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EUROSTAT

Directorate C: National and European Accounts

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Mr Heller
Czech Statistical Office
Na padesátém 81
CZ – 100 82 Praha 10

**Subject: Follow-up of Eurostat dialogue visit
Methodological treatment of claim repurchase following a court decision**

Dear Mr. Heller,

Following up on the discussion with the Czech statistical authorities during the EDP dialogue visit that took place on 18-19 June 2007 in Prague, and on the further correspondence and exchanges of documents on the issue of the recording of an operation relating to a claim repurchase by CSOB from CKA, I would like to inform you of the views of Eurostat on the above-mentioned case.

The accounting issue for which a clarification is requested

The issue for which an opinion is required concerns the correct accounting treatment of a claim repurchase by CSOB (a commercial bank) from CKA (a central government "defeasance structure" unit), following a court decision. There is a question whether the claim repurchase is to be recorded as a non-financial transaction with a positive impact on the government deficit or as a financial transaction without impact on the deficit, and another question of the appropriate time of recording.

Documentation provided

The issue was explained by the Czech statistical authorities during the EDP dialogue visit in June 2007 and was briefly described in the Final findings of the visit. The Czech Statistical Office (CSO) provided, on 2 August 2007, new information on foreseen successive court decisions relating to the claim repurchase. A note providing some considerations on the recording of the claim repurchase was also provided by the CSO on 1 February 2008.

Description of the case

CKA, a defeasance structure unit classified in the central government subsector, purchased in 2002 impaired claims from CSOB, a commercial bank classified outside general government, at their nominal value, implying a significant grant element. The purchase of the claim by CKA of 1.7 bill CZK in 2002 was recorded in national accounts as government expenditure, capital transfer (D.9), in application of ESA95 rules.

Following the 2005 court decision, CSOB was obliged to repurchase the claim from CKA in 2005. The transaction had originally been recorded by the CSO in the financial accounts, as disposal of loans (F.4). During the mission in June 2007, Eurostat felt that it might be more appropriate to record a capital transfer revenue to this effect in 2005, *de facto* compensating the original capital transfer expenditure at time of purchase, and pointed at the need to consider revising the notified 2005 deficit (reduction in the deficit).

Following up on the EDP mission conclusions, the Czech authorities sent a note to Eurostat on 2 August 2007 explaining that there was a new ongoing court process at the High Court of Justice relating to the previous court decision on the case CSOB versus CKA. A second court decision could possibly lead to reverse transaction: the repurchase of the claim by CKA. Eurostat understands that the court decision has not been taken yet.

The current version of the ESA95 Manual on government deficit and debt does not provide a clear guidance for the recording of transactions relating to "repetitive" court decision with retroactive effect. On 21 September 2007 Eurostat recommended the Czech authorities to record the claim repurchase by CSOB in 2005 as an increase of other accounts payable (F.7) of CKA against CSOB, as a counterpart to cash receipts (F.2) amounting to 1.7 bill CZK, as an interim solution, pending further review of the case by Eurostat.

Methodological analysis and clarification by Eurostat

Applicable accounting rules

The Council Regulation 2223/96 incorporates the national accounts concepts and definitions of the European System of Accounts (ESA95) in Community Legislation. The ESA95 Manual on government deficit and debt (MGDD) published by Eurostat provides further elements for interpreting the accounting rules of ESA95. Of particular relevance in this case are §§ 1.33, 1.42, 1.57 and 4.164 of ESA95 and the MGDD Part II.5.2 on financial defeasance and Part III.4 on cases of court decisions with retroactive effect.

Availability of national accounting analysis

The CSO provided on 1 February 2008 a note on the recording of the transaction relating to the claim repurchase by CSOB from CKA in 2005. According to the note, the original recording in national accounts had implied two steps: a revaluation of the assets of government (K.11/AF.42) by an amount of 1.7 bill CZK, because the value of the impaired loans was zero in the ESA95 balance sheet; and a recording of a financial transaction involving the sale of loans (F.4) as a counterpart to cash received (F.2). The Czech authorities expressed some doubts on the Eurostat recommendation of 21 September 2007 on whether to record a transaction in other accounts payable instead of keeping recording a transaction in loans.

Analysis

After an examination of the background documentation and of the analysis provided by the CSO, Eurostat has reached the following views.

Defeasance structure operation

It should be noted that in the context of defeasance structures operations, loans that enter the defeasance are certainly impaired ones. When there is reliable information that they are mainly

irrecoverable, these loans should be accounted for zero (MGDD, Part II.5.2, page 112). Such bad loans should be written-off by the financial institution before the transaction with the defeasance unit takes place. The writing-off is to be recorded via the other changes in volume of assets accounts (K.10) of the financial institution and the other changes in volume of liabilities accounts of the debtor (MGDD, Part II.5.2, page 114). It means that during the management of the defeasance, bad loans do not appear any more in the balance sheet in the system.

Consequently, bad loans in the portfolio of CSOB should have been written-off via the other changes in volume accounts without impact on the deficit, before the defeasance operation took place. The "purchase" of bad loans from CSOB by the defeasance structure unit CKA should be recorded as government expenditure, capital transfer (D.9). This treatment implies a negative impact on the government deficit of 1.7 bill CZK in 2002. No loans should appear, neither in the balance sheet of CKA, nor of CSOB from 2002 onwards. The assets (loans) of CSOB, as well as the liability of the debtor disappeared from the system before the "purchase" of bad loans by CKA took place.

We understand that these recordings have been followed by the Czech statistical authorities.

Classification of the claim repurchase following a court decision

A second issue is the recording of the claim (loan) repurchase by CSOB from CKA, following the court decision in 2005.

According to ESA95 §1.33, a "*...transaction is an economic flow that is an interaction between institutional units by mutual agreement...*". ESA95 § 1.42 indicates that "*...this does not mean that all units necessarily enter a transaction voluntarily, because some transactions are imposed by the law...*". According to MGDD (Part III.4), "*In some cases - when a new situation is created (new rights and obligations, for instance) - what is the subject of controversy and dispute can be resolved only by a Court decision which creates the obligation to pay, and also specifies the exact amounts to be paid. The date of court decision is therefore the time when the transactions are to be recorded*".

This means that an interaction is taking place in ESA95 terms in 2005, following the court decision between CSOB and CKA. This interaction is deemed to be by mutual agreement, even though not voluntarily for each of the parties involved. The relating payment of CSOB to CKA can be qualified as giving money "against nothing"; therefore a capital transfer revenue (D.9) should be recorded at the time of decision in government accounts. This recording entails a positive impact on the government deficit of 1.7 bill CZK in 2005. There is neither a transaction nor an other economic flow in loans, since these do not appear in the system anymore, since 2002.

An event is recorded in 2005 by preference by way of revising the 2002 data (i.e. cancelling the original 2002 expenditure). This is because, whereas a revision of a recording can be applied when *new information* is available on a past event, no revisions should be conducted in case of *new event* - even if seemingly reversing past events. A court decision on a past operation cannot be considered as new information on a past event. On the contrary, it should be considered as a new event, since a new agreement has been reached, which implies new claims/liabilities.

Time of recording in the context of repeated court decisions

According to the information provided by the CSO in August 2007, there is a new ongoing court process at the High Court of Justice relating to the first 2005 court decision on the case of CSOB

versus CKA. CSOB requires the annulment of that first court decision, which could possibly lead to a reverse transaction: the repurchase of the claim by CKA from CSOB. Whereas a revision of the 2005 recording may have to be examined, subsequent to any possible future annulment of the first decision, this should not preclude recording in 2005 an entry in the nonfinancial accounts of government while waiting for a final settlement of the dispute.

Conclusion

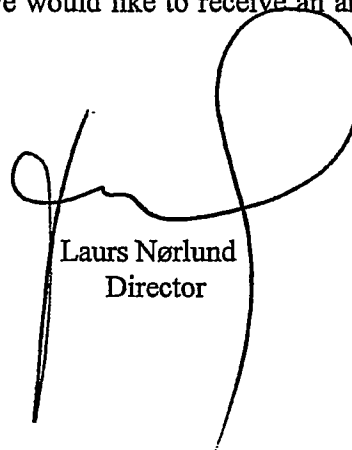
Based on the above considerations, Eurostat's position is that the most appropriate treatment for the claim repurchase by CSOB from CKA is to record a government revenue (capital transfer) of 1.7 bill CZK for 2005, i.e. at the time of the relevant court decision.

Procedure

This view of Eurostat is based on the information provided by the country authorities. If this information turns out to be incomplete, or the implementation of the operation differs in some way from the information presented, Eurostat reserves the right to reconsider its view.

We would like to remind you that Eurostat is committed to adopting a fully transparent framework for its decisions on debt and deficit matters in line with the amended Council Regulation 3605/93 and the note on ex-ante advice, which has been presented to the CMFB and cleared by the Commission and the EFC. Eurostat intends, therefore, to publish all future official methodological advice (ex-ante and ex-post) given to Member States, on the Eurostat web site. In case you have objections concerning this specific case, we would appreciate if you let us know. In any case (regardless of whether you have objections or not) we would like to receive an answer from you on the issue no later than 15 April 2008.

Yours sincerely,



Laurs Nørlund
Director