Decision of Eurostat on deficit and debt

Recording of military equipment expenditure

Decision

Context

In the context of the Excessive Deficit Procedure monitoring, and following bilateral consultations with Member States, Eurostat has observed cases of complex contracts for military equipment that led to uncertainties as to the exact rule of recording in national accounts (ESA 95), to heterogeneous accounting practices across Europe, and to significant difficulties in terms of availability of ESA 95-compliant source data. A specific task force with experts from European countries worked on the issues in 2004 and 2005, which led to the preparation of this Eurostat decision.

The decision specifies the time of recording of government expenditure, and thus the impact on the government deficit, for borderline cases of military equipment under long-term contracts, notably in cases of leased equipment, of complex systems, or of heavy equipment built over many years. In addition, recognising that long-term contracts and the nature of the military goods involved create specific source data difficulties, the decision also specifies the source data that might be used by Member States when compiling the government deficit (EDP B.9), in the absence of accrual based accounting data or other information on deliveries.

Applicable ESA 1995 rules

In national accounts (ESA 95), military equipment, more precisely defined for the purpose of this decision as “military weapons of destruction and the equipment needed to deliver them”, are not considered as assets, by convention, despite seemingly having the required features (ESA 95 par. 3.70e). Therefore, military equipment do not enter the balance sheet of the acquiring government. They are immediately entered as government intermediate consumption at the time they are acquired, instead of as gross fixed capital formation.

Separately, ESA 95 records flows on an accrual basis, that is when economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed or are cancelled (ESA 95 par. 1.57), irrespective of the time of cash payments. Cash payments enter the financial accounts, in general as acquisition of receivables or redemption of payables (ESA 95 par. 5.124).

For intermediate consumption, the accrual time of recording is at the time of consumption (ESA 95 par. 3.72), conventionally determined to be, for military equipment, at time of delivery.

“Delivery” must however be defined for some types of contracts taking into account the specific nature of military equipment. In addition, lack of direct source data may require that the data according to the time of delivery is calculated.

Definition of delivery for some borderline cases of long-term contracts

Leases

The issue

Some manufacturers of military equipment have arranged for contracts that organise leases of the equipment supplied. The question is whether such leases should be considered in national accounts as financial leases or as operational leases.

Methodological analysis

The classification of leases between financial leases or operating leases rests on the transfer of risk (ESA 95 Annex II par. 4). Eurostat considers that, by their nature, risks associated with military equipment lie with the military authorities, the sole competent bodies to decide if and when to use this equipment during conflicts, knowingly exposing the equipment to potential damage.

The classification in national accounts of such leases as financial leases is not determined by the legal terms included in the contract. Lessees' liabilities under financial leases are classified as loans in national accounts, a component of government debt (when the lessee is government) (ESA 95 par. 5.81g).

Decision

Eurostat has decided that leases of military equipment organised by the private sector should be considered as financial leases and not as operating leases, which supposes recording an acquisition of equipment by the government lessee and an incurrence of a government liability to the lessor. Thus there is an impact on government deficit and debt at the time when the equipment is put at the disposal of military authorities, and not at the time of payments on the lease. Those payments are then assimilated as debt servicing, with a part recorded as interest and the remainder as financial transaction.

Long-term contracts

The issue

Military equipment contracts often involve deliveries of a number of the same or similar pieces of equipment, such as aircraft or armoured vehicles, to be delivered gradually over many years and including significant service components, such as training. In the case of complex systems, it is frequently the case that some completion tasks need to be performed for the equipment to be fully operational. The issue is to determine when the government expenditure should arise: gradually over time or at the end of the contract.

Methodological analysis

Deliveries in parts or associated with services should be dealt with in such a way that partial deliveries are accounted gradually as government expenditure. Standard analytical accounting techniques allow for apportioning the expenditure in relation to the goods and services delivered. This implies that the moment of impact on the deficit is not at the completion of the contract, or at the time of payment, but gradually over time. This might be seen as a clarification rather than an interpretation of the texts.

Therefore, in cases of long-term contracts where deliveries of identical items are staged over a long period of time or where payments cover the provision of both goods and services, government expenditure should be recorded at the time of actual delivery of each independent part of the equipment or of provision of service.

In the case of complex systems, it is frequently the case that some completion tasks need to be performed for the equipment to be operational at full potential capacity. These completion tasks would often be under the full responsibility of the authorities/military forces and no longer under the responsibility of the suppliers, who are assumed to have fulfilled their contractual obligations. Some military programmes are based on the combination of several kinds of equipment that may be completed in different periods so that the expenditure may be spread over several fiscal years before the system, globally considered, becomes fully operational. In such cases, whereas the system considered as a whole gains in value when fully operational, individual pieces delivered often have some operational capacity.

Decision

Eurostat has decided that in the case of long-term contracts involving complex systems, government expenditure should be recorded at the time of delivery of individual and operational pieces of equipment that compose the system, and generally not at the time of completion of the contract.

Military equipment built over many years

The issue

A specific type of military contract concerns heavy equipment that takes many years to be built, such as large ships or submarines. The issue is to determine when the government expenditure should arise: gradually over time or at the end of the contract, i.e. at the time of actual physical delivery.

Methodological analysis

The time of actual physical delivery is generally particularly relevant for goods that are considered as intermediate consumption, for which the time of recording is when the goods enter the production process, i.e. when consumed (ESA 95 par. 3.72). Intermediate goods need to have been delivered first, in order to be consumed. Hence, intermediate goods are to be recorded as a use in national accounts at time of delivery, at which point they are

inventoried pending “consumption” (ESA 95 par. 3.120 and 3.121). Military expenditure only differs from other intermediate goods expenditure in that the former are not inventoried upon delivery but, instead, are deemed to be directly consumed.

Another option would be to record government expenditure at the time of transfer of ownership, which is often staged during the building process, because it could be argued that the transfer of ownership creates the obligation for government to pay the constructor, creating therefore a government liability. ESA 95 par. 3.59 already foresees that when a contract of sale is agreed in advance for the construction of a building or other structure extending over several accounting periods, the output produced in each period is treated as being sold to the purchaser at the end of each period. This view was however not retained, because it was deemed that there was insufficient grounds to deviate from the delivery principle for recording intermediate goods.

Thus any payments made by government during the contract, notably those staged to fit with legal transfers of ownership, are to be considered as prepayments on delivery of a product, and enter the financial accounts as acquisition of receivables by government (ESA 95 par. 5.124). By the same token, any obligation to pay arising from the gradual transfer of legal ownership does not give rise to a liability of government in national accounts, and actual payments to settle those obligations are treated as acquisition of receivables by government, and not as a redemption of a liability. A government liability will arise only at time of actual physical delivery, for the amount that exceeds prepayments made to date.

In the case of multi-suppliers, unfinished goods are certainly “delivered” from one supplier to the next supplier. Each delivery gives rise to an entry in the accounts of the new supplier, but not in the books of government, pending actual physical delivery.

Decision

Eurostat has decided that in the case of military equipment built over many years, the time of government expenditure and thus the impact on government deficit is at the time of the actual physical delivery of the final product and not at the time of transfer of ownership, which is often staged during the building process.

Appropriate source data

Background

Eurostat has observed that most countries follow so far, for military equipment expenditure, pure cash recording, or cash-based information with limited adjustments. Eurostat recalls that Member States are obliged to report national accounts data (ESA 95) and the government finance statistics that derive from them, such as government expenditure and government deficit, on an accrual basis. Recognising the variety of source data used to compile national accounts, not always based on accrual based accounting, it is accepted practice that statisticians use proxies to derive the reported statistics. Thus, it is not uncommon that cash information is used, notably after being assessed by national institutes to be close to deliveries.

However, in the context of military equipment expenditure under long-term contracts, the long time lag between cash payments and deliveries, the potentially large amounts in question, the difficulties in interpreting complex contracts and in accessing information on deliveries from the relevant government departments, create a particular situation where cash based information cannot be deemed to generally provide a satisfactory proxy.

Eurostat encourages governments to speed the implementation of accrual based accounting systems in public accounts and in budgeting, a more long-term objective, and, in the meanwhile, to improve coordination between various government departments to provide statisticians with access to the required information at the aggregate level.

Decision

Therefore, and pending further improvements in accounting and statistical systems, Eurostat takes the view that it is acceptable practice, as an interim solution, that government expenditure be recorded on a cash basis, or derived from cash based information, when:

- the cash data are corrected with observed and accurate data on receivables and payables associated with the contracts in question; or
- the cash data are used for small deliveries only, or are corrected for large deliveries; or
- the time of payment is close to delivery (within one year of the time of delivery).

The rules set out above on the appropriate source data aim to provide a reasonable benchmark for Eurostat when assessing the quality of Member States' government finance statistics, notably in the context of the Excessive Deficit Procedure reporting.

Transitional arrangements

This Eurostat decision is immediately applicable, and will apply in particular for the 1 April 2006 Excessive Deficit Procedure notification, in relation to the years of notification: 2002 to 2005 (actual data) and 2006 (planned data). Some revisions in the data, on government deficit mostly, may occur due to the coming into compliance of Member States with the rules above.

However, concerning the acceptable source data, while Member States are encouraged to revise their data using appropriate source information, Member States might choose not to change methods when reporting the years 2002-2004, but not when reporting 2005 onwards, in the case of contracts involving only prepayments. Where a Member State chooses this option, and in order to avoid counting government expenditure twice, delivered equipment from 2005 onwards is to be recorded on a delivery, or proxy, basis for an amount proportionately reduced for the prepayments already recorded as government expenditure in previous years.

1. The PDF version of the ESA 95 Manual on government deficit and debt is available for free download from the Eurostat Website. ESA 95 Manual