

Dilapidation provisions (Lecture A831 – 16.34 minutes)

Provisions are contingencies are dealt with in FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* in Section 21 *Provisions and Contingencies*. While not specifically covered by FRS 102, dilapidation provisions would be within the scope of this section.

The Glossary to FRS 102 defines a 'provision' as:

A liability of uncertain timing or amount.

FRS 102
Glossary
provision

1.1 Background to provisions for liabilities

A provision for a liability is recognised when an entity has a present obligation (legal or constructive) as a result of a past event, it is probable (i.e. more likely than not) that a transfer of economic benefits will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. Unless these conditions are met by the balance sheet date, no provision is recognised and a contingent liability is disclosed instead, if material.

Where it is not clear whether a present obligation exists, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date.

For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This will be the case only where the settlement of the obligation can be enforced by law or, in the case of a constructive obligation, the event (which may be an action of the entity) creates valid expectations in the mindsets of other parties that the entity will discharge the obligation. The only liabilities recognised in an entity's balance sheet are those that exist at the balance sheet date. Where an entity can avoid future expenditure by its future actions, for example by changing its method of operation, it has no present liability for that future expenditure and no provision is recognised.

For a liability to qualify for recognition there must not only be a present obligation, but also the probability of a *transfer of economic benefits* to settle that obligation (generally an outflow of cash). A transfer of economic benefits in settlement of an obligation is regarded as probable if the outflow is more likely than not to occur.

An entity will normally be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is therefore disclosed as a contingent liability.

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The provision is measured before tax and will take account of risks and the time value of money (if material).

1.2 Reimbursement assets

Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party (such as an insurance company), the reimbursement asset must be recognised only when it is *virtually certain* that reimbursement will be received if the entity settles the obligation. Care needs to be taken here because the 'virtually certain' test is a higher hurdle to get over than the probability test and the asset will usually qualify for recognition when the third party has agreed in writing to reimburse the entity. The reimbursement asset must be treated as a separate asset and must not be offset in the balance sheet against the related liability. However, the income can be offset against the expense in the profit and loss account (i.e. the expense can be reported net of the reimbursement in profit or loss).

1.3 Review of provisions

Provisions must be reviewed at each balance sheet date and adjusted, where appropriate, to reflect the current best estimate. If it is no longer probable that a transfer of economic benefits will be required to settle the obligation, the provision must be reversed.

Where discounting is used, the size of a provision will change in each period to reflect the passage of time. This change is recognised as interest expense and disclosed separately from other interest on the face of the profit and loss account.

FRS 102, paragraph 21.10 states that an entity must charge against a provision only those expenditure for which the provision was originally recognised.

1.4 Dilapidation provisions

As noted above, a provision can only be recognised in the financial statements if there is a present obligation as a result of a past event.

With respect to general dilapidations, the tenant will normally maintain the property in good order in the early stage of the lease. Since there is no damage to the property, there is no obligation, and no provision is required hence there is often no need to make provision for dilapidation.

More generally, a dilapidation provision should only be made when damage is caused to the property. This will typically arise towards the end of the lease term when the tenant has ceased to maintain the property to the highest standard.

Some accountants have been known to estimate a final dilapidation provision and then average it out over the life of the lease. A provision will then be built up over the entire lease term. This sort of general provision is not permitted under FRS 102 because there is no past event giving rise to an obligation. A provision can only be made once the damage has been caused because it is the cause of the damage that creates the obligating event.

Example – Replacement roof

Harper Ltd took out a 20-year lease on a property on 1 January 2006. The lease contains general dilapidation provisions that the property should be made good.

At 31 December 2022 (the company's year end), the condition of the roof had deteriorated to such an extent that it will need replacing imminently. The directors have received quotes from contractors to replace the roof.

In addition, it was also discovered that there is some corrosion of the steel walls that could indicate the possible need for the walls to be reskinned in the next ten years.

The replacement of the roof is a current obligation as a result of a past event and should be provided for by way of a provision. This would not be the case if the roof was not in need of repair at the year end.

If the walls are not in need of repair or a full reskin at the year end, then a provision is not required. However, if the terms of the lease would require the corrosion on the walls to be made good then this would give rise to a provision being recognised in the financial statements for the year ended 31 December 2022.

The question that is then asked is whether Harper Ltd should have been making a provision for this at the outset of the lease.

This sort of general provision is not permitted under FRS 102. This is because there must be an obligation at the time the provision is made.

Example – Dilapidation provision

Tennyson Ltd took out a 25-year lease on a property on 1 January 2022. The terms of the lease require all damage caused to the property to be rectified. Tennyson Ltd made alterations to the property during the first year of the lease which cost £180,000. The best estimate of the cost to reinstate the property to its original condition at the end of the lease is £120,000.

How should the financial statements for the year ended 31 December 2022 reflect these matters?

Treatment of improvement costs - £180,000

Provided this satisfies the definition of property, plant and equipment (and meets the recognition criteria in FRS 102, Section 17 *Property, Plant and Equipment*), then the costs can be capitalised and depreciated over their useful lives.

In the 31 December 2022 financial statements, the carrying amount will be £172,800.

Treatment of re-instatement costs - £120,000

A provision should be made for the present value of the cost of the re-instatement work at the time of the original damage. If the provision had been made at the start of the lease term (i.e. 1 January 2022) then the cost of £120,000 would have been discounted for 25 years. Assuming a risk-free discount rate of 5% we obtain a discount factor of 0.295.

Therefore, the original entry in the 2022 accounts would have been:

Dr Fixed assets (£120,000 x 0.295)	£35,400
Cr Provisions	£35,400

This would be depreciated over 25 years at a charge of £1,416 (£35,400 / 25) per annum.

In the 31 December 2022 financial statements, fixed asset will appear as £33,984.

For the first full year and each year thereafter, the provision will be increased by 5% giving the following:

	Interest charge	Year end provision
Y/e 31/12/22	£1,770	£37,170
Y/e 31/12/23	£1,859	£39,029
Y/e 31/12/24	£1,951	£40,980
and so on...		

1.5 Disclosure of judgements and estimation uncertainty

FRS 102, paragraphs 8.6 and 8.7 require an entity to make disclosures about judgements and key sources of estimation uncertainty. Small entities are encouraged to disclose information about judgements.

The FRC's own financial statements contain a very good example of this type of disclosure:

The FRC has an obligation to make good the conditions of the premises at 125 London Wall, in accordance with the lease agreement at the end of the lease term. Provisions for dilapidations is the area involving estimates and judgements where there is the greatest potential risk of a material adjustment in future years. The provision is expected to be utilised at the end of the lease.

FRC financial
statements 31
March 2021

Accounting estimate – The current provision is based on management's current best estimate of the future obligation. This year the estimate draws upon a current year valuation report provided by a third-party surveyor. The provision is expected to be utilised at the end of the lease.

Accounting judgement – In making the estimate management has exercised judgement about the likely future outcomes, including factors such as building and material costs. However various factors and changes in circumstances could affect any amount payable in the future.

1.6 Tax treatment

Like most issues relating to provisions, the tax treatment tends to follow the accounting treatment.