ACCOUNTING FOR DISREPAIR

This article is part two of a trilogy on dilapidations by Simon Hartley (Partner, Head of Property Litigation at RadcliffesLeBrasseur LLP), co-authored by Andy Crook (Partner at Mercer & Hole). The article first featured in Estates Gazette on 20 February 2021.

The impact of recent accounting standards on the landscape of dilapidations liability is explained by Simon Hartley and Andy Crook.

Most commercial tenancies contain repair obligations. They apply throughout the lease term and crystallise on expiry when the tenant is required to yield up the demised premises in a certain condition. These contractual provisions can oblige leaseholders to incur substantial outgoings in maintaining their properties and can represent a significant liability to the landlord if the premises are dilapidated when the tenancy comes to an end.

If a tenant's accounts are to represent its financial position, they will need to make provision for these dilapidations obligations. The issue of how accounts should address lease covenants has been around for a long time. However, the rules regarding leases introduced by international accounting standard 'IFRS 16 Leases' are relatively new and have potentially altered the landscape with regards to accounting for dilapidations.

The Previous Standard

Accounting for dilapidation costs used to be covered by FRS 12 Provisions, Contingent Liabilities and Contingent Assets. This standard said that tenants should account for the cost of dilapidations when an obligation to pay for the dilapidations exists. Unfortunately, accountants could not agree as to whether this meant at the commencement of the tenancy, when the terms of the lease were agreed, or at the end of the tenancy, when any terminal dilapidations claim arose.

The New Regime Under IFRS 16

Enter 'IFRS 16 Leases'. This is an accounting standard about leases - not specifically dilapidations claims. The big change arising from this standard relates to how accounts are to deal with the short-term rental of property. By following the standard, accounts should now show short leasehold property as a depreciating fixed asset in the balance sheet, as opposed to just recording the expense of the rental payments. This presents a problem in deciding what value to place on the short-term lease as a fixed asset. The standard tells us that the value to record in the balance sheet is the total lease costs over the life of the tenancy. This includes the repair and reinstatement costs that the leaseholder is obliged to incur, as set out in the lease.

The standard says that these costs are measured in accordance with FRS 12. It helped clarify the earlier rules by effectively settling the debate as to whether the obligation to account for these liabilities occurs at the start or the end of the tenancy – it is at the start. This is in contrast to the general approach taken by building surveyors specialising in dilapidations, who tend to focus on the liability accruing at lease end.

Using this standard, the future cost of restoring the premises is added to fixed assets at the commencement of the lease so the accounting entries are to debit fixed assets and credit provisions.

The fixed asset is depreciated over the term of the lease but the provision is retained until the end of the tenancy when, theoretically at least, the restoration work is carried out or the dilapidations claim is settled and the provision is released. This means that the profit and loss effect of the tenant's repair obligations is effectively spread over the term of the lease, as the restoration costs that have been capitalised are depreciated.

What are accounting standards?

International Financial Reporting Standards (IFRS) are accounting standards issued by the IFRS Foundation and the International Accounting Standards Board (IASB). They are a standardised way of describing the financial performance of a company so that its financial position is understandable across different jurisdictions. They have replaced many national accounting standards globally.

In the UK, these standards apply to listed companies and a small number of limited companies that choose to use this set of rules.

The IASB published 'IFRS 16 Leases' in January 2016. The new standard required tenants to recognise nearly all leases on their balance sheets, which were to reflect their rights to use an asset for a period of time and the associated liability for payments. IFRS 16 focuses on the transparency of lease obligations on a tenant's balance sheet. This standard was borne out of a desire by accounting standard setters to treat assets that are available to an organisation the same whether those assets are owned or leased under short, or long-term leases.

IFRS 16 became effective for annual reporting periods starting on or after 1 January 2019 (with year ends from December 2020).

The majority of UK limited companies do not use the IFRS but rather Financial Reporting Standard (FRS) 102 (entitled 'The Financial Reporting Standard applicable in the UK and Republic of Ireland'), a single accounting standard covering all aspects of accounting. It was issued by the Financial Reporting Council (FRC), who are responsible for issuing accounting standards in the UK. FRS 102 will often be referred to as UK Generally Accepted Accounting Standards (GAAP).

The old UK accounting standards, like FRS 12, have been effectively incorporated into FRS 102.

Although IFRS 16 only applies to listed companies, this standard helped to clarify dilapidations' treatment for non-listed companies who account under FRS 102 and must also include the dilapidations provisions in relation to their leasehold properties in their financial statements.

Restoration or Maintenance?

The sum to be included in the accounting provision at the commencement of the tenancy incorporates the cost of reinstating any tenant's alterations and of restoring the premises as required by the lease terms. These costs are generally referred to as restoration costs.

The estimate made at the start of the lease is likely to require later adjustment. If the costs are overestimated, there will be a profit and loss gain on the release of the excess provision when the extent of the tenant's exposure is determined. A profit and loss deficit would occur if the initial estimate is too low.

A company should consider its future liability for terminal dilapidations if it prepares its annual accounts in accordance with IFRS 16 and adjust the initial estimate if there is a material change in the anticipated liability (due, for example, to the landlord's plans for the premises reducing or extinguishing its claim under the statutory cap imposed by s18(1) of the Landlord and Tenant Act 1927).

There are some costs that can be spread throughout the term as ongoing repair expenses accrue. Maintenance costs and general wear and tear arise as a direct result of use. These costs are not capitalised like fixed assets or accounted for at the outset of a tenancy. As these expenses arise as a result of usage, the provision should be built up gradually over the lease term.

In practice, it has generally been maintenance costs that accountants occasionally accounted for by making provisions under FRS 12. IFRS 16 has not changed how tenants should deal with maintenance costs except perhaps by drawing a clear distinction between restoration and maintenance costs.

Dilapidations under FRS 102

Under FRS 102, accounts still do not bring short term leases onto companies' balance sheets as fixed assets. Instead, they are accounted for by showing annual rentals, as was previously the practice.

However, because IFRS 16 made it clear that treating dilapidations as fixed assets was in accordance with the requirements of FRS 12, tenants should still do that when accounting under FRS 102. The same dilapidations provisions should be made. With regards to fixed assets, the debit entry is to the leaseholder's fixed assets when the provision for the restoration cost is made (the credit entry). Again, for restoration costs, the future dilapidations liability is accounted for as a fixed asset at the start of the lease and tenants will need an expert to provide them with an assessment.

Practical Consequences

Speaking to many accountants about this treatment, very few seemed aware of what they should be doing in relation to dilapidations. Accounts which fail to provide for these obligations will have possibly been misstated. Companies that fail to make provisions in their accounts could be caught out when questioned by their auditors or investors. Failure to produce accounts that show a true and fair view is potentially a criminal offence.

There is no tax consequence from capitalising the estimated dilapidations at the start of the lease, nor is there a tax effect during the term when the costs are depreciated. At the expiry of the lease, costs relating to repairs and renewals are allowable against corporation tax, unlike capital expenditure (such as reinstatement works). Such costs would include items such as replacement carpets and painting the premises and other decoration required on yielding up.

Payments relating to maintenance are likely to be repair or renewal expenses that are allowable against corporation tax. Where maintenance costs have accrued throughout the term of a lease, the allowance against tax is made when the accrual is provided; with usage over the tenancy period.

It is, therefore, important that companies who enter into commercial leases consider their dilapidations exposure before commencement and take appropriate professional advice to enable them to correctly account for their repair and reinstatement obligations.

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