingent Assets	AASB 137 Provisions, Contingent Liabilities and Contingent Assets

Overview

Summary of key principles

The main accounting requirements for leases are in IAS 17. However, if a lessee's operating lease becomes an onerous contract, IAS 37 also applies. IAS 37.10 defines an onerous contract 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".

IAS 37 requires a provision to be made for an onerous contract. The provision is based on the unavoidable costs of meeting the entity's obligations under the contract. Unavoidable costs are stated in the IAS 37.68 to:

> "…reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it" [emphasis added].

These requirements must be considered along with IAS 37.63's prohibition on providing for future operating losses. It is therefore important to distinguish between unavoidable costs under an onerous lease, and (possibly related) future operating losses. Key differences are that future operating losses: (i) are not independent of the entity's future actions; and (ii) do not stem from an obligation arising from a past event (see IAS 37.19). However, the distinction is not always clear and judgement may be required. The guidance and examples below include situations where this distinction is relevant.

IAS 37.69 requires that, before providing for an onerous contract, an entity recognises any impairment loss on assets dedicated to the contract. Guidance on this is also set out below.

Determining when a lease in onerous

IAS 37 has no explicit requirement for entities to 'search' for onerous contracts. It is nonetheless implicit in the onerous contract principles that reasonable steps should be taken to identify them (subject to normal materiality constraints).

IAS 37 also has no detailed guidance or indicators (such as IAS 36's impairment indicators) to assist in the identification process. Accordingly, entities should apply the onerous contract definition by comparing the unavoidable costs of a lease and the expected economic benefits to be received on a case-by-case basis.

The following paragraphs consider situations that increase the likelihood that a lease in onerous.

Leased asset is abandoned, partly-abandoned or under-utilised

The expected economic benefits from an operating lease are of course reduced if the lessee does not use the leased asset, or uses only part of its capacity. For example, an operating lease of a property normally becomes an onerous contract when the lessee permanently vacates (ie abandons) the property. However, a lease can be onerous even if the underlying asset remains in use. Conversely, a lease is not necessarily onerous simply because the underlying asset is under-utilised.

It is straightforward to conclude that a lease is onerous when the leased asset is abandoned. Additional considerations apply if it is partly-abandoned. In our view it is not appropriate to divide a single lease into onerous and non-onerous portions (for example on the basis of vacant and occupied floors of a leased office building). This is because the IAS 37 onerous test is applied at the contract level. However, practice in this area is somewhat mixed. Some commentators take the view that provision should be made for an 'onerous portion' of a lease if the portion is identifiable and separable (e.g. a vacant, self-contained floor of a larger building).

Leased asset is used in a loss-making operation

A lease is onerous if the expected benefits (net cash inflows) from using the leased asset are less than the unavoidable costs. When the leased asset is used in a loss-making operation, deciding whether the lease is onerous requires a distinction between the net cash inflows relating to the lease and those relating to the operation as a whole. (When the leased asset has been abandoned this distinction is simple because net cash inflows from the leased asset are often zero.)

In our view a lease is onerous only if there is a reliable basis to make this distinction. If future losses are expected but there is no reliable basis to identify the net cash inflows relating to the lease contract, we believe these losses are future operating losses.

Example 1a - Single lease with identifiable cash flows

A restaurant chain operates from several leased premises (all operating leases), and considers each to be a separate cash-generating unit (CGU) for IAS 36 purposes. For a particular site, the lease has three years to run with no break clause. Management's forecasts indicate that the net future operating cash inflows (excluding lease costs) will be only 80% of the unavoidable lease costs over that period. However, management intends to continue to operate the site because the operating cash flows contribute to the lease costs. There is no evidence that an alternative course of actions (e.g. sub-letting) would generate higher net cash inflows. The CGU has been tested for impairment.

Analysis

The facts indicate that the lease is onerous. There is one leased asset associated with one CGU, so the economic benefits associated with the lease can be identified. Management has no alternative courses of action that would result in the unavoidable lease costs being more fully recoverable.

Example 1b - Multiple lease premises in a single operation

A retailer operates from five leased premises in close proximity to one another and regards all five locations as one CGU. Each lease has several years to run. The CGU is loss-making and management is likely to rationalise the number of locations once a review has been completed. Management believes it could operate profitably by abandoning two leases and downsizing to three locations. The CGU has been tested for impairment.

Analysis

At this stage it is likely that none of the leases onerous. The fact that five leases are in one CGU indicates that the cash inflows attributable to each lease are significantly interdependent. Accordingly, there appears to be no reliable basis to conclude that any one lease has unavoidable costs that exceed its expected benefits. At this stage, the CGU's expected future losses should be regarded as future operating losses.

Once management has committed (in a manner that creates valid expectations in other parties) to vacate a specific location, the future economic benefits for the lease can be distinguished. At that point an onerous contract provision is required. (Note that the closure commitment is not an 'obligating event' or 'past event' as referred to in IAS 37.17-22. The past event is signing the lease contract - see IAS 37.IE8. However, management's closure commitment results in specific leases becoming identifiable as onerous.)

Note: IFRIC agenda decision

The above analysis is consistent with an IFRIC agenda decision (in December 2003). The IFRIC considered various issues relating to onerous contract provisions. The IFRIC decided against adding the topic to its agenda but its 'rejection note' stated that: "the Board is considering additional guidance to the existing requirements to make it clear that if a contract becomes onerous as a result of an entity's own actions, no provision is recognised until that action occurs".

Rentals are above-market

In our view, a lease is not onerous solely because the rentals are higher than current market rates. IAS 37 is not a fair-value based standard. Nonetheless, an adverse change in market conditions may increase the likelihood that the lessee will be unable to recover its rental costs (either through sub-letting or operational use).

Measuring onerous lease provisions

General measurement principle

In our view, once a lease is considered onerous, the provision should be determined as the present value of the unavoidable costs, net of the expected benefits under the contract. This net approach is not explicitly stated in IAS 37 but is consistent with the definition of unavoidable costs (see above).

Example 2 - Single lease with identifiable cash flows

Facts are as per example 1a, with the following additional details. For the remaining three years, the annual rental is $1,000 and the expected annual net cash inflows from operations are $800.

Analysis

Before taking into account the effect of discounting (which is required if material), the onerous lease provision is $600 ($200 for each of the three years).

Unavoidable costs

The unavoidable costs of a lease contract reflect the lease net cost of exiting the contract. The provision should therefore be based on the course of action that minimises the present value of the unavoidable costs, net of future economic benefits. Depending on the facts and circumstances, this might reflect one or a combination of:

- Continuing to pay the rentals until lease expiry of the next break clause;
- Paying a contractual break fee or penalty; and/or
- Negotiating a settlement with the landlord (lessor).

Where applicable, unavoidable costs include non-rental costs payable under the lease contract such as maintenance, insurance and dilapidations.

Example 3 - Vacant property with non-contractual settlement

A major nightclub operator leases several properties from a single landlord (lessor). One of those properties has been abandoned. The lease has give years to run at an annual rental of $20,000 with no break clause. Sub-letting is not permitted. Based on past experience, given the company's business relationship with this landlord, management expects that the landlord will agree to terminate the lease for compensation of $50,000. The discount rate is $10,000.

Analysis

Based on this information the appropriate provision is $50,000, reflecting the expected outcome of a negotiated settlement. This is less than the present value of five payments of $20,000 discounted at 10%.

Expected economic benefits

The expected economic benefits to be received under a lease contract are normally the net cash inflows from operational use of the leased asset. The benefits are more readily determinable for an abandoned property or other asset, and are often zero (but see discussion of sub-lease income below). The determination is more difficult, and greater use of management judgement and estimates is therefore required, in situations such as:

- Leased assets used in a loss-making operation (see discussion above);
- Leased premises that have been vacated temporarily;

- Leases over corporate assets such as head office buildings; or
- Leases that are embedded in wider contracts for goods or services.

Sub-lease income

The treatment of sub-lease income often gives rise to application questions. In our view, an onerous lease provision should be measure net of available income from sub-letting (estimated where necessary), when:

- The lease contract permits sub-letting; and
- The least cost strategy to exit the lease is to continue to pay the head-lease rentals and sub-let the asset.

In most cases management will pursue the exit strategy that minimises expected net exist costs. However, companies sometimes decide not to sub-let an asset even if viable, for example to prevent competitor access to a prime location. In our view, an onerous lease provision should still be measured net of available sub-lease income in these circumstances. This is because:

- This view is consistent with the unavoidable cost principle in IAS 37.68 (in other words, a portion of the head-lease rentals could be avoided even though management has decided to incur the full cost); or
- The decision not to sub-let could be reversed in future. Hence the benefits foregone are future operating losses.

Available income from sub-letting is of course subject to more estimation uncertainty when no sub-leases are in place or being sought. However, in our view IAS 137's principles require a best estimate to be made (subject to the overall reliable measurement threshold in IAS (37.14(c)). Accordingly, it is not appropriate to ignore sub-lease income solely on the grounds of uncertainty as to timing or amount (if sub-letting is permitted under the contract, and market conditions are such that sub-lessors could be found).

Example 4a - Vacant property with sub-lease

A services company has rationalised its head office facilities and vacated a leased office building. The lease has two years to run at a rental of $5,000 per annum. The head-lease permits sub-letting. The company has sub-let for one year at a rental of $3,000 per annum. Management estimates that there is a 50% probability that it will be able to extend or replace the sub-lease at the same rental for a second year. Other contractual costs are immaterial.

Analysis

Based on this information, and before discounting, management determine that an appropriate provision is $5,500 (head-lease costs of $10,000 for Y1 and Y2 less the expected value of sub-lease income of $3,000 for Y1 and 50% of $3,000 for Y2).

Example 4b - Property held vacant to prevent competitor access

A grocery retailer has vacated one of its leased retail sites in a prime location after opening a new larger store in the same area. The lease has three years to run, with no break clause, at annual rental of $100,000. The lease allows sub-letting, but the only expressions of interest are from competing grocery retailers. Available evidence indicates that these competitors would pay a rental of $90,000 per annum. The landlord has also indicated it would accept a payment of $40,000 to terminate the lease. However, management's current intention is to prevent competitor access to the site so it declines both opportunities.

Analysis

Based on this information, the appropriate provision is $30,000 before discounting. The least cost exit strategy is to continue to pay the head-lease rentals and sub-let the property, at a net cost of $10,000 for each of the three years. The provision should therefore be measured taking account of available sub-lease income even though management has decided not to sub-let.

With reference to Example 4b above, some commentators argue that the available sub-lease income should be ignored because it is not an 'expected economic benefit' based on management's intentions. Under this view, the provision would be reduced only if sub-lease income is actually expected to be received (and not merely available). However, in our view, if the lease was entered into with the intention of operational use, the 'expected economic benefits' are those from using the leased asset. Available sub-lease income reduces the unavoidable costs as defined in IAS 37.68 and should therefore be considered in estimating the least cost means of exiting the contract.

Link with impairment testing

IAS 37.69 states that:

> "Before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets dedicated to that contract (see IAS 36)" [emphasis added].

This means that evidence that a lease or other contract is onerous also indicates impairment for IAS 36 purposes. It is then necessary to consider which assets are 'dedicated' to the lease. IASs 36 and 37 have no guidance on this and judgement may be required. In our view, the dedicated assets are assets that are closely integrated with, and whose use is dependent on, the leased asset. For example, in a property lease, leasehold improvements are normally dedicated assets.

Impairment testing is performed before recognising an onerous lease provision. Hence the carrying value of a CGU is not reduced by an onerous lease provision for the purpose of comparison with its recoverable amount. Instead, the carrying value of the CGU's assets is compared with their recoverable amount. Any excess above recoverable amount is an impairment loss. The need for an onerous contract provision is assessed as a second step.

It should also be noted that:

- It is possible that an impairment loss arises but no onerous contract provision is required;
- It is also not possible that an onerous contract provision is required as well as an impairment loss; and
- It is not appropriate to avoid an onerous contract provision when the related economic benefits are distinguishable from the CGU as a whole, on the grounds that the CGU is profitable. For example, a lease of an abandoned property is normally onerous even if management considers that lease to be part of a profitable CGU (our view is, in any case, that the lease should be removed from the CGU on abandonment.

Example 5 - Onerous contracts and impairment

A leased retail site is a single CGU and is in the process of being wound down. Prior to any impairment testing, the assets dedicated to the lease and the CGU (all of which are leasehold improvements) have a net book value of $100. The lease has one year to run with no break clause. The following table shows the required impairment write-down and onerous contract provision under two alternative scenarios for the CGU's expected cash inflows and outflows. The effect of discounting is immaterial. It is also assumed that the fair value of the leasehold improvements is negligible (and hence their recoverable amount is determined based on value-in-use).

	Scenario 1	Scenario 2
	$	$
Expected cash inflows	90	15
Expected cash outflows:		
- lease payments	(10)	(10)
- other costs	(20)	(20)
Net cash flows	60	15
Accounting implications:		
Impairment loss (IAS 36)	40	100
Onerous contract provision (IAS 37)	NIL	10

Notes:

1. **Scenario 1**: the lease contract does not meet the onerous test even though the CGU is impaired. The CGU is written down to its recoverable amount of $60 (a write-down of $40)
2. **Scenario 2**: because the future net cash flows are negative the assets are written down to nil (a write-down of $100). This write-down does not absorb the unavoidable costs of the lease, which is onerous. The onerous lease provision is $10, being the lower of the costs of the lease ($10) and the CGU's total net cash outflows ($15).

Future developments

The IASB has active agenda projects to replace IAS 17 with a new Standard on leasing, and to review IAS 37.

The current leasing proposals, if enacted, will change the accounting for non-recoverable lease costs from provisioning to impairment of the lessee's so called "right-of-use" asset. The new Standard on leasing is scheduled for completion in 2011 but is unlikely to be in mandatory effect before 2014.

The IAS 37 project has been delayed several times and its completion date remains very uncertain. As noted, the leasing proposals may in any case remove the need to provide for onerous leases under IAS 37. However, the IAS 37 project may eventually alter the general requirements on onerous contracts and introduce wider changes to the recognition and measurement of non-financial liabilities.

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