

REGISTRATION OF THE FINANCIAL NETTING CONTRACT IN INSOLVENCY PROCEEDINGS

UHER MARINA

Uher Expert

uher.marina@yahoo.com

NAGY CRISTINA MIHAELA

”Tibiscus” University of Timișoara, Faculty of Economic Science

cristinanagy2009@yahoo.com

Abstract:

Emerged as a novelty in the Romanian legislation in insolvency proceedings, the financial netting agreement is closely debated as a qualified financial contract between two entities used in order to achieve mutual compensation of rights and obligations.

Key words: *The financial netting contract, insolvency proceedings, mutual compensation, bilateral netting agreement, The accounting record of this mutual compensation*

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Introduction

If in the legal practice field, until the appearance of this type of contract, practitioners in insolvency acted to the unilateral cancellation of their contracts by requiring the termination of the netting agreements, the legal regulations of this contract will hopefully put an end to the intense applications addressed to the courts.

Netting of cash flows or obligations is a means of reducing credit exposure to counterparties¹.

"The main cause of losses and **insolvency** of banks is the difficulty to cope with events that may occur, but have not been foreseen. Risk exposure may cause losses or additional expenses for the bank"².

Interpreted both in law and in fact, these contracts are considered to be valid only for the situation where they bring material benefits and rights to the parties who signed them and, most of the time, they were called for annulment and only compensation rights were performed, obligations have been viewed as debt obligations of creditors with firms in insolvency proceedings.

Results and discussion

The financial netting agreement is a qualified contract and according to the law 85/2014, the netting agreement (bilateral netting agreement) is³:

- a) any master netting agreement - any agreement or clause in a qualified financial contract between two parties, which stipulates a netting of payments or a fulfillment of certain obligations or achievement of present or future rights arising out of or in relation to one or more qualified financial contracts;
- b) any master agreement – master netting - any master netting agreement between two parties, which stipulates the netting between two or more master netting agreements;
- c) any subsequent guarantee agreement or in relation to one or more master netting

¹ <http://www.riskglossary.com/>

² Haranguș, Daniela (2014). Banking Risks in the Romanian Banking System, in Annals of Tibiscus University of Timisoara , Economic Science Series. Timisoara , Vol. XX / 2014, pp. 150 – 155

³ Law 85/2014, article 5, pt. 1 and Law 85/2006, article 3, pt. 34

agreements;

Any netting agreement entails the settlement of several bilateral netting transactions in relation to one or more qualified financial contracts, of one or more of the following transactions⁴:

a) termination of a qualified financial contract and/or acceleration of any payment or performance of an obligation or achievements of a right under one or more qualified financial contracts having as a basis a bilateral netting agreement (netting);

b) calculate or estimate the value of compensation, the market value, the liquidation value or the replacement value of any of the obligations or rights referred to in subparagraph a);

c) conversion into one currency of any values, calculated according to subparagraph b);

d) compensation, up to a net amount (off-set), of any values calculated according to subparagraph b) and converted according to the provisions of subparagraph c);

Payment netting reduces settlement risk: If counterparties are to exchange multiple cash flows during a given day, they can agree to net those cash flows to one payment per currency. Not only does such payment netting reduce settlement risk, it also streamlines processing⁵.

The closing of a netting agreement implies that the only obligation deriving from such qualified financial contracts is to provide a net obligation for an amount of payment or obligation to perform, resulted from the netting agreement, the only right of the other party as being to receive appropriate rights accompanied by the obligation to do what results from this type of contract.

If the debtor is part of a contract included in a master netting agreement, stipulating the transfer of certain goods, securities or financial assets representing the goods listed on a regulated market of goods, services and derivatives, at a certain date or in a period of time, and the term occurs or the period expires after the opening of the procedure, a bilateral netting transaction of all the contracts covered by the master netting agreement in question will be performed, and the resulting balance will be paid to the debtor's property, whether it is credit, and will be included in the debt if it is an obligation of the debtor's property⁶.

The novelty comes with the arrival of law 85/2014, since until the occurrence of the law regarding financial netting agreements, any interested creditor could have denounced the mutual compensation; this could have been achieved during insolvency proceedings, only with the consent of the creditors and the bankruptcy judge.

In many cases, in the judicial practice, how compensation of mutual obligations is made was subject to the rule for the period when it was performed, if it was conducted over a period of time before entering the debtor's insolvency procedure, so it could be considered an act for the benefit of certain creditors, if it was done during insolvency proceedings, so it had to be subjected to the approval of the court.

In terms of registering it into the account records, it is subject to registration upon signature by all the interested parties, recorded in the same way as any regular compensation reports.

The accounting record of this mutual compensation of obligations to do so and, therefore, to receive is quantified through the amounts paid or received by the parties; the accounting results and the tax implications of the recording vary from case to case.

The mutual compensation transactions in the accounting practice have generated three types of accounting records, namely:

a) direct recording to cancel the obligation to pay alongside the existing debt collection

⁴ Law 85/2014, article 5, pt. 40 and Law 85/2006, article 3, pt. 33

⁵ <http://www.riskglossary.com/>

⁶ Law 85/2014, article 125

as follows:

401. analytic (Suppliers) = 4111.analytic (Customers)

b) a brokerage account available as receipts and payments concerned:

5121.. (4) Available at the bank = 4111. analytic (Customers)

in parallel with that provider payment transaction:

401. analytic (Suppliers) = 5121. (4) Available at the bank

c) use of another intermediate account, namely 581, Internal transfers as follows:

581 (Internal transfers) = 4111.analytic (Customers)

in parallel with that provider payment transaction:

401. analytic (Suppliers) = 581 (Internal transfers)

We believe that direct recording for the cancellation of mutual obligations is more accurate than using the available accounts or internal transfers as it distorts the values of the amounts received in cash or through bank accounts and do not reflect the correct view of the transaction.

Accounts of bilateral netting transactions has tax implications in determining the value added tax and income tax in some cases depending on the entity's fiscal vector carrying out the transaction.

Given that the bilateral netting is performed by an entity that applies the VAT on receipt, or by both entities, compensation will automatically generate the ability to pay and deduct the VAT relating to those transactions by both parties involved in the transactions performed.

If compensation is performed with a taxpayer that carries out single entry accounting, this collection will automatically generate receipts through the record of receipts and payments, which are assimilated with the collected revenue, generating payment obligations with respect to taxes and fees due to the government, in the present state, the tax income from commercial transactions.

Accounting and tax implications of these types of contracts must be recorded in the accounts, although from the accounting practice comes the situation that insolvency practitioners do not carry out single entry accounting in the simplified procedure of bankruptcy, and, sometimes, not even in the general procedure of insolvency.

If the Romanian economic legislation regulates the netting reports, but also the amounts to which they are to be performed between economic agents, the qualified financial netting agreement widens the application of the compensation limit, with the possibility of being completed with companies from other countries than Romania.

Using this type of qualified financial agreements allows for flexibility in performing economic transactions, but also the ease in annulling, by agreement, the mutual obligations arising from these contracts.

The recording of the mutual obligations arising from these contracts often requires the signing of a financial contract and the accelerating of any payment absolutely necessary for the exit from the insolvency the debtor is facing, payments requiring the accelerating in the performing of the production cycle to relieve the financial situation and payments to creditors, by means of maximizing the assets in insolvency.

One of the advantages of the financial netting agreement is that it is converted into a single currency, which allows bilateral clearing of mutual obligations in a particular currency established by mutual agreement, without requiring the conversion into a national currency, which would involve exchange rate differences.

Also, under this contract, a net amount agreed by both parties can be achieved, a value that these entities record in the accounts as agreed.

The recording of the financial netting agreement will generate positive economic effects on the balance sheet items that will reduce the total debt of the entity in the short term, and will accelerate the collection of the rights arising from the contract within a shorter period than the term granted by the entity.

Although it seems to be used in preference when the entity is in the observation period and also during the year in which the debtor is in the general insolvency procedure, its scope can be extended for the period in which the debtor is during the simplified procedure of insolvency, when it comes to capitalizing assets, in order to maximize the existing assets, in order to satisfy the existing creditors on the debt record, which is permanently consolidated.

Establishing a net value on the existing assets by means of a qualified financial netting agreement, in some situations, can make the creditors content in the proceedings, because it accelerates the collection of rights and also speeds up payment to creditors.

From the current accounting practice, this type of contract is used for compensations made with partners outside the country, for which the compensation practice of some mutual obligations is frequent; the bilateral clearing of debts is achieved by their mere agreement, by not being involved in the establishment process of compensatory rules.

Although for these contracts there is a certain freedom of decision and regulation, however, the National Bank of Romania, through the law no. 26/2006, binds Romanian entities to undertake statistical reporting of data for balance of payments, until the occurrence of a change in this law, by means of the law 12/2009, where the reporting ceiling was 50,000 euros, at the date of the present, it is worth 12,500 euros.

The submission of this information is mandatory for entities that conclude these bilateral netting agreements.

Conclusions

From the present accounting practice, the use of these types of contracts is done by multinational companies to accelerate the cancellation of mutual rights and obligations, and their use for companies entered in the insolvency procedure is extremely rare, because the Romanian legislation is limited on netting payments, by offsetting the maximum allowable amount of 10,000 lei at the signing of a single netting transaction.

Legislation on debt netting application for firms bear additional costs for the entities involved, longer recording and annulment periods, periods that can be detrimental to all entities participating in the netting process.

Closing a financial netting agreement reduces the costs for the entities involved in compensation, cuts the clearing times and speeds up the production process. Moreover, we believe that the application of financial netting agreements should be accomplished through state-owned companies, which, at present, are obstructing the national economy, because they do not pay the amount to the entities that provided them with services or delivered goods.

Even if a full cancellation of these liabilities is not possible, the Romanian government has the obligation to perform such obligations arising from these tax claims in order not to obstruct, in terms of financial aspects, the business of the entity.

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