A Practitioners Guide to IAS37 & Its Application to Corporate Real Estate

By Howard Cooke

Core Consult

Corporate Occupier Real Estate Consulting Ltd

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FORWARD

Since I wrote a booklet on FRS12 (Financial Report Standard 12) several years ago some things have moved on while other things have not changed. To an extent, the discussion on FRS12 has metamorphosed into one about IAS37 (International Accounting Standard 37) with a considerable amount of discussion on the changes to IAS37 once Operating Leases are brought on to the Balance Sheet. That discussion continues and a new draft is awaited on Operating Leases. How relevant these guidelines will be post any changes to operating leases remains to be seen.

The aim of this paper is to provide an outline approach to how IAS37 can be applied to property because IAS37 in itself is just a set of principles. Those principles are for all lease provisions not just property ones. The format of this paper sets out the definitions for IAS37 and then how they can be applied to a property. There are examples and graphs to illustrate the issues.

I had originally hoped that, a standard set of criteria for IAS37 would be adopted to achieve a degree of consistency across companies, as the intention of the International Accounting Standards Board (IASB) is to create a level playing field. That would have allowed a third party to undertake a comparison of the financial accounts between two companies in the knowledge that there has been commonality in their preparation. However, the IASB has not done so and no other organisation has stepped in to the void to fulfil that role, consequently, there remains no common approach.

Some may question the need for IAS37 for commercial property leases because of the fall in the length of leases over the last couple of decades. Whilst the 25 year lease as a standard has now disappeared it does not stop occupiers taking leases that are too long for the business case, and I have come across tenants taking 35 year leases in the 2000's to give them certainty of occupation.

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INTRODUCTION

What are the differences between FRS12 and IAS37?

They were developed in parallel by the IASC and the Accounting Standards Board (ASB) and published on the same day. The text is virtually identical. FRS12 preceded IAS37 in that the former came into effect for accounting periods on or after 23 March 1999, whereas IAS37 came in on 1 July 1999.

FRS12 gives slightly more guidance on the discount rate to be used and on the recognition of an asset. So, in answer to the question, the differences are minimal. They are to all intents and purposes they are one and the same, and throughout reference is made to IAS37 but it applies to FRS12.

So why the switch from FRS12 to IAS37?

The two continue to apply to the latter for those governed by IAS regulations and the former for those in the UK governed by the ASB. The real change has been that the subject of lease liabilities has suddenly come on to the radar screen of the large corporates with the realisation that they cannot be hidden away.

From the point of view of Corporate Real Estate Managers (CREMs), having a standard reference point should help in dealing with the conflicts that occur between the real estate needs and the demands of the finance department. From the Finance department's viewpoint the pressure is usually to save money and therefore they seek to avoid increasing provisions, whereas the CREM needs to ensure that the provision for surplus property is sufficient to cover the liability and ideally at a level that will allow deals to happen. In particular, there is sufficient provision to allow the CREM to undertake works to bring the property up to a lettable standard and ideally to agree surrenders with landlords at a sensible level.

IAS37 is not just aimed at surplus properties: it applies to all onerous contracts and includes agreements for photocopier leases and fleet cars. However, surplus leasehold liabilities are a prime example of onerous contracts and there are a number of specific considerations that need to be addressed in determining a provision for a surplus property lease.

THE BASIC CONSIDERATIONS

The rationale behind IAS37 was to avoid what became known as 'big-bath' provisions, where a corporate would make provisions for anything and everything they could think of as a means of tidying up the company for the future.

There have been many instances where large provisions have turned a company from profit to loss post take-over. Over time, as many of the events provided for did not materialise, the provision was released and would then under-pin the performance of a company for that year if, perhaps, trading conditions had been difficult. It was thus used in certain cases as a technique to manipulate the results and hence, the share price of a company.

The objective of IAS37 is to ensure that proper recognition and measurement techniques are applied to provisions to provide appropriate disclosure.

A provision should be made when:
- An entity has a present obligation as a result of a past event;
- It is probable that an outflow of economic benefit will be required to settle the obligation;
- A reliable estimate can be made of the amount of the outflow

A contingent liability differs in that it is looking at possible obligations and measurement cannot take place at the moment. In simple terms, a provision will be needed for a leasehold property that is surplus and is either vacant or has been sublet. It will be a contingent liability if the same property were assigned. While there may be a risk of default by the assignee, the liability for the company cannot be measured until it happens - other than in circumstances such as there being a rent subsidy to pay for a period of time.

Fundamental Points

What are the fundamental points for the CREM?

- **The obligation is current.**

  This does not mean that the lease is necessarily still in existence. A lease may have expired but, because there are ongoing discussions for dilapidations and settlement of other matters, there is still a liability. There needs to be activity on the case. However, if the lease has expired three years earlier and nothing has been heard from the landlord and they have not initiated the dilapidations process, then the company should consider it a contingent liability.

- **There is a cash liability**.

  If so, it is obvious that money has to be committed for payment.

- **The cashflow is to be measured**

  What is envisaged is a detailed calculation of the cashflow that is sustainable in front of the auditors. Making a simple assumption that two years rent will be sufficient is not a measured output, just a guess.

- **Best estimate**

  The cashflow should represent the best estimate that can be made to settling the obligation. It may not necessarily be the sum that a landlord will accept for the surrender. It could be the difference between the likely expenditure and the projected income stream from a subletting; the premium figure that is likely to be paid to an assignee to take the lease on; the premium payable to the landlord for taking a surrender; or the gross costs to expiry if the property is never likely to let.

  The best estimate should be based on the most likely outcome, so the CREM should not just look at one solution for each property in a portfolio but should take a rational view of each property.

- **Estimates should be based on the experience**

  Estimates should be based on the experience of the management team and, if appropriate, on evidence from independent experts. That means the management team must have a first hand understanding of the requirements of IAS37.

  It also covers the need to have market evidence of the property to substantiate the assumptions on reletting income. Having a default assumption that the headlease rent will be achieved everytime is not appropriate for an office portfolio where rents were set at the peak of the market.

- **Risk**

  There is the issue of risk to deal with in any assessment. That is a function of the nature of the properties in a portfolio and the market conditions. If the letting market for a particular property is difficult with a considerable over supply, then the CREM needs to take that into account and not make similar letting assumptions that he would do in a buoyant letting market. Fully re-assessing the IAS37 figure annually should help to deal with this aspect.

- **Range of answers**

  Calculation of the provision could result in a range of answers. Take the example of an office suite that has been sublet but where there is a break clause in the subtenant's favour in three years' time and there is then a further five years before the headlease expires. Does the CREM assume the sub-tenant will break or not? If there is an assumption of the break, will the property re-let or not? Potentially there are three outcomes to calculation without even considering when the property would re-let. While the wording requires that the mid-point is taken, this is not always appropriate and the issues of probability and risk rear their heads again. The guiding principle has to be one of prudence rather than out-right optimism.

- **Time value of money**

The standard refers to the time value of money and that it is material in the calculation. The choice of discount rate needs to be a pre-tax rate reflecting the market's view of the combination of money, time value and risk. The discount rate should avoid double counting so, if the cashflow has already dealt with specific risks, the discount rate does not need to take that element into account. The choice of rate is not specified so it is down to the individual company to determine its own. Clearly, the higher the rate adopted, the smaller the actual provision so, from a prudence point of view, a lower rate should be applied.

One way of looking at the issue is to ask the question: what rate of interest would a bank guarantee over the period of the lease so that, by depositing the provision today and if everything assumed came true, the last payment would take the deposit down to £0? The best rate that banks seem willing to guarantee over what could be a reasonable length of time is Base Rate. So investing the money today will see the last penny available to cover the last penny of monies due at the expiry of the portfolio, with interest being added in.

Therefore, over time this rate has varied considerably. From an organisations viewpoint, the lower the interest rate the larger the provision, but also the greater the likelihood of sufficient monies available to undertake deals, in particular surrenders.

- **Reassessment**

The provision will change over time as events occur. A number of factors will have an effect, both property specific; such as a subletting of the unit, or at a macro level such as a significant change in interest rates. Another factor that has to be carefully monitored is changes in law. A prime example of this is the Health & Safety and Environmental legislation. These changes should be picked up with the annual re-assessment of the provision on a property by property basis.

METHODOLOGY FOR CALCULATION OF A PROVISION

To create a cashflow a number of elements are required:

- A cashflow model – whether a macro, simple spreadsheet or a piece of paper, the CREM needs to decide on the methodology to be adopted and then to use it consistently.

- Accurate data on the property for the 'normal' costs of rent, rates, service charge, insurance and maintenance costs, etc.

- Lease details that have been verified including restrictive lease terms, especially on alienation, and rent review provisions. This has to include all of the lease documents because the Agreement for Lease entered into ten years ago might include an obligation to construct a building in the car park by the 15th year of the term.

- Estimates of other costs such as dilapidations and potential costs such as one off service charge costs for replacement of lifts etc.

- Knowledge of the market for each property supported by letting advice from local letting agents on vacant properties. The largest swing factor in a provision is caused by the effect of a property letting or becoming vacant. While making a standard set of assumptions, as a default mechanism is a good starting point, the CREM should look at each property and aim to make property-specific assumptions. That will include when the property will let, for how long, at what rent, with what incentives, etc. All of which will provide an income stream to offset the gross cost.

- In appropriate circumstances, the solution is to sublet a property in several parts. A typical example is a multi-storey office building with individual floors being sublet. This creates other costs and the CREM will need to run the building with a service charge etc. and all the costs will need to flow through to the provision.

- A grey area is where a property remains part occupied. Does that property fail to be provided for or not? It would appear not because it is not an onerous contract. If benefit is still being obtained from the lease, it does not need to be provided for, although what should be considered are the benefits against costs for the property.

- For a sublease, a good knowledge of the lease documentation is essential to cover service charge caps, schedule of conditions which will restrict dilapidations' liabilities, etc.

- Second-guessing what a tenant is going to do on a lease expiry or break is impossible and the appropriate way to deal with this is for the CREM to run different scenarios and adopt a compromise figure.

- Part of the assessment required is the likely increase in rents at reviews, whether they are fixed uplifts or to open market rents.

There are two areas that sit outside the property remit – Tax and VAT. Companies have different tax regimes and ability to recover VAT and how tax is dealt with lies with the Finance Department at the macro level rather than being calculated as part of the IAS37 model.

KEY VARIABLES AFFECTING THE PROVISION

It is important to remember the 'Pareto Principle', which states that for many phenomena, 80% of the consequences stem from 20% of the causes. In the case of an IAS37 calculation, 80% of the sensitivity comes from 20% of the variables. These key factors need to be the focus of accuracy and understanding.

- **Data**

As with all considerations of a portfolio, the essential starting point is the data and having accurate, up-to-date information. Clearly, the better the data the better the results but there can be a diminishing return from trying to improve the data. For example, struggling to get hold of the most recent insurance demand from the freeholder is unlikely to make a material change to the outcome.

- **Lease Documentation**

Arguably this forms part of the data for the property but, increasingly, there is a separation between the two. While a CREM might have a spreadsheet of data, they will rarely have all of the leases. Ideally, when undertaking an assessment of the IAS37 liability, the lease documentation needs to be reviewed in depth. In particular, focussing on the following key areas: the Demise; Lease term; Rent review terms; User; Break clause provisions; Alterations; Alienation provisions; and Licences for Alterations and Subletting, together with any deeds of variation.

While spreadsheets provide useful summaries, over time increased risk of the data being compromised and errors creep in. This is true of all databases and undertaking a regular review of the source information is important. While this should be an exercise that is within the capability of a CREM, there may be certain factors, such as the operation of a break clause, which should be referred to a litigation solicitor.

Erroneous assumptions are often made about documents. Just because something has been agreed does not necessarily mean that it has been implemented.

- **Demise**

It may seem obvious but checking the extent of the demise is a key element. Has it remained the same throughout the term and what exactly is included? Obvious examples are variations to take out or put in an area. This could include corrections of an original error or the tenant taking an extra area such as a basement storage unit. This will affect the rental value for the whole as well as the obligations on maintenance etc.

On the other side of the coin, there may be an assumption that the car spaces are demised with the offices whereas, in fact, only some are but the rest are held under licence, which can be terminated on three months' notice. This could be a crucial issue for a city centre location when trying to sublet the space. It is also a way of reducing costs quickly.

- **Lease Term**

When does the lease expire? Are there rights of renewal under the Landlord & Tenant Act 1954? This will affect how a potential assignee will view the space if there is a short term remaining on the lease.

Where a sublease is already in existence and it expires well before the headlease, it cannot automatically be assumed that the subtenant will renew. An assessment will need to consider the options of no renewal; no renewal but subsequent letting and of renewal on open market terms. Whichever is adopted will depend on the probability assigned to each of the three scenarios.

- **Rent Review Terms**

In most recent leases the wording of the review clauses has become fairly standard. Leases do have quirks that have been subsequently removed because of case law highlighting flaws with the wording. There may be some residual matters that have not been picked up in the past but could be in the future. The biggest problem is something, which will increase the rent passing to a figure in excess of the current market value.

There are factors, which will depress rents as well. A good example is the assumption in the review that the lease term will be the longer of 15 years or the remainder of the term, or it will be the original term granted, where that is a long term, say 25 years. With the move to shorter leases and a norm of around 10 years, these long terms without a break clause will reduce the rent that a tenant is prepared to pay. Often in these cases the rent in the headleases has been set in a boom market or with a sale-and-leaseback and are over-rented. What these restrictions do is reduce the chance of any rental uplift in the headlease.

One often made assumption is that the sublease rent will match the headlease rent at the next review. That is rarely the case unless the rent review clause in the sublease provides a matching. This is because the terms of the two leases will tend to vary in areas such as demise, term, repairing obligation (especially the effects of a schedule of condition on rental value) etc. It is always a possibility that the sublease rental value exceeds that of the headlease.

- **Restricted User**

Restricted user clauses still exist, although they have become less frequent. Nonetheless, there are clauses that are not deemed to be particularly onerous but will affect the ability to dispose of the property.

- **Alienation**

Leases tend to fall in to three categories:

- Assign whole and prohibit subletting
- Assign or underlet whole only
- Assign whole or sublet either whole or in part

Assignment of whole tends to be restricted to short-term leases or in specific property circumstances. This can be a problem if the length of term remaining exceeds three years, which is compounded when the property is over-rented. That leaves a corporate with only one option – to assign and pay a premium to the assignee. That will expose the assignor to the risk that, if the assignee becomes insolvent during the term of the lease, a proportion of the premium has been squandered.

The ability to sublet the whole does add to a corporate's flexibility in that they can then control the property and, where it is over-rented, subsidise the shortfall each quarter.

Subletting of the whole or in parts is generally restricted by reference to specific parts and number of occupiers. This is to prevent too much fragmentation of the building. A freeholder will look for additional protection in such circumstances by seeking to have the subleases excluded from the security provisions of the Landlord & Tenant Act 1954. Indeed, the trend is for all sublettings to have this provision unless it is of a large building where any subtenant will be investing a considerable amount of money in fit out and so on.

One problematic area is that of a subletting clause, which provides that, the rent in the sublease shall be the higher of the market rent or the rent passing under the headlease. This clause can have a major impact on the ability of a corporate to dispose of excess space, in particular when the headlease rent is at or above market value.

This is known colloquially as the 'Homebase Case', and refers to the case of Allied Dunbar v Homebase (*Allied Dunbar Assurance plc v Homebase* [2002] 2 EGLR 23). Homebase was seeking to sublet an old retail warehouse unit which was over-rented and, as a consequence of changes in demand, the wrong size and design. The headlease restricted subletting to the higher of market rent or the rent passing under the headlease. Homebase, therefore, sought to mitigate its liability by circumventing the restriction by using a well used mechanism at the time of a side deed. This provided that the subtenant would only pay the current market rent despite what was in the sublease, which provided a rent at the same level as the headlease.

Allied Dunbar objected to the deal, in part because under the proposed deal, the subtenant would have had the right to renew on varied terms, and took the matter to the Courts. The Court of Appeal upheld the decision of the

High Court that the side deed was to be included, as part of the lease documentation and therefore the approach could not be used.

Since that judgement, the side deed route to circumvent the restrictive alienation provisions has been closed. The extent of this problem varies between types of property and relates mainly to offices below 5,000 to 10,000 sqft on leases granted through to the mid 1990s. From experience, one of the areas affected by the provision is that of leases to companies in the financial services sector where up to 30% of a portfolio might have had such a restriction.

Dealing with such a clause can be difficult as there is, as yet, no obligation on landlords to vary a lease. Landlords can, therefore, charge whatever premium they want in whatever format. This is often to take a proportion of the rent that the corporate achieves in any subletting. In an IAS37 calculation dealing with the impact of a Homebase clause should see at least two options calculated. One where there is no subletting until the market rent exceeds the headlease rent, and secondly with a capital sum to the landlord included.

- **Alterations**

Tenants generally carry out works to a property to make the premises suitable for their own occupation, be that demountable partitions or loading doors. Leases contain reinstatement clauses requiring a tenant to take out the alterations and put the property back in to the condition it was at the commencement of the lease. Alterations should be capable of being tracked by means of Licences granted by the landlord to the tenant.

Problems arise when tenants carry out works without getting consent, making it difficult to assess the impact of the alterations on any terminal dilapidations for the property. In addition, these alterations can also be a barrier to letting space and a unit, which has a very specific fit out, may struggle to let in the market. This is discussed in more detail below.

- **Break Clause Provisions**

The specific wording of a break clause is very important. It will determine how easily a lease, headlease or sublease can be broken. Case law on this subject continues to evolve.

Break clauses fall into three general categories:

- No compliance – apart from providing vacant possession, the tenant has no obligation to do any works or pay monies

- Compliance is relatively simple to achieve – monies that are demanded are paid

- Rigorous compliance is required – often a mixture of paying any arrears, whether demanded or not, and reinstating the premises to their original condition.

The latter group causes the most problems to assess as far as an IAS 37 calculation is concerned. Can the break be operated in reality? If not, then there should be default assumptions that a headlease break will not take place but any subtenant breaks, the worst case for the corporate. It is not prudent to assume that breaks will automatically be exercised, as there are many cases of corporates failing to comply with the lease requirements.

- **Current Market Conditions**

In the same way that using a formula that states that the term of a subletting will be co-terminous, a formula of achieving a subletting in one year, with a six month rent-free and achieving the headlease rent cannot be assumed.

The specific market conditions should be looked at to determine the rental value, the incentives that will need to be granted, and the term of any sublease together with an estimate as to how long it will take to achieve a letting.

One of the key factors in determining net liability is how long it takes to let a property and the timing of when the rent payments start. The longer the void period the higher the liability because, once let, costs such as rates and service charges tend to be picked up from the start of the letting by the tenant. Letting agents often tend to be over-optimistic about letting a unit and it is essential that the CREM interrogates them thoroughly to ascertain the true position.

Knowing what is needed in terms of works to the unit will affect the speed of letting as well as the terms achieved. Marketing works are important but the relationship between carrying them out and the speed of letting difficult to prove in absolute terms. Finance Directors in corporates need assurance that by undertaking capital expenditure on a surplus property, they will get an immediate return; most will want some empirical evidence. However, this rarely exists and only experience shows that if a property is in need of extensive works, doing those works will provide a much better chance of achieving a deal rather than leaving the space dilapidated, the latter will virtually guarantee no deal being done.

The structure of a likely deal with rent frees and breaks needs to be carefully considered as part of this overall assessment of the market.

In the event that the solution is to divide a building in to smaller units, for example letting individual floors of an office building, the cashflow needs to reflect the additional costs of creating lettable units. This will include splitting services, provision of receptionist and so on.

- **Building Condition**

Putting the property into a condition where it can compete with other available space in the area is very important and should minimise the length of time the property is vacant. Undertaking works will improve the lettability of the majority of properties. However, for a small number of properties, no amount of refurbishment will improve the chances of letting the property. That may be due to restrictions on subletting, restricted user clause or, that there is simply no demand for the type of property in that location. So, each property needs specific consideration about what can and should be done.

- **Dilapidations**

The other aspect to the condition of the building is dilapidations. Virtually all leases contain an obligation to keep the premises in repair and to undertake decoration on a regular basis. When the premises are in a state of disrepair the tenant is in breach of those clauses and at risk from action by the landlord. The landlord may serve an Interim Schedule of Dilapidations or may be able to enter the premises and undertake the works themselves, recharging the costs to the tenant, under what is known as a Jervis v Harris clause (*Jervis v Harris* [1996] 1 EGLR 78).

When considering what marketing works to carry out the CREM should consider the risk from these events and also look long term to the end of the lease and what works will need carrying out. A common dilemma is found with office suites and whether to strip out partitions as part of the marketing works or to leave them in and redecorate them. The lower cost of option is generally to leave in and redecorate.

A key consideration is whether a potential subtenant would want the premises partitioned. If they do, then leave them in but is generally better to strip out the partitions out and let any incoming tenant deal with the matter themselves.

There are a number of reasons for this approach. Firstly, the partitions are unlikely to be in the right places for the incoming tenant. Secondly, many tenants are unable to get a clear view of the amount of space when a unit is heavily partitioned and will be more attracted to an open plan space of the same size. Thirdly, the definition of demise between the headlease and sublease will differ in that the subtenants will have the partitions as part of their demise and will not have an obligation to remove them at the end of their lease, whereas the headlessor will have the obligation.

Finally, by stripping out and taking the unit back to the original condition, the tenant is then dealing with most of the dilapidations liability. If the space does not let, very little will be needed to do at the end of the lease. This compares to redecoration and carpeting of partitioned space, which will all then be stripped out as part of dilapidations.

Determining dilapidations liability is difficult. Firstly, a view must be taken on the works needed and the probable cost of the works. Overriding this are the provisions of the Landlord & Tenant Act 1927 which limits the liability for terminal dilapidations to the lesser of the costs of the works or the diminution in the value of the property. For older properties, there is an argument that the allowance in the IAS37 should be zero because the obvious option will be to redevelop the site. However, the landlord cannot be forced into redevelopment and, if they opt for bringing the premises into good order and trying to let it, the tenant will be caught. This is very dependent upon the market conditions the prudent approach, therefore, is to provide for the cost and seek to mitigate the liability at the time.

There is the additional risk of environmental issues such as asbestos and oil contamination. Generally, this should be considered outside of the IAS37 provision and the appropriate allowances made. Ideally, the remediation works should be carried out to ensure that the premises complies with repairing obligations and statute.

- **Discount rate**

The time value of money needs to be taken into account and the cashflow discounted accordingly. At what rate should the cashflow be discounted? Is that at a risk-free rate? Or does the rate express some risk in itself? In part, the question is one of approach. The more explicit the cashflow in looking at the variables and the more focused the organisation is on considering the sensitivity of the cashflow to key variables, the less the discount rate has to be taken into account.

It can be argued that the best risk-free rate is to have no discounting so the provision is the cash provision. Generally, organisations will have rates they use for applicable projects. The key point here is that, unlike projects that have to produce a rate of return, the discount rate here is akin to saying that, if you put the provision into a bank account, will that pay all the bills in the future should that scenario be achieved? What interest rate will a bank pay over the longer term? They will be reluctant to make long-term commitments because of the volatility of the market. Research indicates that the current base rate could probably be achieved for the life of a liability of, say, 10 to 15 years.

Does the discount rate need to be any different? Should the WACC rate (Weighted Average Cost of Capital) provide a better figure? This is unlikely because the WACC rate is generally 4-5 % above Base Rate and, therefore, there will be a possible shortfall between the figure 'invested' and what is needed.

The other factor to bear in mind is what the landlord will be looking at when discussing surrender. One criterion that a landlord will have of any potential deal is his income stream. He may look at that on a cashflow basis against Base Rate or by applying the yield for the property, which, generally, will be a low figure in the current market, so the occupier should not be too far apart from that figure.

- **Miscellaneous**

There are a number of miscellaneous points that warrant a mention.

- Risk of Tenant Default

There is the possibility that a sub-tenant will default and go into liquidation or bankruptcy. How should that be dealt with? One option is to create a model that will take into account the chances of the income being received. It will assume for a particular tenant only 80% of the income will be received. That will work only when there is one property surplus to requirements.

In a portfolio situation, arguments can be put forward that the risk of all or a substantial number of the subtenants defaulting is either low or high. Low because of the mitigation from the diversity of the portfolio; high, because, if the properties are of a similar type, the market for those properties will be the dominant factor. So, if the secondary retail market is having tough trading conditions, it will affect all such retailers and, if the portfolio is only in that sector, there will be a disproportionate rise in risk of tenant default.

A sound approach is to look at the portfolio holistically when the individual calculations have been done and to take a broad-brush approach. The calculations only provide indicative numbers rather than hard and fast ones because there are too many variables, so a broad allowance should cover the default risk.

- Tax

Should allowances be made for tax, in particular VAT? It is impossible to make generalisations on this because the tax position differs between companies. The simplest approach is to carry out the calculations without tax and then the specific tax position of the company can be taken into account by the accountants in the appropriate part of the Annual Accounts.

VAT is difficult in that financial services companies, for example, do not fully recover VAT, so the question of VAT may have an impact on the total cost. In particular, the impact can be felt on service charge costs.

All occupiers will be affected by non recoverable VAT where there is a substantial service charge cost and the building has not been elected because the landlord will then be recharging the costs gross, without the VAT shown separately. In those cases, the gross cost needs to be taken into account. However, if they are disposing of a portfolio of surplus properties, the probable purchaser will be unlikely to be affected and will be able to recover VAT.

- Provisions for part occupation

In cases where a tenant only occupies part of the property, does a provision have to be made? The key is the lease structure. If the part vacant space is one lease and the occupied space is another, then the lease that comprises the vacant space needs to be provided. Where it is, say, one lease of two floors in an office building and one floor is vacant, that is more difficult. However, it is a matter of whether the lease has become an onerous contract and how prudent the company wants to be. The benefits need to be considered against the liability.

- Timing of the release of the provision

When certainty has been reached, the balance of monies can be released. The point of certainty, however, varies. On surrender, it should be at the point at which the surrender completes providing that there are no residual matters to resolve.

On assignment, the risk then becomes a contingent one, and that will depend on how these risks are dealt with in the accounts. For an expiry, the question of dilapidations needs to be resolved. Should there be no claim there may be a need to retain that proportion for some time, up to the expiry of the limitation period, which is 12 years. However, the likelihood of a claim diminishes over time in line with the landlord's ability to prove his case.

A trickier decision is the reduction of the provision if a tenant is found at a much earlier date than anticipated. Should the IAS37 calculation be re-run and the excess released? Prudence is important in any approach.

EXAMPLES OF HOW TO APPLY THE PRINCIPLES

The best way of understanding the issues is to look at a specific property example and the various scenarios that can flow from the process.

EXAMPLE 1 – SINGLE LET

Property details

The building is a three storey block of offices on ground, first and second floors, with car parking around the building. The property sits on a small business park in a town close to the M25.

Headlease

- Term – MN plc took a lease on the whole building for a 20 year term expiring 28 September 2018.
- Passing Rent – £243,747 per annum (£21.29 psf). The Estimated Rental Value is £12.50 psf and the next review is 29 September 2013.
- Service Charge – The costs of the service charge to the landlord is only £6,000pa reflecting the costs of landscaping of the estate.
- Insurance – The freeholder insures the fabric of the building and the cost of this is £5,000 pa.

Sublease

- Demise – Whole
- Term – To 25 September 2013
- Passing Rent - £168,000 pa (£14.68 psf).
- Service Charge – To refund landlords costs.
- Insurance – To refund landlords costs.

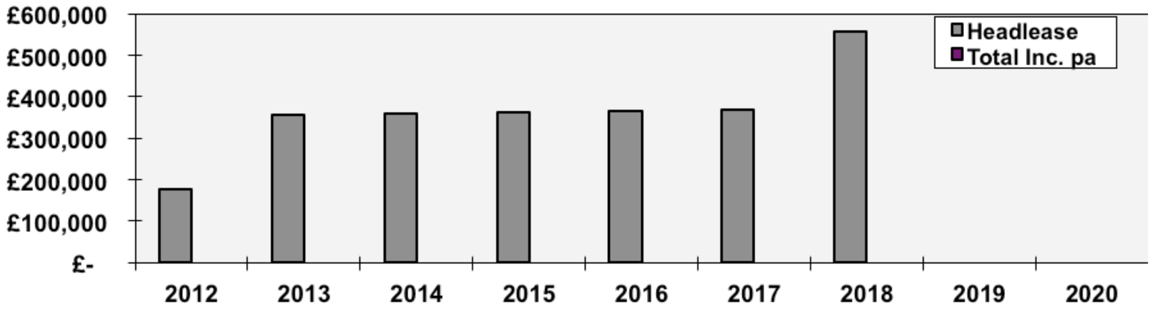
Market view

The market has dropped in the area following the over development of the town. Current rental levels are now £16 psf for brand new space and for good second hand £12.50 psf. The estimated period for letting a new unit is 18 months with a 6 month rent-free period.

The Calculation

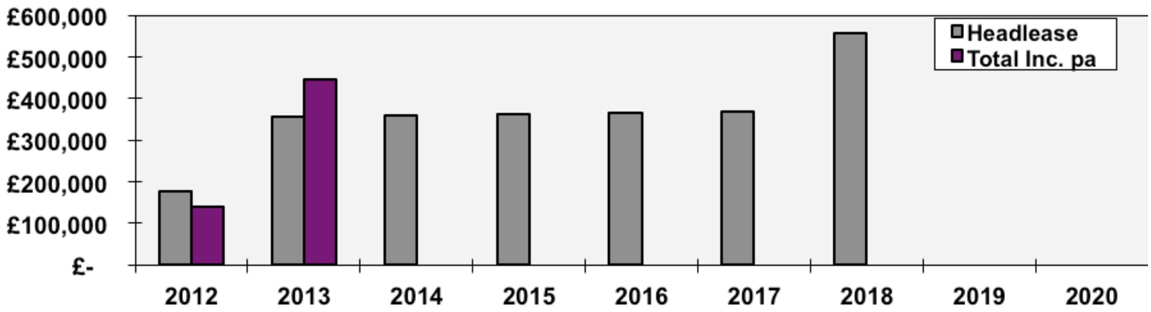
In this case all of the information on the property is known. Setting up the outgoings is the first step and that shows the Gross Cash Liability for the Corporate is £2.540,190, which provides a Net Present Value (NPV) of £2,304,200.

Profile of Liability No Income



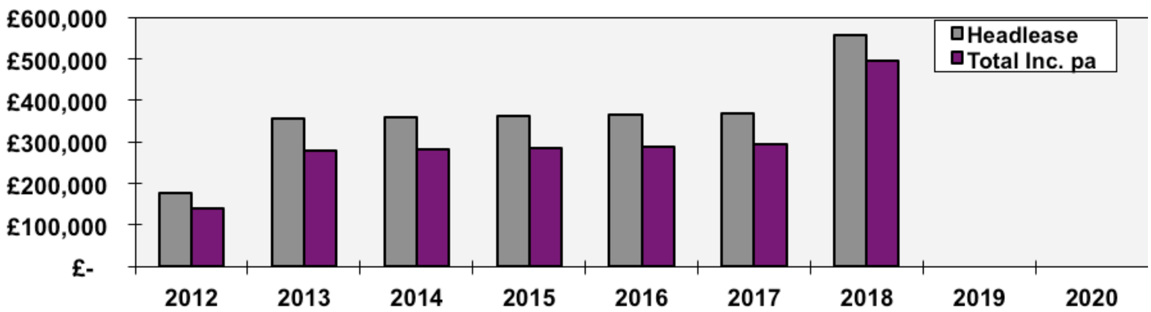
Profile of Liability With Sublease To Expiry

Cash cost to expiry remains as £2.54m, there is now projected income of £0.582m, giving a net cost of £1.958m, and NPV of £1.734m.



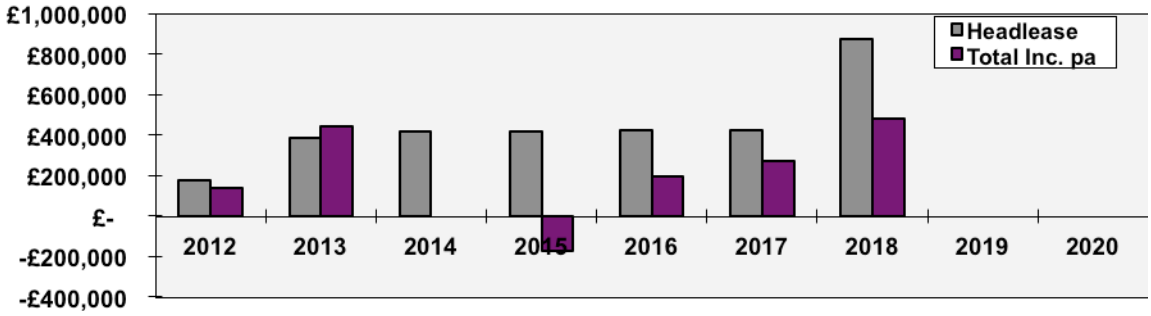
Profile of Liability With Sublease Renewal

If it is assumed that the sub-tenant renews their lease cash cost is still £2.54m, but the projected income becomes £2.061m, giving a net cost of £0.479m, and an NPV of £0.439m, a change of £1.3m.



Profile of Liability With Sub-tenant Vacates & Space Relets

If however, the tenant vacates and a new tenant is found the cost profile changes again. Assuming a re-let after 18 months and a 15 month rent free the Cash Cost to expiry increases to £3.11m to reflect capital expenditure on the unit, the projected income becomes £1.353m, providing a net cost of £1.758m, and an NPV of £1.583m.



Which is right? Until the position is known with the sub-tenant - all of them and none of them! The range of NPV from £0.439m through £1.583m to £1.734m shows the difficulty in reaching a figure to provide in the accounts. Clearly the assumptions for the re-letting can in themselves provide a wide range of options.

One clear point here though is the benefit of getting the existing tenant to take a term to expiry, the upside is £1.3m compared to vacant to expiry. Therefore a sharing of some of that with the sub-tenant would remove a lot of risk and improve the provision.

EXAMPLE 2 – MULTI LET BUILDING

This is the same property but in this case space has been sublet, but the subleases have breaks in.

Property details

The building is a three storey block of offices on ground, first and second floors, with car parking around the building. The property sits on a small business park in a town close to the M25. Each floor consists of 2,500 sqft net internal area and the suites are self-contained. The main common parts comprise a reception desk and staircase, and there is a fire escape staircase at the rear of the property.

Headlease

- Term – MN plc took a lease on the whole building for a 20 year term expiring 28 September 2018.
- Passing Rent – £243,747 per annum (£21.29 psf). The Estimated Rental Value is £12.50 psf and the next review is 29 September 2013.
- Service Charge – The costs of the service charge to the landlord is only £6,000pa reflecting the costs of landscaping of the estate.
- Insurance – The freeholder insures the fabric of the building and the cost of this is £5,000 pa.

Sublease 1

- Demise – Units 1 & 2
- Term – To 25 September 2018
- Break Clause – 29 September 2014, subject to a minimum of 12 months' notice and compliance with repairing obligations and payment of all monies due on the break date.
- Passing Rent - £168,000 pa (£22.36 psf). The next review is 29 September 2013.
- Service Charge – To pay a reasonable proportion of the costs incurred by the headlessor, including the costs paid to the freeholder for the maintenance of the Estate. This has been charged at 66.67%.
- Insurance – To refund a due proportion.

Sublease 2

- Demise – Unit 3

- Term – To 25 September 2018

- Break Clause – 28 September 2013 on three months notice, no compliance issues.

- Passing Rent - £66,400 pa (£16.88 psf)

- Service Charge – To pay a reasonable proportion of the costs incurred by the headlessor, including the costs paid to the freeholder for the maintenance of the Estate. This has been charged at 33.33%.

- Insurance – To refund a due proportion.

Market view

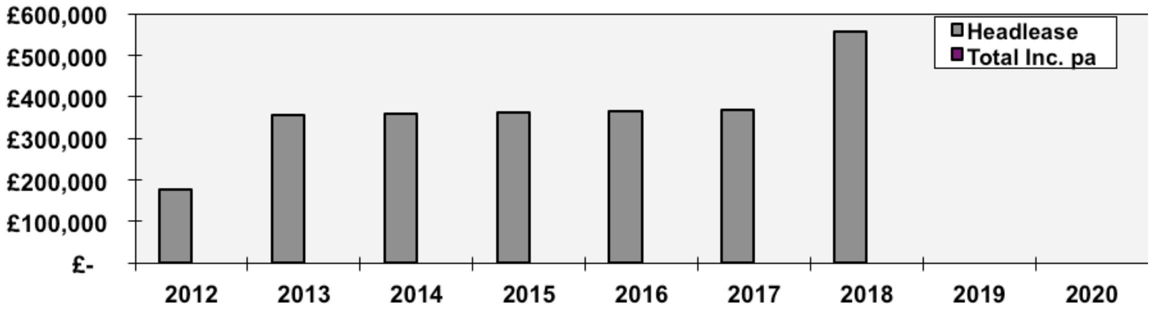
The market has dropped in the area following the over development of the town. Current rental levels are now £16 psf for brand new space and for good second hand £12.50 psf. The estimated period for letting a new unit is 18 months with a 6 month rent-free period.

The Calculation

In this case all of the information on the property is known. Often there is missing data and broad assumptions need to be made on the cost of rates etc. The only decision here is on the discount rate, and that has been taken at 5.0%.

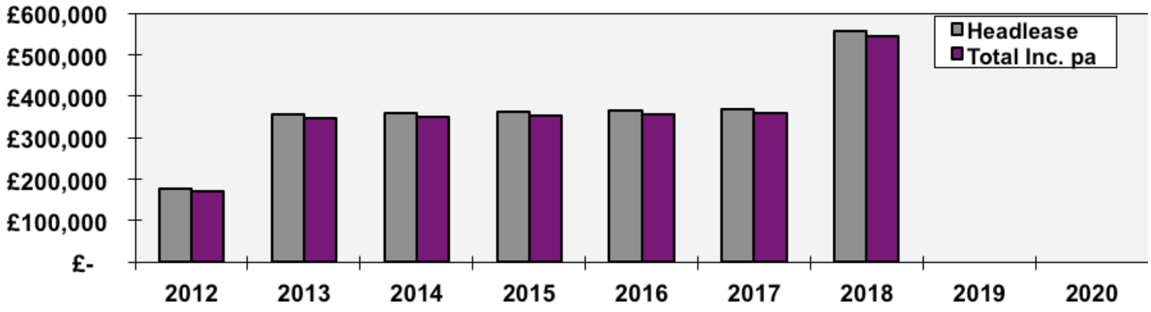
Profile of Liability No Income

The Cash Liability is £2.540,190 and the NPV £2,304,200 – the same as Example 1.



Profile of Liability with Subleases Running to Expiry

There is already an income stream for the property and this needs to be built into the model. The effect is that, because there is a substantial income already in place, the Net Cash Liability is £65,530 and the NPV £56,450.

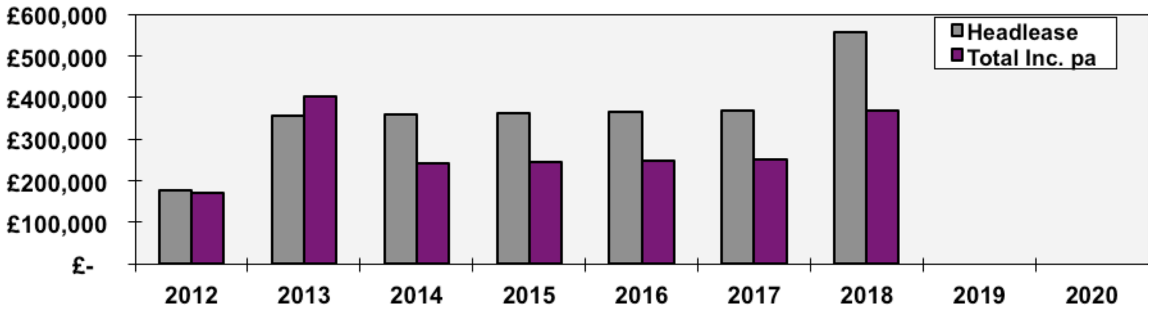


Lease Expiries/ Break Clauses

There are no lease expiries in this example. If there were, the impact of the expiries would need to be considered and with it, the prospects of a sub-tenant renewing and on what terms. However, here the key issue is what might happen with the break clauses in both subleases.

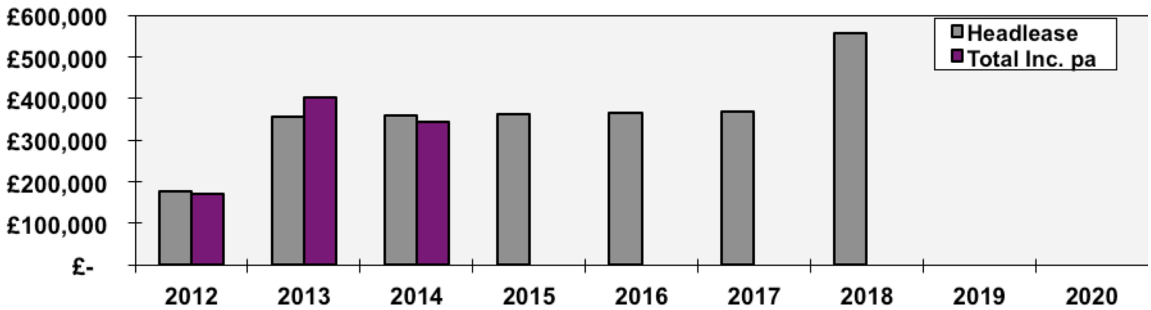
Profile of Liability with Sublease 2 Broken

If the first break is exercised on Sublease 2 the NPV increases to £499,930. The profile then becomes:



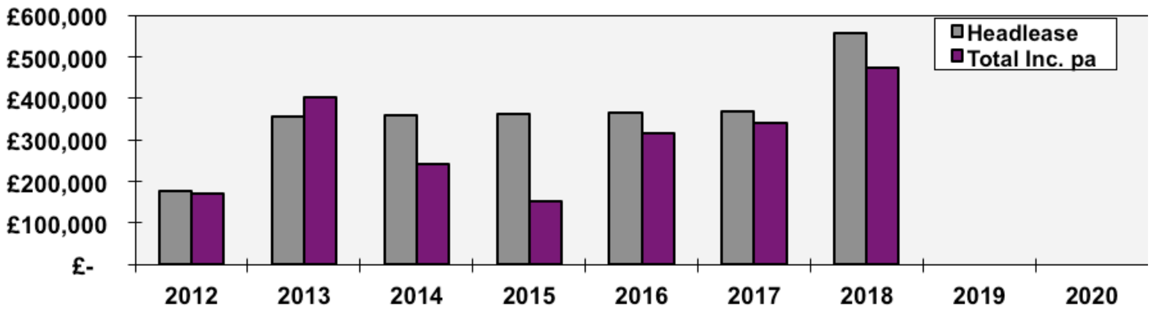
Profile of Liability with Subleases 1 & 2 Broken

If Sublease 1 also breaks the following year, then the NPV increases to £1,298,960. The profile then becomes:



Profile of Liability with Subleases 1 & 2 Broken & reletting of Unit 3

Clearly, an important consideration here is the re-letting of the space and at what cost. If Sublease 2 space is relet with a 2 year void period and a 9 month rent free period letting at the market rent, the NPV improves from £499,930 to £400,920. The improvement is not as marked as one might expect because of the building in of costs of refurbishment of the space and re-letting.



Core Consult

CONCLUSION

I hope the above helps with considering how to approach surplus property leases and the liability to the business.

There is no fixed approach, just a series of principles to follow. Those principles need to be carefully applied because of the potential variance in the selection of the options. Generally over a portfolio of any size there is likely to be an averaging of the outcomes to give an overall cost close to a well-developed assessment. What is probable though is that none of the individual outcomes will exactly match those assessed. Simply to many variables come into play. As with Capital Valuations of Property, IAS37 Assessments are a mixture of Science and Experience.

ABOUT THE AUTHOR

Howard Cooke is a Director of CORE Consult (Corporate Occupier Real Estate Consulting Ltd), a real estate consulting firm, where he provides consultancy advice to Corporate Occupiers. He has worked in this specific field for over 25 years undertaking projects for clients on a range of issues including portfolio analysis and restructuring; acquisitions; disposals; corporate disposals and acquisitions.

He is an Associate Tutor at The College of Estate Management, Reading; lectures at CASS Business School and Oxford Brookes University; joint author of the 'Corporate Occupiers' Handbook' and author of a number of papers on property matters.

Contact Details:

Howard Cooke
E: hc@core-consult.co.uk
T: 01628 782639
M: 07768 996705

Corporate Occupier Real Estate Consulting Ltd
Company No. 5059834 VAT Registration: 125 6926 03
Registered Office:22 Wycombe End, Beaconsfield, Buckinghamshire, HP9 1NB