This accounting policy paper is based on IPSAS 19 Provisions, Contingent Liabilities and Contingent Assets as adopted by the Treasury of the Republic of Cyprus.

Provisions, Contingent Liabilities and Contingent Assets

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1. INTRODUCTION

1.1 Provisions, Contingent Liabilities And Contingent Assets

Provision is a liability of uncertain timing or amount. There are certain circumstances in which provisions should be recognized, measured and disclosed. Provisions differ from contingent liabilities and contingent assets. Certain information shall be disclosed about contingent liabilities and contingent assets in the notes to the financial statements, to enable users to understand their nature, timing, and amount.

Provisions are presented seperately, as liabilities, on the face of the statement of financial position, whereas contigent liabilities are not recognised and hence are not presented as liabilities. Similarly, contingent assets are also not recognised or presented as assets in the statement of financial position.

Examples of provisions in the public sector include provisions for litigations, warranty provisions, restructuring provisions, envirnomental provisions (provisions for decommissioning, dismalting, depollutions or site restoration).

1.2 Objectives

The objective of this accounting policy is to propose the accounting treatment and disclosures for Provisions, Contingent Liabilities and Contingent Assets. The aim of this policy is to provide technical accounting guidance for the preparation of financial statements, so as to enable the financial statements to give a true and fair view of the financial performance and financial position of the entity. The aforementioned policy is prepared following guidance from all relevant International Public Sector Accounting Standards (IPSASs).

1.3 Scope

1. This accounting policy applies in accounting for provisions, contingent liabilities and contingent assets in the financial statements of the Government of the Republic of Cyprus and its consolidated entities, except:
   - those provisions and contingent liabilities arising from social benefits provided by an entity for which it does not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of those benefits (see Accounting Policy on Social Benefits);
   - those resulting from executory contracts, other than where the contract is onerous;

- insurance contracts within the scope of the relevant international or national accounting standard dealing with insurance contracts;
- those covered by another accounting policy such as Construction Contracts (see Accounting Policy on Construction Contracts) and Leases (see Accounting Policy on Leases);
- those arising in relation to income taxes or income tax equivalents;
- those arising from employee benefits, except employee termination benefits that arise as a result of a restructuring, as dealt with in this policy;
- financial instruments (including guarantees) that are within the scope of another accounting policy (see Accounting Policy on Financial Instruments) ; and
- contingent consideration of an acquirer in a public sector combination which is within the scope of another accounting policy (see Accounting Policy on Public Sector Combinations).

2. This accounting policy applies to provisions for restructuring (including discontinued operations). In some cases, a restructuring may meet the definition of a discontinued operation, in which case suitable disclosures shall be made.
3. Some amounts treated as provisions may relate to the recognition of revenue, for example where an entity gives guarantee in exchange for a fee. This accounting policy does not address the recognition of revenue (see Accounting Policy on Revenue from Exchange Transactions). This accounting policy does not change the requirements of the Accounting Policy on Revenue from Exchange Transactions.
4. This accounting policy defines provisions as liabilities of uncertain timing or amount. Where the term provision is used in the context of items such as depreciation, impairment of assets and doubtful debts, these constitute adjustments to the carrying amounts of assets and are not addressed in this accounting policy.
5. This accounting policy neither prohibits nor requires capitalization of the costs recognized when a provision is made.

1.4 DEFINITIONS USED

Constructive obligation is an obligation that derives from an entity's actions where:

(a) by an established pattern of past practice, published policies, or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Contingent asset is a possible asset that arises from past events, and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Contingent liability is:
(a) a possible obligation that arises from past events, and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
(b) a present obligation that arises from past events, but is not recognized because:
   (i) it is not probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; or
   (ii) the amount of the obligation cannot be measured with sufficient reliability.

Executory contracts are contracts under which neither party has performed any of its obligations, or both parties have partially performed their obligations to an equal extent.

Legal obligation is an obligation that derives from:
(a) A contract (through its explicit or implicit terms);
(b) Legislation; or
(c) Other operation of law.

Liability is a present obligation of the entity for an outflow of resources that results from a past event.

Obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

Onerous contract is a contract for the exchange of assets or services in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits or service potential expected to be received under it.

Provision is a liability of uncertain timing or amount.

Resource is an item with service potential or the ability to generate economic benefits.

Restructuring is a program that is planned and controlled by management, and materially changes either:
(a) The scope of an entity's activities; or
(b) The manner in which those activities are carried out.

2. RECOGNITION

2.1 PROVISIONS

A provision shall be recognized when:

(a) An entity has a present obligation (legal or constructive) as a result of a past event;

(b) It is probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; and

(c) A reliable estimate can be made of the amount of the obligation.

*If any of these conditions are **not** met, no provision shall be recognized.*

2.1.1 PRESENT OBLIGATION

1. Present obligation is a legally binding obligation or constructive obligation, which an entity has little or no realistic alternative to avoid. Obligations are not present obligations unless they are binding and there is little or no realistic alternative to avoid an outflow of resources.

2. In some cases it is not clear where there is a present obligation. In these cases, 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 reporting date.

2.1.2 PAST EVENT

1. A past event that leads to a present obligation is called an obligating event. 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 is the case only:

   (a) Where the settlement of the obligation can be enforced by law; or

   (b) Where the event, in the case of a constructive obligation, creates valid expectations in other parties that the entity will discharge the obligation.

2. Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognized for costs that need to be incurred to continue an entity's ongoing activities in the future. The only liabilities recognized in an entity's statement of financial position are those that exist at the reporting date.

3. A decision by an entity's management, governing body, or controlling entity does not give rise to a constructive obligation at the reporting date, unless the decision has been communicated before the reporting date to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.
4. An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity, gives rise to a constructive obligation.
5. Where details of a proposed new law have yet to be finalized, an obligation arises only when the legislation is virtually certain to be enacted as drafted (legal obligation).

2.1.3 Probable Outflow Of Resources Embodying Economic Benefits Or Service Potential

A probability of an outflow of resources embodying economic benefits or service potential to settle that obligation must exist, in order for a liability to qualify for recognition. An outflow of resources or other event is regarded as probable if the event is more likely, than not, to occur, that is, the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an entity discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits or service potential is remote [see paragraph 5(3)].

2.1.4 Reliable Estimate Of The Obligation

1. The use of estimates is essential in calculating provisions, especially in those cases, which by their nature are more uncertain than most other assets or liabilities. An entity will be able to determine a range of possible outcomes and can therefore make a reliable estimate of the obligation.
2. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognized. That liability is disclosed as a contingent liability [see paragraph 5(3)].

2.2 CONTINGENT LIABILITIES

A contingent liability is:

(a) a possible obligation that arises from past events, and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

(b) a present obligation that arises from past events, but is not recognized because:

(i) it is not probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation; or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

An entity shall ***not*** *recognize a contingent liability.*

1. A contingent liability is disclosed, as required by paragraph 5(3), unless the possibility of an outflow of resources embodying economic benefits or service potential is remote.
2. Where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.
3. Contingent liabilities are assessed continually to determine whether an outflow of resources embodying economic benefits or service potential has become probable. If it becomes probable that an outflow of future economic benefits or service potential will be required for an item previously dealt with as a contingent liability, a provision is recognized in the financial statements of the period in which the change in probability occurs.

An Illustrative Decision Tree which explains whether a Provision or a Contingent Liability exists, as per paragraphs 2.1 and 2.2 above, is presented in paragraph 9.2.

2.3 CONTINGENT ASSETS

Contingent asset is:

> *a possible asset that arises from past events, and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.*

An entity shall ***not*** *recognize a contingent asset.*

1. Contingent assets are not recognized in financial statements, since this may result in the recognition of revenue that may never be realized. However, when the realization of revenue is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.
2. A contingent asset is disclosed, as required by paragraph 5(5), where an inflow of economic benefits or service potential is probable.
3. Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits or service potential will arise and the asset's value can be measured reliably, the asset and the related revenue are recognized in the financial statements of the period in which the change occurs. If an inflow of economic benefits or service potential has become probable, an entity discloses the contingent asset [see paragraph 5(5)].

3. MEASUREMENT

3.1 BEST ESTIMATE

*The amount recognized as a provision shall be the **best estimate** of the expenditure required to settle the present obligation at the reporting date.*

1. The best estimate of the expenditure required to settle the present obligation is the amount that an entity would rationally pay to settle the obligation at the reporting date or to transfer it to a third party at that time.
2. The estimates of outcome and financial effect are determined by the judgment of the management of the entity, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the reporting date.
3. Uncertainties surrounding the amount to be recognized as a provision are dealt with by various means according to the circumstances. Where the provision being measured involves a large population of items, the obligation is estimated by weighting all possible outcomes by their associated probabilities i.e. by estimating the "expected value" *(see illustrative examples – example 1).*
4. Where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability.
5. The provision is measured before tax or tax equivalents.
6. The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision. Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgments under conditions of uncertainty, so that revenue or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

3.2 PRESENT VALUE

Where the effect of the time value of money is material, the amount of a provision shall be the present value of the expenditures expected to be required to settle the obligation.

1. When a provision is discounted over a number of years, the present value of the provision will increase each year as the provision comes closer to the expected time of settlement, to reflect the time value of money i.e. unwinding the discount shall be included in interest expense.
2. The discount rate shall be a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability. The discount rate shall not reflect risks for which future cash flow estimates have been adjusted.

3.3 FUTURE EVENTS

Future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

Expected future events may be particularly important in measuring provisions. For example, an entity may believe that the cost of cleaning up a gasworks' site at the end of its life will be reduced by future changes in technology that are reasonably expected to occur. The amount recognized reflects the cost that technically qualified, objective observers reasonably expect to be incurred, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology, or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an entity does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

3.4 EXPECTED DISPOSAL OF ASSETS

Gains from the expected disposal of assets shall not be taken into account in measuring a provision.

Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an entity recognizes gains on expected disposals of assets at the time specified by the accounting policy dealing with the assets concerned.

3.5 REIMBURSEMENTS

Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognized when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation.

1. The reimbursement shall be treated as a separate asset. The amount recognized for the reimbursement shall not exceed the amount of the provision. In the statement of financial performance, the expense relating to the provision shall be presented net of the amount recognized for a reimbursement.
2. Reimbursements may relate to the cases where an entity is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses, or suppliers' warranties). The other party may either reimburse amounts paid by the entity, or pay the amounts directly.
3. In most cases, the entity will remain liable for the whole of the amount in question, so that the entity would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognized for the full amount of the liability, and a separate asset for the expected reimbursement is recognized when it is virtually certain that reimbursement will be received if the entity settles the liability.
4. In some cases, the entity will not be liable for the costs in question if the third party fails to pay. In such a case, the entity has no liability for those costs, and they are not included in the provision.

3.6 CHANGES IN PROVISIONS

Provisions shall be reviewed at each reporting date.

1. Provisions shall be reviewed at each reporting date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation, the provision shall be reversed.
2. Where discounting is used, the carrying amount of a provision increases in each period to reflect the passage of time. This increase is recognized as an interest expense.

3.7 USE OF PROVISIONS

A provision shall be used only for expenditures for which the provision was originally recognized.

Only expenditures that relate to the original provision are set against it. Setting expenditures against a provision that was originally recognized for another purpose would conceal the impact of two different events.

4. APPLICATION OF THE RECOGNITION AND MEASUREMENT RULES

4.1 FUTURE OPERATING NET DEFICITS

Provisions shall not be recognized for net deficits from future operating activities.

1. Net deficits from future operating activities do not meet the definition of liabilities and the general recognition criteria set out for provisions.
2. An expectation of net deficits from future operating activities is an indication that certain assets used in these activities may be impaired. An entity tests these assets for impairment (see Accounting Policy on Impairment of Cash and Non-Cash Generating Assets).

4.2 ONEROUS CONTRACTS

If an entity has a contract that becomes onerous, the present obligation (net of recoveries) under the contract shall be recognized and measured as a provision.

1. Many contracts evidencing exchange transactions (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore there is no obligation. Other contracts establish both rights and obligations for each of the contracting parties. Where events make such a contract onerous, the contract falls within the scope of this accounting policy, and a liability exists that is recognized as a provision. Executory contracts that are not onerous fall outside the scope of this accounting policy.
2. In case of an onerous contract, the present obligation that is recognized as a provision is net of amounts recoverable. These are the unavoidable costs under the contract reflecting the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it, or, any compensation or penalties arising from failure to fulfil the contract *(see illustrative examples – example 2).*
3. Before a separate provision for an onerous contract is established, an entity recognizes any impairment loss that has occurred on assets dedicated to that contract.

4.3 RESTRUCTURING

A constructive obligation to restructure arises only when an entity:

(a) Has a detailed formal plan for the restructuring identifying at least:

(i) The activity/operating unit or part of an activity/operating unit concerned;

(ii) The principal locations affected;

(iii) The location, function, and approximate number of employees who will be compensated for terminating their services;

(iv) The expenditures that will be undertaken; and

(v) When the plan will be implemented; and

(b) Has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.

1. The following are examples of events that may fall under the definition of restructuring:

   (a) Termination or disposal of an activity or service;

   (b) The closure of a branch office or termination of activities of a government agency in a specific location or region, or the relocation of activities from one region to another;

   (c) Changes in management structure, for example, eliminating a layer of management or executive service; and

   (d) Fundamental reorganizations that have a material effect on the nature and focus of the entity's operations.

2. A provision for restructuring costs is recognized when a constructive obligation to restructure exists.

3. Within the public sector, restructuring may occur at the whole-of-government, ministry or department or service level.

4. For a plan to be sufficient to give rise to a constructive obligation when communicated to those affected by it, its implementation needs to be planned to begin as soon as possible, and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins, or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the government or individual entity is at present committed to restructuring, because the timeframe allows opportunities for the government or entity to change its plans.

5. A decision by management or the governing body to restructure, taken before the reporting date, does not give rise to a constructive obligation at the reporting date unless the entity has, before the reporting date:

   (a) Started to implement the restructuring plan; or

   (b) Announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

   If an entity starts to implement a restructuring plan, or announces its main features to those affected, only after the reporting date, disclosure may be required in accordance with the Accounting Policy Events After the Reporting Date, if the restructuring is material and non-disclosure could influence the economic decisions of users taken on the financial statements.

6. No obligation arises as a consequence of the sale or transfer of an operation until the entity is committed to the sale or transfer, that is, there is a binding agreement where a purchaser has been identified.

5. DISCLOSURES

1. For each class of provision[1], an entity shall disclose:

   (a) The carrying amount at the beginning and end of the period;

   (b) Additional provisions made in the period, including increases to existing provisions;

   (c) Amounts used (that is, incurred and charged against the provision) during the period;

   (d) Unused amounts reversed during the period; and

   (e) The increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

   Comparative information is not required.

2. An entity shall disclose the following for each class of provision:

   (a) A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits or service potential;

   (b) An indication of the uncertainties about the amount or timing of those outflows. Where necessary to provide adequate information, an entity shall disclose the major assumptions made concerning future events, as addressed in paragraph 3.3; and

   (c) The amount of any expected reimbursement, stating the amount of any asset that has been recognized for that expected reimbursement.

3. Unless the possibility of any outflow in settlement is remote, an entity shall disclose, for each class of contingent liability at the reporting date, a brief description of the nature of the contingent liability and, where practicable:

   (a) An estimate of its financial effect, measured as per paragraphs 3.1 – 3.4;

   (b) An indication of the uncertainties relating to the amount or timing of any outflow; and

   (c) The possibility of any reimbursement.

4. In cases where external valuation is used to measure a provision, information relating to the valuation shall be disclosed.

[1] A grouping of Provisions that have similar nature or function, such as penalties, clean-up costs of environmental damages, decommissioning costs of defense installation, etc.

5. Where an inflow of economic benefits or service potential is probable, an entity shall disclose a brief description of the nature of the contingent assets at the reporting date, and, where practicable, an estimate of their financial effect, measured using the principles set out for provisions in paragraphs 3.1 – 3.4.
6. Where any of the information required by paragraphs 3 and 5 above, is not disclosed because it is not practicable to do so, that fact shall be stated.
7. In extremely rare cases, disclosure of some or all of the information required by paragraphs 1 – 6 above, can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset. In such cases, an entity need not disclose the information, but shall disclose the general nature of the dispute, together with the fact that, and the reason why, the information has not been disclosed.

6. TRANSITIONAL PROVISIONS

No transitional exemptions are elected to be applied on the adoption of IPSAS 19 "Provisions, Contingent Liabilities and Contingent Assets".

7. EFFECTIVE DATE

The rules mentioned above shall be effective for annual financial statement covering periods beginning on or after 1 January 2023.

8. REFERENCES

This Accounting Policy is based on the following standards:

IPSAS 19 Provisions, Contingent Liabilities, Contingent Assets

IPSAS 33 First time adoption of accrual basis IPSASs

9. APPENDICES

9.1 APPENDIX 1: PROVISIONS AND CONTINGENT LIABILITIES

<table>
<tr><td colspan="3">Where, as a result of past events, there may be an outflow of resources embodying future economic benefits or service potential in settlement of (a) a present obligation, or (b) a possible obligation whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.</td></tr>
<tr><td>There is a present obligation that probably requires an outflow of resources.</td><td>There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.</td><td>There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.</td></tr>
<tr><td>A provision is recognized (paragraph 2.1)</td><td>No provision is recognized (paragraph 2.2)</td><td>No provision is recognized (paragraph 2.2)</td></tr>
<tr><td>Disclosures are required for the provision [paragraphs 5(1) and 5(2)]</td><td>Disclosures are required for the contingent liability [paragraph 5(3)]</td><td>No disclosure is required [paragraph 5(3)]</td></tr>
</table>

A contingent liability also arises in the extremely rare case where there is a liability that cannot be recognized because it cannot be measured reliably. Disclosures are required for the contingent liability.

9.2 APPENDIX 2: CONTINGENT ASSETS

<table>
<tr><td colspan="3">Where, as a result of past events, there is a possible asset whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.</td></tr>
<tr><td>The inflow of economic benefits or service potential is virtually certain.</td><td>The inflow of economic benefits or service potential is probable, but not virtually certain.</td><td>The inflow of economic benefits or service potential is not probable.</td></tr>
<tr><td>The asset is not contingent [(paragraph 2.3(1)]</td><td>No asset is recognized (paragraph 2.3)</td><td>No asset is recognized (paragraph 2.3)</td></tr>
<tr><td></td><td>Disclosures are required [(paragraph 5(5)]</td><td>No disclosure is required [(paragraph 5(5)]</td></tr>
</table>

9.3 APPENDIX 3: REIMBURSEMENTS

Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.		
The entity has no obligation for the part of the expenditure to be reimbursed by the other party	The obligation for the amount expected to be reimbursed remains with the entity, and it is virtually certain that reimbursement will be received if the entity settles the provision	The obligation for the amount expected to be reimbursed remains with the entity, and the reimbursement is not virtually certain if the entity settles the provision
The entity has no liability for the amount to be reimbursed [paragraph 3.5(5)]	The reimbursement is recognized as a separate asset in the statement of financial position, and may be offset against the expense in the statement of financial performance. The amount recognized for the expected reimbursement does not exceed the liability [paragraphs 3.5, 3.5(1) and 3.5(2)]	The expected reimbursement is not recognized as an asset (paragraph 3.5)
No disclosure is required	The reimbursement is disclosed, together with the amount recognized for the reimbursement [paragraph 5(2.c)]	The expected reimbursement is disclosed [paragraph 5(2.c)]

10. ILLUSTRATIONS

10.1 ILLUSTRATIVE EXAMPLES

Example 1: EXPECTED VALUE

A government medical laboratory provides diagnostic ultrasound scanners to both government-owned and privately owned medical centers and hospitals on a full-cost recovery basis. The equipment is provided with a warranty under which the medical centers and hospitals are covered for the cost of repairs of any defects that become apparent within the first six months after purchase. If minor defects were detected in all equipment provided, repair costs of €1 million would result. If major defects were detected in all equipment provided, repair costs of €4 million would result. The laboratory's past experience and future expectations indicate that, for the coming year, 75% of the equipment will have no defects, 20% of the equipment will have minor defects and 5% of the equipment will have major defects. In accordance with paragraph 2.1.3, the laboratory assesses the probability of an outflow for the warranty obligations as a whole.

The expected value of the cost of repairs is:
(75% of nil) + (20% of €1m) + (5% of €4m) = 400,000

Example 2: ONEROUS CONTRACTS

A governmental department has entered into a supply contract for raw materials used in one of its operations (operation XY). During December 20x7, the department discontinued the operation XY. However, the supply contract continues for the next three years, it cannot be cancelled and the raw materials to be supplied cannot be used for any other purpose, nor can be resold. The annual supply cost is €10.000. The penalties payable for early cancellation are €15.000. Assume a discount rate of 10% per annum.

The following steps must be followed, for a Provision to be recognised:

1st Does an obligation as a result of past event exist? Yes: The obligating event arises from the combination of the closure of the operation together with the existence of a signed supply contract which includes a commitment to make purchases for €10.000 per year for 3 years.

2nd Does an outflow of resources embodying economic benefits in settlement? Yes, when a contract becomes onerous, an outflow of resources embodying economic benefits is probable.

3rd Conclusion: this is an Onerous Contract since the unavoidable costs (total costs to fulfil the contract, or penalties payable) exceed the benefits.

4th A Provision should be recognised for the lower of:

- Costs to fulfil the contract → PV of €10.000 annual costs for 3 years discounted at 10% = €24.869 *or*
- Penalties payable = €15.000 → lower amount

5th A "*Provision for onerous contract*" for the amount of €15.000 is recognised.

10.2 ILLUSTRATIVE DECISION TREE