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FINAL FINDINGS

EDP dialogue visit to Cyprus

24-25 September 2014

Executive summary

In accordance with Council Regulation (EC) No 479/2009 of 25 May 2009, as amended, on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community, Eurostat carried out an EDP dialogue visit to Cyprus on 24-25 September 2014.

The aim of the visit was to discuss the quality and exhaustiveness of primary data sources, to clarify some issues relating to EDP tables, to review the progress achieved in implementing ESA 2010 methodology (in particular sector classification of units) and to assure that provisions from the Manual on Government Deficit and Debt and recent Eurostat decisions will be duly implemented in the Cypriot EDP tables and national accounts. In addition, the issues of quality management, audit, and institutional arrangements concerning EDP statistics production were discussed.

In particular, the visit aimed to review the existing institutional responsibilities as regards the compilation of EDP statistics and government accounts, discuss the quality and exhaustiveness of primary data sources - and in particular local government accounts and data sources - discuss the implementation of ESA 2010, the statistical treatment of various government transactions, and planned structural reforms.

Special attention was given to the statistical treatment of operations concerning the Cooperative Central Bank and the Cooperative Banking Sector of Cyprus. Eurostat also reviewed the current developments regarding gas/oil exploration and exploitation.

Eurostat greatly appreciated the co-operation and transparency demonstrated by the Cyprus statistical authorities during the meeting and the documents provided prior to the dialogue visit.

Eurostat took note that there had been no substantial changes in the institutional set-up for compiling GFS and EDP data in Cyprus and welcomed the signing of a Memorandum of Understanding between the National Statistics Office (NSO), the Ministry of Finance (MoF), the Central Bank of Cyprus and the Fiscal Council. Eurostat also encouraged the NSO to work towards the development of cooperation on EDP related issues with the Supreme Audit Office of Cyprus (the Auditor General of the Republic).

As regards data sources, Eurostat welcomed the introduction of monthly electronic surveys to collect data of semi-government organisations and Local Government units.

Eurostat urged the NSO to complete and send the new EDP inventory of sources and methods.

Eurostat examined the draft EDP tables of the Oct 2014 EDP reporting. In this context, the Cypriot statistical authorities committed to address a number of technical and presentational issues in the forthcoming October 2014 EDP Notification.

Concerning ESA2010 implementation, Eurostat took note of the recent reclassifications of public entities in General Government, and clarified that the implementation should cover all the EDP reporting period as well as relevant historical years. In general, Eurostat appreciated the work of the Cypriot statistical authorities on the implementation of ESA 2010 and took note of some specific further points. The Cypriot statistical authorities should introduce the ESA2010

treatment of military expenditure for all years from the Oct 2014 notification onwards. The Cypriot statistical authorities should also follow in the future the ESA2010 rules for Standardized guarantees for any schemes that will continue operating in Cyprus. Closing schemes will be recorded when guarantees are called as historically no standardized guarantee scheme has ever been called in Cyprus.

Regarding tax refunds, the Cypriot statistical authorities, following further investigation of data sources and administrative arrangements, will introduce an accrual recording of tax refunds from the Apr 2015 notification.

As regards specific government transactions in the context of the financial crisis, the discussion focused primarily on an operation involving the Central Cooperative Bank. In this regard, the Cypriot Statistical authorities undertook to provide financial statements of the consolidated Cooperative Banking Sector for the 1st half of 2014, as well as for historical years (pre-2010) as soon as possible. Eurostat and the NSO will then analyse the Cooperative Central Bank injection to reach a final view on its statistical recording. Regarding other operations, the NSO should confirm the major creditors of LAIKI Bank and the Government share of credits. The Cypriot statistical authorities will also confirm the status of Government bonds used in previous liquidity operations for banks.

A first discussion on the issue of the statistical classification of the planned hydrocarbon exploitation partnership was also conducted, in anticipation of specific details about the plan.

Introduction

In accordance with Council Regulation (EC) No 479/2009 of 25 May 2009, as amended, on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community, Eurostat carried out an EDP dialogue visit to Cyprus on 24-25 September 2014.

The delegation of Eurostat was headed by Mr John Verrinder (Head of Unit D3 "Excessive Deficit Procedure II"). Eurostat was also represented by Mr Denis Besnard (unit D1) and Mr Georgios Papadopoulos (unit D3). DG ECFIN and the European Central Bank (ECB) also participated in the meeting as observers.

Cyprus was represented by the Cypriot Central Statistical office (CYSTAT), the Central Bank of Cyprus (the CBC) and the Ministry of Finance (MoF).

The previous Eurostat EDP dialogue visit to Cyprus had taken place on 26 Sep 2012. There were two outstanding action points from the 2012 visit: AP 2 regarding the transmission of the new EDP inventory, and AP 11 regarding a reconciliation analysis between the cash working balance of EDP Table 2A and the movements in currency and deposits in EDP Table 3B. These points are discussed under the relevant sections of this report (section 1.2 and section 3 respectively).

The purpose of this EDP dialogue visit was mainly to review the implementation of ESA2010 methodology and to ensure that the provisions of the Eurostat's Manual on Government Deficit and Debt, as well as Eurostat's decisions, are duly implemented in the Cypriot EDP and Government Finance Statistics (GFS) data. In addition, the issues of quality management, audit, and institutional arrangements concerning EDP statistics production were discussed.

In particular, the visit aimed to review the existing institutional responsibilities as regards the compilation of EDP statistics and government accounts, discuss the quality and exhaustiveness of primary data sources -and in particular local government accounts and data sources- discuss the implementation of ESA 2010, the statistical treatment of various government transactions, and planned structural reforms.

Special attention was given to statistical treatment of operations concerning the Cooperative Central Bank and the Cooperative Banking Sector of Cyprus. Eurostat also reviewed the current developments regarding hydrocarbon exploration and exploitation.

With regard to procedural arrangements, the Main Conclusions and Action Points will be promptly sent to Cyprus for review. Then, the Provisional Findings would be sent to Cyprus for review and comments. After this, the Final Findings will be sent to the Cyprus authorities and to the Economic and Financial Committee (EFC) and published on the website of Eurostat.

Eurostat greatly appreciated the co-operation and transparency demonstrated by the Cyprus statistical authorities during the meeting and the documents provided prior to the dialogue visit.

1. Statistical organisation issues

1.1. Institutional responsibilities in the framework of the reporting of data under the Excessive Deficit Procedure (EDP) and Government Finance Statistics (GFS) compilation

The Cypriot NSO (CYSTAT) is responsible for compiling and transmitting GFS tables. While it is fully responsible for the production of non-financial accounts, annual and quarterly financial accounts of general government are produced in close cooperation with the MoF. CYSTAT is also responsible for the compilation of the EDP notification tables, except for planned debt and deficit data.

Eurostat reviewed the institutional responsibilities in place and the framework of the reporting of data under the Excessive Deficit Procedure (EDP) and Government Finance Statistics (GFS) compilation. The role and responsibilities of CYSTAT, the MoF and the Cyprus Central Bank (CCB) in production and reporting of EDP/GFS data have not substantially changed since the last EDP dialogue visit which took place in May 2012.

In 2014 Cyprus voted a new Law to transpose into its national legal system the provisions of Council Directive 2011/85/EU on Budgetary frameworks. The Law is known as the 2014 Fiscal Responsibility and Budgetary Framework Law (Law 20(I)/2014 - 21/2/2014). It contains interesting provisions as regards statistical reporting, quality management, control and audit.

The Law introduces an independent new public entity, the Fiscal Council. The Fiscal Council is an independent public unit whose members do not take instructions from the Government or the parliament. The main responsibilities of the Fiscal Council is to provide an a priori evaluation of the macroeconomic and budgetary forecasts of the government prepared in the context of the elaboration of the budget and the Strategic Framework for Fiscal Policy in order to be adopted, monitor compliance with the numerical financial rules as set out in Article 5 of Directive 2011/85/EU, and provide an a priori and a posteriori public evaluation of the public fiscal policy.

The Law introduces requirements for all economic operators in General Government regarding the establishment of internal audit systems.

The Auditor General of the republic performs an external audit of the consolidated general government financial statements, inter alia.

All general government entities and Local Authorities are required to submit their annual financial statements to the Minister and the Accountant General within (4) months from the end of the financial year.

Finally, the Law foresees sanctions in cases of refusal to prepare and submit any information required under this Law or submission of false information.

Moreover, in 2014 a Memorandum of Understanding was signed between:

- The Ministry of Finance (MoF)
- The University of Cyprus

- The Central Bank of Cyprus (CBC) and

- The Fiscal Council.

CYSTAT is not a signing counterparty as the signature of the Minister of Finance also commits CYSTAT (CYSTAT is, for administrative purposes¹, under the Minister of Finance).

The MoU was foreseen in the Economic Adjustment Programme and its main goal is to setup a common framework for the cooperation, responsibilities, and exchange of statistical data and other information between the institutions.

The role of CYSTAT (as well as of the other parties) is clarified in the text. As regards EDP compilation it seems that the MoU does not introduce any changes to the already established arrangements. CYSTAT is solely responsible for the collection and compilation of General Government accounts and General Government debt and deficit statistics according to ESA methodology. CYSTAT is obliged to inform the Fiscal Council about these statistics. The University of Cyprus is involved in forecasting. The Ministry of Finance is responsible for forecasting as well as collection and compilation of statistics and forecasts as regards Public Debt and Deficit. The Fiscal Council is informed of developments in EDP actual data and the forecasts.

1.1.1. Institutional cooperation and EDP processes

Eurostat reviewed the institutional responsibilities in place for the compilation of EDP and GFS data as well as the responsibilities of CYSTAT, the MoF and the CBC for collecting data from upstream entities. CYSTAT confirmed that there have been no substantial changes since the last EDP dialogue visit which took place in May 2012.

The Cypriot statistical authorities explained how the Memorandum of Understanding between CYSTAT and the MoF works in practice and in particular how the EDP process is coordinated between the institutions.

The Cypriot statistical authorities explained that the responsibilities of the upstream entities for statistical reporting are ensured through the New 2014 Fiscal Responsibility and Budgetary Framework Law.

Eurostat welcomed the signing of the Memorandum of Understanding between the institutions involved in EDP compilation.

Findings and conclusions

The new MoU describes the role and responsibilities of each institution involved in EDP compilation.

¹ According to CYSTAT homepage: "The Statistical Service, although functions under the Ministry of Finance, maintains its autonomy in technical matters and has exclusive responsibility for the choice of methodology, technique, definitions and procedures for the realization of the programmes of statistical activities, as well as for the publication of the statistical data produced".

See http://www.cystat.gov.cy/mof/cystat/statistics.nsf/history_en/history_en?OpenDocument

The National Statistical Institute remains responsible for the compilation of data on actual deficit while information on planned deficit and actual and planned debt are produced by the Ministry of Finance. It appears that, as previously, the involvement of the Central Bank is restricted to providing only some of the source data.

Therefore, in practical terms, as regards EDP compilation, Eurostat noted that the new MoU simply describes the already existing processes and does not introduce any changes.

1.1.2. Quality management framework

Eurostat asked CYSTAT about the issue of limited staff resources within CYSTAT, working on EDP/GFS. Eurostat welcomed the arrival of a recent recruit, however, it noted that resources and expertise should be further improved. Eurostat urged the Cypriot authorities to ensure sufficient staffing resources in order to guarantee the continuity and quality of EDP/GFS statistics.

CYSTAT explained that there is currently a hiring moratorium in the Cypriot public sector. This makes it almost impossible hire new personnel. Other departments (such as the MoF) also work with limited personnel.

Eurostat noted that there is a late response in some cases in implementing actions from EDP dialogue visits (e.g. delivery of the new EDP inventory has been postponed several times), also due to the limited resources available.

Eurostat enquired about the existence of adequately formal and detailed quality control procedures for EDP compilation processes or the existence of a quality management framework for EDP statistics at CYSTAT.

CYSTAT explained that until recently there was no formal quality management practice. However, the recent introduction of the 2014 Fiscal Responsibility and Budgetary Framework Law is expected to provide the basis for the further developments in quality management and internal control. Additionally, the EDP compilation system is already quite robust as the existence of FIMAS (the integrated IT system for reporting all central government, budgetary and extra-budgetary funds as well as Social Security Funds transactions) ensures the adherence to standardized reporting rules in these sectors. Furthermore, standardized reporting of Local Government units and semi-government organizations is now ensured through specially developed written forms and procedures. Specific training on ESA2010 principles and accrual accounting is being provided by CYSTAT to the accounting staff of these entities. CYSTAT has also drafted a relevant Manual, circulated to the staff in these units.

Transactions are routinely cross-checked using counterpart information when available, or against annual financial reports of the units involved, or against FIMAS entries.

The above arrangements would ensure that data flows from the upstream data providers are standardized and well documented. CYSTAT explained that, currently, coverage of these entities (in particular Local Government units) is not 100% but CYSTAT and MoF are working on achieving full coverage and a very good quality of data.

Findings and conclusions

- Eurostat is concerned about staff resources available at CYSTAT for EDP/GFS work. Eurostat urges the Cypriot authorities to ensure sufficient staffing resources in order to guarantee the continuity and quality of EDP/GFS statistics.

1.1.3. Audit and internal control arrangements

The 2014 Law on Fiscal Responsibility and Budgetary Framework introduces a clear requirement for Internal Control in all public bodies. External audit by the Auditor General of the General Government accounts is also described in the Law.

The latest report (2012) of the Auditor General of the Cyprus Republic states that due to human resources shortages not all entities could be audited (ministries and main entities were covered, but smaller units were not). Additionally, the Auditor General has found that, at that time, there were serious shortcomings in the internal control systems of many public entities/units.

According to the Law, external audit is mandatory for all subsectors of general government. All of them are audited by the Auditor General of the Republic. Furthermore very few of the special funds are also subject to a statutory audit by private audit firms. In addition, the auditor general may conduct any further audit work (financial, performance or other). The audit includes the financial situation, findings and recommendations.

Discussion

Eurostat enquired about any developments in the field of cooperation with the Auditor general whether formal (i.e. through the establishment for instance of a dedicated working group or similar) or informally. Eurostat also asked whether in any recent audit there were any results relevant to EDP/GFS statistics.

CYSTAT explained that cooperation between CYSTAT and the Auditor General is not currently specifically developed; however, both parties have already established contacts to improve and develop the cooperation (in particular on issues related to EDP/GFS).

Findings and conclusions

- Eurostat considers cooperation between National Statistical Institutes and national Supreme Audit Institutions to be mutually beneficial and therefore is asking all Member States to review this issue.

Action Point 1: The Cypriot authorities will consider the enhancement of cooperation between CYSTAT and the Auditor General of the Republic, reporting back to Eurostat by end 2014.

1.2 New EDP Inventory

Introduction

The latest version of the Cypriot EDP Inventory was drafted in December 2012 and is publicly available both on the Eurostat and CYSTAT websites.

Cyprus has not yet sent to Eurostat the new EDP inventory. The current consolidated inventory of sources and methods of Cyprus dates back to 2012 and is published on Eurostat's website. The inventory provides information on data availability and data sources for all subsectors of the general government sector.

The general government sector comprises (a) central government (S.1311), (b) Local government (S.1313) and (c) Social Security Funds (S.1314). The subsector State Government (S1312) is not applicable for Cyprus.

The subsector S.1311 consists of the main unit "The State", extra budgetary accounts including 19 non-profit organisations.

At the beginning of September 2014 Cyprus indicated that a first version of the new inventory could be completed shortly after the Oct 2014 notification.

Discussion

Eurostat urged CYSTAT to complete and submit the new format EDP inventory as soon as possible after the Oct 2014 notification (this was one of the two outstanding action points from the 2012 dialogue visit).

Findings and conclusions

Action Point 2: CYSTAT will send to Eurostat the EDP inventory of sources and methods in the new format by the end of Oct 2014².

2. Review of key data sources

Introduction

Eurostat reviewed the key data sources and methods used, and the public accounting standards used in all general government subsectors.

Budget reporting is the main data source for compiling the accounts of the State. The data reported in the Budget are on a cash basis. The most recent year for which final data on central government are available in the April notification is the year (n-1). The classification of revenue and expenditure used in the Budget reporting of the State Budget is applied to all general government subsectors. All the information regarding the transactions of the State is obtained from the National Treasury. The Statistical Service has on-line access to the National Treasury accounts, having thus the ability to monitor all transactions on a daily basis.

Budget reporting is also the main data source for the compilation of the accounts of the extra-budgetary funds. Data based on interim reports (reporting figures for the January-December period) for year n-1 for extra-budgetary funds are available in the April (n) notification. There are also 19 semi-government organisations included in this sector. Until recently, for the compilation of the EDP tables in the April notification, the Statistical Service uses estimates of the balances of these units provided by them as well as information from the National Budget as these institutions are heavily financed by the Budget. The data used are on a mixed basis.

² Action point completed.

The audited accounts of the Ministry of Labour and Social Insurance are the source of information on the accounts of the sub-sector Social Security Funds. Final audited accounts for each of the six funds comprising SSFs are available within 6 months after the closing of the year. Semi-final and final data provided by the funds are used for the first notification for the year n-1. There is no need for any adjustment as all relevant data received from the audited accounts are on an accrual basis.

Recently fiscal reporting by local governments has improved – since 2013, local government entities have provided monthly revenue and expenditure data to the National Treasury, using a web-based platform (similar to Central government data) to ease reporting by LGs. More recently, the MoF has begun collecting data on local government arrears, but coverage still needs improvement.

In the reconciliation table of Art. 3(2) of Directive 2011/85 on Budgetary Frameworks (published on CYSTAT web page), CYSTAT notes on this subject that as regards semi-government organisations and local authorities' data, these are reported to the National Treasury within 20 days after the end of every month, and then tabulated and forwarded to CYSTAT. This collection scheme is carried out using online reporting through a dedicated web portal as of March 2013.

2.1 Extra-budgetary and semi government bodies, financial accounts

Discussion

CYSTAT described the FIMAS accounting IT system (the system used to collect all transactions of Central government units, budgetary funds and Social Security Funds) and the use of bridge tables. CYSTAT explained that FIMAS will not be extended to incorporate also local authorities. CYSTAT has online access to FIMAS. CYSTAT further noted that there are ongoing plans to move FIMAS to full accrual accounting (this is a long-term project and it is expected to be realized in 5-6 years). CYSTAT confirmed that financial accounts are compiled in close cooperation with the Ministry of Finance.

As regards Local Authorities data (Local Government subsector), CYSTAT explained that data from local authorities and Semi-government organisations (belonging to Central government) is collected through especially dedicated monthly surveys, directly from each local authority. This collection scheme is carried out using online reporting through a dedicated web portal. Training and manuals have been provided to the accountants in the local authorities.

CYSTAT confirmed that data from Semi-government organisations and Local Authorities are collected by the National Treasury electronically through a dedicated web portal and are then transmitted to CYSTAT. CYSTAT explained that, in their view, already coverage and quality are satisfactory and any small coverage/quality problems which are still experienced are expected to be solved soon. CYSTAT also noted that in order to achieve full compliance by all units, sanctions have been approved by the Ministry of Finance and are enforced in case of non-compliance to the reporting obligation.

CYSTAT confirmed the above developments and efforts to achieve 100% coverage of LG units and extra-budgetary funds, through the specially designed monthly data surveys.

Eurostat took note of these developments.

2.2 Public sector accounting and accrual of expenditure/revenue

Discussion

Eurostat enquired about the use of potentially non-harmonized public accounting systems by entities at the various government subsectors.

CYSTAT explained the various accounting standards used by the government subsectors in Cyprus:

- Central government units: treasury report (budget / cash basis with information to generate accruals)
- Local government units: municipalities use business accounting, villages keep books on cash basis
- Public Corporations: business accounting
- Social Security Funds: accruals accounting (business accounting)

Eurostat took note of the above information regarding public accounting systems used in the various General Government subsectors.

3. EDP reporting – analysis of the draft October 2014 EDP notification

Introduction

Eurostat appreciated the timely and complete EDP transmissions and the comprehensive supporting documents sent with each notification. Eurostat also appreciated the provision of draft tables for the Oct 2014 notification, provided by CYSTAT prior to the mission.

During the April 2014 EDP notification no major problems were encountered regarding the recording of government transactions and the required adjustments to the reported working balance. The adjustments are rather small and the majority of these adjustments relate to financial transactions included in the working balance. The accruals adjustments in Table 2A relate to some categories of income taxes, VAT, and defence trade credits. The working balance is on a mixed basis.

3.1 Examination of the EDP tables

Discussion

Eurostat reviewed all draft EDP tables and the various entries in the tables.

The draft Oct 2014 EDP tables show small revisions as compared to Apr 2014. Revisions due to the introduction of ESA2010 amount to a small decrease of deficit and an increase of debt. These revisions are mainly due to the inclusion of two public companies into General Government.

Eurostat commented on the fact that the impact from the recent reclassification of entities to GG was reported only for 2013. This should be extended to cover the entire reporting period in the final version of the EDP tables.

CYSTAT demonstrated how the various entries in the tables come from the Treasury report as well as other provided documents.

Eurostat noted that a capital transfer reported in the Treasury report is not explicitly shown in Table 2A, rather the amount is already subtracted from the figure reported under "Equities, acquisition (+)".

Eurostat noted that an operation involving KA Finanz should not lead to entries to EDP table 2A.

One of the two outstanding actions from the 2012 mission required CYSTAT to "...reconcile the reported figures between the cash working balance of EDP Table 2A and the movements in currency and deposits in EDP Table 3B for the EDP reporting period". CYSTAT had provided an analysis for one year only. Eurostat enquired about this issue. During the meeting, CYSTAT presented a reconciliation analysis for year 2013.

CYSTAT confirmed that as already noted in previous missions, in **Table 2D**, data for social security funds are on an accrual basis. The only accruals adjustments necessary are for other accounts receivable.

Findings and conclusions

- Eurostat noted that the operation involving KA Finanz should not lead to entries to EDP table 2A but be considered as restructuring of a loan.

Action Point 3: CYSTAT will improve the presentation in EDP table 2A of capital injections treated as capital transfers in the Oct 2014 notification and all subsequent notifications³.

Action Point 4: CYSTAT will introduce the ESA2010 treatment of military expenditure for all years from the Oct 2014 notification onwards⁴.

Action Point 5: CYSTAT will introduce the data for entities recently reclassified in General Government for the 2010-2013 period in the Oct 2014 notification, and in the complete time-series for the March 2015 notification.

3.2 Questionnaire related to the EDP tables

Eurostat noted that Table 11 of the questionnaire related to the EDP tables should be updated in the forthcoming notification (see also the discussion in section 4.3.12 below).

4. Methodological issues and recording of specific government transactions

4.1 Delimitation of general government sector

Eurostat enquired about the register of government controlled entities not classified to general government.

In the EDP Consolidated Inventory of Sources and Methods (see Annex 2), it is stated that "*The NSI has the responsibility for classification of units, based on the criteria set by the ESA 95 manual on general government deficit and debt. Each and every unit is examined whether is a*

³ Action point completed.

⁴ Action point completed.

private or public unit, whether the unit enjoys autonomy of decision and finally whether it is a market or non-market producer according to the 50% rule."

A list of all units classified into General Government (GG) sector is annexed to the Inventory. An updated list of GG entities was provided prior to this mission. The updated list contains some additional units (semi-government organisations).

CYSTAT also provided an updated questionnaire on Government Controlled entities classified outside General Government. Note that the 2013 financial reports are not yet available but the 50% market test (under ESA2010) was performed using the most recent available data from financial reports or surveys.

The list was checked as regards the new qualitative rules of ESA2010 and the new rules on financial institutions. As a result, Eurostat communicated to CYSTAT its opinion that some additional units should be reclassified to GG (the central oil stockholding entity). CYSTAT agreed with Eurostat and reclassified the units prior to the mission.

Eurostat took note and explained that the impact to debt/deficit because of the inclusion of these units should also be shown on all the reporting years as well as historical years.

CYSTAT explained that they will carry out the 50% test again once final data for 2013 are available for all entities, following their standard practice.

Eurostat asked if CYSTAT has performed the qualitative tests for government control and market/non-market according to ESA2010. CYSTAT replied that they had done, and that as a result some very small units were already moved in General Government.

Eurostat took note of the explanations.

4.2 Implementation of the accrual principle

4.2.1 Taxes and social contributions

Introduction

The Cyprus statistical authorities use a time adjusted cash method to adjust VAT and income tax receipts onto an accruals basis. CYSTAT further explained that there were no changes in methods for recording taxes and social contributions. A time-adjusted cash method of 2 months is used for some income taxes, VAT and one month for social contributions.

Discussion

Eurostat enquired about the statistical treatment of tax refunds.

CYSTAT explained that there is an obligation of the Government not to increase arrears in tax refunds. The Government has managed to reduce arrears in the last couple of years.

Eurostat underlined that the time of recording of tax refunds should be according to the accruals principle.

Eurostat enquired about the Immovable Property Tax. The Cypriot authorities have reformed the immovable property tax with the objective to improve the fairness of the tax burden and to increase the efficiency of the tax administration (this was part of the Economic Adjustment Programme of Cyprus). A specific related issue was that the accounts of the Lands and Surveys Department are not detailed enough to separately record taxes on use of land, payment for services provided by the Department, and tax on capital transactions payable on the purchase or sale of non-financial assets.

CYSTAT explained that it was not aware whether or not the Lands and Surveys Department actually keeps separate accounts of these sources of income.

Findings and conclusions

Action Point 6: Following further investigation of data sources and administrative arrangements, CYSTAT will introduce an accrual recording of tax refunds from the Apr 2015 notification.

Action Point 7: The accounting entry for Land and Surveys Department proceeds will be split into its component parts from 2015 onwards.

4.2.2 Interest

ESA2010 foresees that interest payments under swap arrangements have to be recorded as deficit-neutral financial flows, while ESA95 foresaw a recording as property income (hence affecting the deficit/surplus). The results of a recent analysis by CYSTAT suggested that the impact of this methodological change would be insignificant in the case of Cyprus. CYSTAT confirmed during the meeting that swaps are not in use in Cyprus.

4.3 Recording of specific Government transactions

4.3.1 Government transactions concerning the Financial Crisis

- LAIKI Bank

Introduction

In 2013, the majority of the Laiki bank's assets were transferred to the Bank of Cyprus (BoC). The old Laiki Bank kept only the bad/nonperforming assets which will be liquidated. The shareholders of this entity are the previous major depositors in the bank, following the bail-in operation.

CYSTAT's view has been that the remainder of the old LAIKI should not be classified in General Government, for the following reasons:

- i. The decision-making for this entity is in the hands of the administrator appointed by the Resolution Authority, until the liquidation of the entity will be effected, and
- ii. the majority of the risks associated with this entity, as well as the majority of the expected losses from the liquidation of the assets lies on the depositors and not on the General Government, In addition, no guarantee of the General Government exists for compensating the depositors against any potential losses.

Prior to the visit, CYSTAT also provided the Sale of Certain Operations of Cyprus Popular Bank Public Co Ltd, Decree of 2013. The Decree specifies the assets which were not transferred to BoC.

Discussion

Eurostat enquired about any developments regarding the old Laiki Bank which could have an impact on its classification. CYSTAT confirmed that there are no developments, the entity is currently in liquidation and there is no government involvement.

Eurostat further enquired about the possibility that Government is one of the major creditors. In that case it could be the case that the law foresees special powers to the Government as a major creditor in a liquidation process. CYSTAT noted that in their knowledge this was not the case, but agreed to confirm.

- Recapitalisation of the Central Cooperative Bank

Introduction

The Cyprus Cooperative banking sector comprises the Cooperative Credit Institutions ("CCIs") and their central body, the Cooperative Central Bank Ltd ("CCB"). Prior to the 2014 restructuring, there were 93 legally independent CCIs providing retail banking services. The Cooperative banking sector has been one of the key players on the Cypriot banking market. In December 2012 it held total assets of EUR 17.1 billion corresponding to 95.5% of the GDP of Cyprus. It was, after Bank of Cyprus (BoC), the second-largest Cypriot bank in terms of deposits and loans, accounting for EUR 15.2 billion of deposits and for EUR 13.9 billion of loans representing a 22% share in deposits and a 19% share in loans.

The key problem of the Cooperative banking sector was its large volume of overdue loans. In Nov 2013 the level of non-performing loans ("NPLs", defined as loans with payment arrears of more than 90 days) accounted for over 40% of the cooperatives' total gross loans' value ("NPL ratio"). The problem of a high NPL ratio did not suddenly emerge as a result of the recession of 2012-2013 but had already reached problematic levels beforehand. The NPL ratio had already been very high, at 32% of gross loans in 2011 and 29% in 2010.

In July 2013 the Central Bank of Cyprus finalised the strategy for the restructuring and recapitalisation of the Cooperative banking sector including a plan to merge the individual CCIs into a maximum of 18 CCIs. A key element of that strategy is that, following recapitalisation, the State will in the future have almost full ownership of the CCB, while there will also be a reform in the ownership and control by the CCB over the CCIs, i.e. an end to the current structure where the CCIs are owned and controlled by their members and they in turn control the CCB. The strategy was agreed within the Framework of the Economic Adjustment Programme for Cyprus.

The final restructuring plan for the cooperative sector was submitted to the European Commission in January 2014. The Commission approved restructuring aid for the cooperative credit institutions as compatible with the internal market on 24 February 2014. The State injected EUR 1.5 billion (in the form of ESM bonds) in the CCB in exchange for 99% of ordinary shares. The EUR 1.5 billion had been received from the ESM (in the form of ESM bonds) as part of the agreed financial assistance.

The restructuring of the group includes among other things strong governance and internal control (the CCB will be empowered with the executive management of the entire group including its future risk management), a general payroll cost reduction, merging of the CCIs down to 18 entities, and reduction of the number of branches.

The merger of individual cooperative credit institutions into 18 entities was completed in March 2014. The cooperative credit institutions that subsequently become unviable will be required to merge with viable ones.

According to the plan, the CCB has an option which lasts from 2014 until 2028 to repurchase part or all of the participation and voting rights of Cyprus in the ownership structure of the CCB with the repurchase price being at least equal to the EUR 1.5 billion injected increased by a cumulative and compound annual interest rate fixed at 10%, net of any dividends paid out.

Cyprus may sell - in parts or as a whole - its shares in the CCB, but may not do so before December 2018. Such a sale must be organised via an open, transparent, non-discriminatory and unconditional competitive tender and on market terms, with the shares sold to the highest bid. If there are at least two or more bidders, the members of the Group may exercise pre-emptive rights to match the best price offer and acquire the shares at that price.

Discussion

Eurostat noted that from a methodological point of view the question is how to treat the EUR 1.5 billion injection. Eurostat noted the following:

- The Cooperative sector was already in difficulty prior to the Cyprus banking sector crisis. This was due to mismanagement and a risky lending approach. The 2012-2013 banking sector crisis further worsened the situation.
- There is no private sector participation in the recapitalization.
- The plan does not envisage a guaranteed rate of return for the Government.
- According to the Eurostat decision on bank recapitalizations during the financial crisis, if a recapitalization concerns one-off exceptional losses which are only due to unforeseen events (events beyond the responsibility of the financial institutions), then it may be treated as a financial transaction. In this case, the reasons behind the losses in the Cooperative sector have been identified as prior mismanagement (risky lending practices, lack of centralised control/strategy). As noted in the State Aid letter, the sector was already in difficulties prior to the 2012-2013 crisis. Therefore, it cannot be argued that these losses were solely due to an unforeseen event, beyond the responsibility of the financial institution.
- The Cooperative Banking Sector (consolidated results) show a net loss at least for 2012 (loss of EUR 17.3 million) and 2013 (loss of EUR 1.697 billion).

Eurostat thanked CYSTAT for the provision of all relevant documents regarding the February 2014 recapitalization.

CYSTAT described their initial view that the recapitalization is an investment of the State. The restructuring plan foresees a Return on Equity (RoE) of 2.4% in 2014 and above 10% thereafter.

The CCB announced a net profit of EUR 15 million for the first half of 2014. CYSTAT suggested that the situation is reviewed again by end 2014, after the stress-tests of Cypriot banks are also completed.

Eurostat clarified that, according to the methodology (MGDD III.2), this operation cannot be considered as an investment (i.e. acquisition of equity) as it clearly has the characteristics of a capital transfer, namely:

- There was no private sector investor participating on the same terms as government;
- The funds are provided to a corporation that has shown a recent series of losses.

Eurostat further explained that having studied the documents provided, its preliminary view is that the capital injection should be treated as a capital transfer up to the amount covering the accumulated net losses of the Cooperative Banking Sector. The capital transfer will impact on the 2014 deficit. If there is any amount exceeding the accumulated net losses this could be treated as acquisition of equity following MGDD III.2.2.2.1, as there is an obvious fundamental restructuring plan of the corporation, aiming at preventing the occurrence of new losses and returning the sector to sustainable profitability.

Since the results of historical years were not already available on a consolidated basis, Eurostat suggested that CYSTAT collects these as soon as possible.

- Bank of Cyprus

Eurostat also enquired about any relevant developments in the Bank of Cyprus. CYSTAT explained that there are no developments relevant to EDP/GFS as regards the Bank of Cyprus. The Bank is currently in the process of increasing share capital by private investor participation. Eurostat took note of the explanations.

- Other issues (Non-performing loans, government bonds, and seizure of assets legislation)

As regards non-performing loans CYSTAT confirmed the situation as described in the table provided prior to the visit. Eurostat took note of the estimates for NPLs.

Eurostat enquired whether any government bonds (issued to banks for liquidity purposes during the financial crisis) still remain to the banks. CYSTAT promised to investigate.

Eurostat also took note of the plans for bringing in force new legislation on seizure and sale of loan collaterals, and enquired about any recent developments. CYSTAT confirmed that the legislation was not yet finalised. Eurostat commented that the situation will be considered again upon developments.

Findings and conclusions

Action Point 8: CYSTAT will confirm the major creditors of LAIKI Bank and the Government share of credits. If Government is a major creditor, CYSTAT will confirm if this confers special

powers to Government as regards the liquidation process of LAIKI. CYSTAT will send to Eurostat a report on this issue as soon as possible⁵.

Action Point 10: The Cypriot authorities will confirm the status of Government bonds used in previous liquidity operations for banks, as soon as possible⁶.

Action Point 12: The Cypriot authorities will provide financial statements of the consolidated Cooperative Banking Sector for the 1st half of 2014, and for historical years (pre-2010) as soon as possible.

Action Point 13: Eurostat and CYSTAT will analyse the Cooperative Central Bank injection and reach a final view on its statistical recording by 15 Dec 2014.

4.3.2 Fiscal structural reforms.

Introduction

The economic adjustment programme for Cyprus foresees a number of fiscal-structural reforms, of which the new National Health System, Pensions reform and the guaranteed minimum income could potentially have implications as regards EDP statistics.

According to the March 2014 Commission review of the programme, full implementation of the national health system (NHS) is planned by mid-2016. The plan foresees that primary care consultation services will be covered by mid-2015, which will be followed by outpatient specialist care and outpatient pharmaceutical care in January 2016, with full implementation by mid-2016. As regards, the guarantee minimum income scheme, this scheme will reform the existing welfare system in Cyprus which currently encompasses a broad range of individual benefits provided by different Ministries and Departments. The aim is to ensure efficient use of public funds within the welfare system, while at the same time ensuring an appropriate balance between welfare benefits and incentives to take up work, and enhancing the protection of vulnerable households.

Pension reforms according to the Programme include mainly measures to reduce pension costs (increase retirement age, abolish preferential treatment regime for certain groups of employees, introduce further contributions and increased rates, etc.). These measures will be valid for both the Public Sector as well as the various private sector funds.

Discussion

Eurostat enquired about any developments as regards the planned Fiscal-structural reforms, envisaged in the economic adjustment programme, and in particular the new National Health System, Pensions reform and the guaranteed minimum income.

CYSTAT explained that as regards the Pensions reform and the National Health Systems there is there are no developments relevant to EDP/GFS statistical treatment. The National Health System is still in the planning phase and no concrete details are known. Eurostat noted that after

⁵ Action point completed.

⁶ Action point completed.

the plans for the new NHS are finalised the classification of public hospitals will need to be checked again.

As regards pensions, CYSTAT confirmed that the capital transfer transactions performed to compensate losses of the pension funds of certain public corporations are already included in the working balance of 2013, while some amounts will also be included for 2014.

CYSTAT noted that as regards the planned guaranteed minimum income scheme, this simply brings together a number of already existing benefits under the same framework, and has no implications as regards statistical treatment.

Eurostat took note of the explanations and added that these issues will be revisited upon new developments.

4.3.3 Sale and lease back operations

Eurostat enquired about plans to perform a sale and lease back operation between the State and the Central Bank of Cyprus. CYSTAT confirmed that this operation is now cancelled. Instead a simple sale operation will take place, in which the State will sell a number of non-financial assets to the CBC in exchange of a loan write-off. Eurostat confirmed that the situation should be monitored.

4.3.4 Statistical recording of land annexations – follow-up

This issue had been discussed in 2012. In July 2012, Eurostat asked the Cyprus statistical authorities to provide an analytical note describing the issue of land annexations. In this note Eurostat was informed along all the relevant details that the stock of outstanding liabilities of the State did not include outstanding payment related to land annexations because according to legislation those obligations were considered contingent liabilities. Eurostat responded to this analysis of CYSTAT and expressed its opinion according to which "...recording cash compensation when it is paid would be the most appropriate for the statistical treatment of this case, to ensure that government expenditure is recorded when government acquires economic ownership of the land." In the 2012 mission, Eurostat and the statistical authorities of Cyprus had reached the conclusion that there were no outstanding statistical issues relating to land annexations, and Eurostat was informed that a substantial amount of annexations had been cancelled in 2012.

Eurostat enquired about any recent relevant developments in the issue of land annexations. CYSTAT confirmed that there has been no change in the setup and the agreed treatment is still followed. CYSTAT informed Eurostat that the amounts involved are now smaller as many of the planned annexations are meanwhile cancelled.

4.3.5 Cyprus Airlines

Eurostat enquired about the situation in Cyprus Airlines and in particular if there are any further government transactions planned. CYSTAT confirmed that there are no transactions planned. The previous transactions were recorded as capital transfers. The government is currently looking for a private investor to take over the company.

Eurostat recalled that the Commission is expected to issue its opinion about the latest capital transfer in Cyprus Airlines. Eurostat commented that the situation will be checked again upon new developments.

4.3.6 CYTA

Eurostat enquired about CYTA, the Cyprus telecommunications company. CYSTAT confirmed that there are no relevant developments. The company is planned to be privatized, according to the economic adjustment programme. Eurostat commented that the situation will be checked again upon new developments.

4.3.7 EU flows

Eurostat asked if there are any fines or penalties regarding EU funds. CYSTAT replied that any fines are automatically netted and the amounts are very small anyway.

4.3.8 Guarantees

Eurostat enquired about the existence of standardized guarantees in the sense of ESA2010 5.190. CYSTAT explained that in law there exist standardized guarantee schemes, for instance as regards certain categories of housing loans. However, these have never been called in the past. Therefore there are no historical data which can be used to estimate the percentage of loans expected to be called. CYSTAT further explained that some of these standardized guarantee schemes will most probably be cancelled, whereas others may continue. CYSTAT expects that in the following months (possibly within 2014) part of these guarantees may be called. Eurostat noted that any guarantees called, will be recorded as such. If any of these schemes continues then the called amounts will then provide historical data to estimate a standard percentage of guarantees to be called in the future. This will then be used to apply the standardized guarantees methodology for future years and new/ongoing standardized guarantee schemes. CYSTAT agreed with the suggested approach.

Findings and conclusions

- It was agreed that for those standardized guarantee schemes which are closing, expenditure will be recorded at time of call.

Action Point 9: CYSTAT will identify standardized guarantee schemes which will continue in the future and will develop a calculation approach for these schemes according to the MGDD. CYSTAT will send a report to ESTAT on this issue by end Jan 2015.

4.3.9 Debt assumptions, debt cancellations and debt write-offs

Eurostat enquired about any recent cases of debt assumptions, debt cancellations and debt write-offs. CYSTAT confirmed that the only case was a case of a debt assumption, already discussed under section 3.1 above (KA Finanz).

4.3.10 Capital injections in public corporations

Eurostat enquired about any recent capital injections into public corporations. CYSTAT replied that the only recent case was Cyprus Airways, which is recorded as a capital transfer. The issue of the recapitalization of the Central Cooperative Bank is treated in section 4.3.1 above.

4.3.11 Dividends, super dividends

Eurostat enquired if CYSTAT performs regularly the super dividend test. CYSTAT confirmed that the test is performed always and any identified cases are treated according to the methodology.

4.3.12 PPPs and concessions

Eurostat enquired about the list of PPP contracts. CYSTAT noted that one of these contracts (the Agia Napa Marina, previously appearing in the list) is now cancelled as the private investor has no funds. CYSTAT confirmed that also the Moni desalination plant has been abandoned as the asset was destroyed by the 2011 naval base explosion. Eurostat took note of the explanations and noted that the list should be updated in the forthcoming notification.

4.3.13 Other: emission trading permits, privatization, securitisation

Eurostat enquired about the treatment of emission trading permits. CYSTAT replied that the revenue amounts involved are negligible; therefore they are currently not recorded. However, CYSTAT monitors the situation continuously and the amounts will be recorded if the amounts become significant.

According to the economic adjustment programme, there are plans to privatize several public entities, inter alia, CyTA (telecoms), EAC (electricity), CPA (commercial activities of ports), as well as real estate and land assets. Eurostat enquired about the developments in these plans for privatization of public corporations. CYSTAT replied that nothing has materialized so far. The privatization unit has been established (it is treated as a general government unit) but it has not yet started any operations and there has been no income from privatizations yet. CYSTAT also confirmed that no securitization operations have taken place during the reporting period.

Eurostat took note of the information and commented that the situation will be checked again upon new developments.

4.4 Exploitation of energy reserves

Introduction

Cyprus has recently signed exploration agreements with international consortia, to search for the existence of natural gas. Cyprus is in the process of drafting a specific law on the resource fund which will manage the hydrocarbon resources. Prior to the mission, CYSTAT confirmed that no specific draft of the law on the resource fund is available yet.

There have been recent announcements in the press by the Cypriot government on developments regarding the gas fields. The government is also in negotiations with a consortium for the construction of a Liquefied Natural Gas (LNG) terminal.

Discussion

Eurostat enquired about the developments regarding gas exploration and exploitation contracts. CYSTAT explained that the Law about the resource fund is still in the planning phase and nothing concrete is known. There are no further concrete developments regarding exploitation contracts. Exploration contracts are treated according to the agreed methodology. The Cypriot statistical authorities enquired about the potential statistical classification of the planned hydrocarbon exploitation partnership. Eurostat will provide advice to the extent that concrete details are known.

Findings and conclusions

Action Point 11: Eurostat will provide advice on the statistical classification of the hydrocarbon exploitation partnership agreement by end Nov 2014⁷.

5. Implementation of ESA 2010

As of the October 2014 EDP notification, Member States should start transmitting EDP notification tables and related questionnaires in line with the ESA 2010 methodology.

Eurostat asked about the progress made regarding the implementation of ESA 2010. The Cypriot statistical authorities explained that implementation of ESA2010 methodology in Cyprus mainly involves the reclassification of a number of public unit into General Government (see the discussion in section 4.1 of this report), treating of military expenditure as gross fixed capital formation (no impact on EDP), and standardized guarantees (discussed under section 4.3.8 above).

Lump sum payments received from pension schemes and the change in the treatment of interest payments under swaps and FRAs are not applicable for Cyprus. Deferred tax assets are also not relevant for Cyprus.

Eurostat took note of the explanations and appreciated the work of the Cypriot statistical authorities on the implementation of ESA 2010.

6. Other issues (*ESA95 Transmission Programme, any other business*)

CYSTAT noted that any specific questions of Eurostat regarding the ESA95 transmission programme will be dealt with through the usual email communications. CYSTAT enquired about the status of the quarterly non-financial accounts table. Eurostat promised to confirm as soon as possible.

Action Point 14: Eurostat will confirm to CYSTAT the modalities for transmission of quarterly non-financial accounts for General Government as soon as possible⁸.

⁷ Eurostat sent a note to CYSTAT in November 2014. The issue will be revisited again by 31 March 2015.

⁸ Action point completed.

Annex. List of participants in the EDP dialogue visit to Cyprus on 24 – 25 September 2014

National Statistical Office (CYSTAT)

Mr Stavros Karagiorgis

Ministry of Finance

Mr George Panteli

Central Bank of Cyprus

Mr Chrisostomos Tsountas

EUROSTAT

Mr John Verrinder

Mr Denis Besnard

Mr Georgios Papadopoulos

ECB

Mr Robert Gadsby

DG ECFIN

Mr Christos Paschalides

Draft agenda of the EDP dialogue visit to Cyprus

24-25 September 2014

1. Statistical organisation issues

1.1 Institutional responsibilities in the framework of the reporting of data under the EDP and government finance statistics compilation

1.1.1 Institutional cooperation and EDP processes

1.1.2 Quality management framework

1.1.3 Audit and internal control arrangements

1.2 New EDP Inventory

2. Review of key data sources

2.1 Public sector accounting and accrual of expenditure/revenue

2.2 Extra-budgetary and semi-government bodies

2.3 Financial accounts

3. EDP reporting – analysis of the draft October 2014 EDP notification

3.1 Examination of the EDP tables

(a) EDP Tables 2A-2D

(b) EDP Tables 3B-3E

3.2 Questionnaire related to EDP Tables

4. Methodological issues and recording of specific government transactions

4.1 Delimitation of general government sector

– Register of government controlled entities not classified to general government

4.2 Implementation of accrual principle

4.2.1 Taxes and social contributions

4.2.2 Interest

4.3 Recording of specific government transactions

4.3.1 Government transactions concerning the Financial Crisis

- Recapitalisation of the Central Cooperative Bank

- LAIKI Bank

- Bank of Cyprus

- Non performing loans

4.3.2 Fiscal-structural reforms

- New National Health System

- Pensions

- Guaranteed minimum income

4.3.3 Sale and lease back operations

4.3.4 Statistical recording of land annexations – follow-up

4.3.5 Cyprus Airlines

4.3.6 CYTA

4.3.7 EU flows

4.3.8 Guarantees

4.3.9 Debt assumptions, debt cancellations and debt write-offs

4.3.10 Capital injections in public corporations

4.3.11 Dividends, super dividends

4.3.12 PPPs and concessions

4.3.13 Other: emission trading permits, privatization, securitisation

4.4 Exploitation of energy reserves

5. Implementation of ESA 2010

5.1. General progress on implementation

5.2. Changes in classification of units under ESA 2010

- Application of ESA2010 rules on Government Control

- Application of ESA2010 rules on the 50% test and qualitative criteria

5.3. Other specific issues

6. Other issues

6.1. ESA95 Transmission Programme (tables 2, 6, 7, 9, 11, 25, 27 and 28)

6.2. Any other business