Accounting for dilapidations

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INTRODUCTION

• Introduction

• Who are haysmacintyre?

• Aim of today

  – Accounting for dilapidations
  – Audit requirements
  – Impact of IFRS 16
  – Tax treatment
Overview of accounts

- What are the purposes of financial statements?
  - To provide a greater understanding of the business and its performance
  - To present accurate view of the company’s position
  - UK GAAP vs IFRS

- What are a director’s responsibilities?
  - Obliged to show a true and fair view
  - Make reasonable judgements and accounting estimates
  - Follow accounting standards
Accounting for dilapidations

- Accounted for like any other provision – 3 criteria
  - A present obligation as a result of a past event
  - Payment is probable – i.e. it’s more likely than not
  - Can it be accurately measured?

- What do these actually mean?
Important to differentiate between types of dilapidations

- Arising at the start of the lease (decommissioning costs) – could be part of capital cost
- Arising during the tenancy (wear and tear) – expense

Is it value enhancing?

Results in a liability to be annually reviewed
## Balance sheet

### At end of year

<table>
<thead>
<tr>
<th>Fixed assets</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Property</td>
<td>300</td>
<td></td>
</tr>
<tr>
<td>Land and buildings</td>
<td>300</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Assets</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Cash at bank and in hand</td>
<td>10</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dilaps provision</td>
<td>(200)</td>
<td></td>
</tr>
<tr>
<td>Provision</td>
<td>(200)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net assets</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserves</td>
<td>110</td>
<td></td>
</tr>
<tr>
<td>Share capital</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Profit and loss</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Shareholders’ funds</td>
<td>110</td>
<td></td>
</tr>
</tbody>
</table>
### Profit and Loss

<table>
<thead>
<tr>
<th>Year</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover</td>
<td>£1,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>(£200)</td>
</tr>
<tr>
<td><strong>Gross Profit</strong></td>
<td>£800</td>
</tr>
<tr>
<td>Admin costs</td>
<td>(£350)</td>
</tr>
<tr>
<td><strong>Operating profit</strong></td>
<td>£450</td>
</tr>
<tr>
<td>Interest and tax</td>
<td>(£75)</td>
</tr>
<tr>
<td><strong>Profit</strong></td>
<td>£375</td>
</tr>
</tbody>
</table>

But the depreciation will be charged over the life of the lease... eg. 4 years

£300 – overheads

£50 – depreciation of dilapidations

**EITHER...**
## Profit and Loss

### OR...

<table>
<thead>
<tr>
<th></th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover</td>
<td>£1,000</td>
</tr>
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</tr>
<tr>
<td><strong>Operating profit</strong></td>
<td>£300</td>
</tr>
<tr>
<td>Interest and tax</td>
<td>(£75)</td>
</tr>
<tr>
<td><strong>Profit</strong></td>
<td>£225</td>
</tr>
</tbody>
</table>

- £300 – overheads
- £200 – dilapidations
What’s the impact?

- Reduction in profit
- Reduction in net assets

**BUT**

- The accounts show a true and fair view
- Investment decisions are based on accurate figures
- Dividend payments are based on true reserve levels
What are the risks of not including?

- Breaches in bank covenants won’t be identified
- Cash flow impact / timing of tax relief
- Investment decisions may be inappropriate
- Directors are not fulfilling their obligations
How much detail is needed for an audit?

- Generally require a professional assessment (not required by accounting standard)
  - A quantified schedule with reasoning
- Directors need to be able to support their judgements to the auditors
- Consideration of management’s judgements
- What disclosure is required?
  - Carrying amount, movements, brief description of the obligations
New accounting standard from 1 January 2019 for leases

Only for companies that following IFRS, not UK GAAP

Why IFRS 16? Significant liabilities not included (Tesco - £1.4bn on net assets and £10.6bn of lease liabilities)

Operating leases come onto the balance sheet – all finance leases

Recognise a liability at the present value of minimum lease payments

Depreciate the asset

Unwind the liability using an effective interest rate

The asset and the liability will not agree
IFRS 16 example

Lease of Life Limited has period end of 31/12 and the date of transition is 01/01/20X4, so the lease has 7 years remaining at the date of transition. Assumption is lease commences 01/01/X1 on a 10 year term. Annual rent of £120,000 with a maintenance element of £12,000 per annum. We have assumed a discount rate of 3%. Extracts for the financial years X3 and X4 have been presented below.

### Profit and loss

<table>
<thead>
<tr>
<th></th>
<th>IAS 17 (previous treatment)</th>
<th>IFRS 16</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FY X4</td>
<td>FY X4</td>
</tr>
<tr>
<td>Gross profit</td>
<td>500,000</td>
<td>500,000</td>
</tr>
<tr>
<td>Other expenditure</td>
<td>(250,000)</td>
<td>(250,000)</td>
</tr>
<tr>
<td>Rental expenditure</td>
<td>(113,333)</td>
<td>-</td>
</tr>
<tr>
<td>Maintenance costs</td>
<td>-</td>
<td>(12,000)</td>
</tr>
<tr>
<td>Depreciation</td>
<td>-</td>
<td>(88,291)</td>
</tr>
<tr>
<td>Operating profit</td>
<td>136,667</td>
<td>149,709</td>
</tr>
<tr>
<td>EBITDA</td>
<td>136,667</td>
<td>238,000</td>
</tr>
<tr>
<td>Finance charge</td>
<td>-</td>
<td>(19,073)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>136,667</td>
<td>130,636</td>
</tr>
</tbody>
</table>

### Balance sheet

<table>
<thead>
<tr>
<th></th>
<th>-</th>
<th>644,883</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tangible fixed assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lease creditor</td>
<td>-</td>
<td>(635,780)</td>
</tr>
<tr>
<td>Net lease (liabilities)/assets</td>
<td>-</td>
<td>9,103</td>
</tr>
</tbody>
</table>

9,103
Increases in EBITDA – what were previously admin payments are now classified as depreciation and interest payments

Potential changes in company valuations based on multiples of EBITDA

Impact on share option and bonus arrangements that are framed with reference to financial performance

Loan covenants based on measures of EBITDA may require re-assessment and re-negotiation

Balance sheet values and gearing rations will increase
How does it impact dilapidations?

- An annual dilapidations assessment continues to be accounted for under IAS 37

- If a tenant makes change to a property when moving in and will incur a provision to restore the asset to it’s original position, these costs form part of the leased asset under IFRS 16
• Dilapidations are key area of the accounts and given judgement involved can be subject to scrutiny

• Liability should be assessed annually to provide an true and fair position

• Obtain a surveyors report to quantify the annual amount

• IFRS 16 is new in 2019 and will significantly change lease accounting

• Seek professional advice!
Tax treatment of dilapidations claims
Provisions

- Tax follows the accounts
- Under the accounting standards, three conditions:
  1. A present obligation as a result of a past event
  2. It is probable that economic benefits will be required to settle this obligation
  3. A reliable estimate can be made
- Where above are met, HMRC generally accepts provisions are tax deductible except where there is an express rule to the contrary (i.e. provisions for capital expenditure)
Dilapidations

- Works of repair or re-instatement for which a lessee ("tenant") is liable if the lease provides that:
  1. The tenant is responsible for the repairs and
  2. The tenant is responsible for delivering up the leased property at the end of the lease in the state in which it was at the beginning of the lease
- Tax relief can be claimed at the time the provision is made, rather than at the point when the dilapidations work is carried out
• Capital expenditure is not an allowable deduction

• Revenue expenditure (i.e. deferred repairs) is tax deductible to the extent that the cost would have been allowable if the repairs had been executed during the lease

• The distinction between revenue and capital is often difficult to ascertain

• Question of law, not accountancy
Several tests have been developed through case law to ascertain whether expenditure is capital or revenue in nature:

1. The enduring benefit test
2. The identifiable asset test
3. The entirety test

Each case should be judged on its own facts
Capital expenditure

- HMRC’s manual specifically provides that no deduction is allowed for:

  1. The cost of rebuilding the leased premises
  2. The cost of re-instatement of any portion of the leased premises which has been demolished by the tenant
  3. The cost of the demolition of any structure which the tenant has added

- However, may qualify for capital allowances
Timing differences

- Record timing differences between tax and accounts to ensure that relief is not given twice, or expenditure is disallowed twice.

- Make sure that the provision in the P&L is linked to an appropriate provision schedule in the tax computation.

- Where there are timing differences, there are likely to be deferred tax consequences.
Lease end adjustments

- If accounting provision exceeds the dilapidations expenditure, the excess is added back to the taxable income and taxed in the year of the works.

- If accounting provision is less than is needed, any additional actual expenditure can be deducted within the year the work is completed.

- If no provision for dilapidations is made, then relief for the expenditure will be given when the actual expenditure is incurred.
Composition payments – lessee ("tenant")

- Tax treatment determined by the underlying costs that the payment is meant to make good

- To the extent that the payment covers deferred repairs, it will be allowable

- The deduction is not conditional on the dilapidations being made good
Composition payments – lessor (“landlord”)

- Capital receipt - where the landlord disposes of the property or occupies it themselves (compensation for the tenant being in breach of the terms of the lease)

- Income receipt - where the landlord does not expend the payment from the tenant in making good the dilapidations (compensation for the lower rent the property can now command)
Composition payments – lessor ("landlord")

- Not taxed on the receipt - where the landlord uses the payment to make good the dilapidations (and assuming the property will continue to be let)

- If the cost of the repairs exceeds the payment received - deduction for the amount of the excess

- If the payment exceeds the cost of repairs - the excess treated in accordance with the prior two bullet points