



## Solution 74.26

<b>Component</b>	Provisions
<b>Index</b>	Present obligation
<b>Short title</b>	Mandatory renovation in an operating lease

Attention: This guidance is based on the revised standards and interpretations that are mandatory for accounting periods commencing 1 January 2005. A company may early adopt an individual revised standard, but only in its entirety. Guidance based on the previous version of the standards is included in the "Applying IFRS 2004" guidance.

### Issue

A provision should be recognised when [IAS37R.14]:

- a) an entity has a present obligation as a result of a past event;
- b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- c) a reliable estimate can be made of the amount of the obligation.

When should management recognise a provision for expenditure to be made to restore leased property to its original condition at the end of the lease term?

### Background

Entity A, a retailer, leases several stores for a period of 10 years, with options to extend the lease contracts.

The lease contracts specify that entity A has the obligation to restore the stores to the original condition at the end of the lease terms, even if the lease is terminated early.

The restoration to the original condition means that A will have to repair all damages and put back any alteration made to the premises.

If management of entity A does not restore the stores, it will have to pay a penalty calculated as a reasonable amount required by third parties to restore the stores to their original condition.

Management of entity A is not sure whether it will extend the lease contract after 10 years.

### Solution

Management of entity A should recognise a provision when a damage occurs to the store or when an alteration is made to the premises. That is the moment when the obligation arises, because the repairs are due.



There is no present obligation at inception of the lease to make any expenditure, independent of management's future actions. There is a probability that management will have to make expenditure regarding the restoration for any normal damages that may occur, but the expenditure is not due at the moment of entering the lease agreement.