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news release

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New decision of Eurostat on deficit and debt

Recording of military equipment expenditure

Eurostat, the Statistical Office of the European Communities, has taken a decision on the recording, in national accounts, of some borderline cases of military equipment expenditure under long-term contracts, and on acceptable source data to be used for compiling these statistics.

The case

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 appropriate recording in national accounts (ESA 95), to heterogeneous accounting practices across Member States, and to significant difficulties in terms of source data availability.

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, complex systems or heavy equipment built over many years. In addition, because long-term contracts and the nature of the military goods create specific source data difficulties, the decision also specifies those cases where cash source data could be acceptable as proxies for deliveries for military equipment expenditure, pending improvement of accrual based source data.

Leases of military equipment

Some manufacturers of military equipment have arranged for contracts that organise leases of the equipment supplied. The classification of leases between financial leases or operating leases rests on the transfer of risk. Eurostat considers that, by their nature, the risks associated with military equipment lie with the military authorities, who are the sole competent bodies to decide if and when to use this equipment during conflicts, knowingly exposing the equipment to potential damage.

Eurostat has decided that leases of military equipment organised by the private sector should be considered as financial leases, and not as operating leases. This supposes recording an acquisition of equipment by the government and the incurrence of a government liability to the lessor. Thus there is an impact on government deficit and debt at the time that the equipment is put at the disposal of the 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 a financial transaction.

Long-term contracts

Military equipment contracts often involve the gradual delivery over many years of a number of the same or similar pieces of equipment, such as aircraft or armoured vehicles, or including significant service components, such as training. Moreover, 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. 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 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 the actual delivery of each independent part of the equipment, or of the provision of service.

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.

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 actual physical delivery of the final product and not at the time of transfer of ownership, which is often staged during the building process.

Source data

Eurostat has observed that most countries use for military equipment expenditure pure cash recording or cash-based information with some limited adjustments. Eurostat recalls that Member States have 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.

Pending further improvements in the accounting and statistical systems, Eurostat takes the view that it is an acceptable practice, as an interim solution and pending improvement of accrual based source data, that government military equipment 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).

This decision is in line with the European System of Accounts (ESA 95) and is consistent with the opinion of the Committee on Monetary, Financial and Balance of Payments statistics (CMFB) as described in annex.

Transitional arrangements

The rules set out above 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. They are of application for the next notification exercise, to take place before 1 April 2006, in relation to the years included in the notification. Some revisions to the data, on government deficit mostly, may occur due to the application by Member States of the rules above.

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

Eurostat is releasing on its web site the text of this decision (see Activities/Eurostat news). Moreover, Eurostat will include in the ESA 95 Manual on Government Deficit and Debt a chapter further explaining the above-mentioned treatment.

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CMFB

COMMITTEE ON MONETARY, FINANCIAL AND BALANCE
OF PAYMENTS STATISTICS

CMFB opinion

concerning the treatment of military equipment expenditure in national accounts

1. On Eurostat's request the CMFB Chairman, with the assistance of the CMFB Executive Body, asked the CMFB Members to state their opinion on the treatment in national accounts of government military expenditure. Twenty-two (22) national statistical institutes and twenty-three (23) national central banks from the EU Member States returned the questionnaire. A total of forty-five (45) national institutions responded to the questionnaire. The ECB also provided its opinion.
2. In the following, military equipment will mean military weapons of destruction and the equipment needed to deliver them.

The CMFB recalls that government expenditure must be recorded on an accrual basis according to ESA 1995. Military equipment must therefore be recorded at the time of delivery, irrespective of the cash payments. "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.

3. The results of the consultation were as follows:
 - 3.1 Based on a very large majority of the replies received, the CMFB considers that leased military equipment should be treated as a financial lease in the European System of Accounts (ESA 1995).
 - 3.2 Based on a very large majority of the replies received, the CMFB considers that the time of recording of military equipment expenditure should follow the actual delivery of the independent parts of that equipment on the one hand, and the provision of services on the other hand in the following cases:
 - where deliveries of identical items are staged over a long period of time
 - where payments comprise provision of both goods and services

A majority is of the opinion that the same rules should apply in the case of complex systems, where final completion may take time.

- 3.3 A majority is of the opinion that, for military equipment produced over many years (e.g. aircraft carrier), the time of recording should be the time of the actual physical delivery of the final product.
- 3.4 Based on a very large majority of the replies received, the CMFB considers that, in some specific circumstances, cash source data can be acceptable for long-term contracts pending improvement of accrual based source data, provided that any of the three following circumstances apply:

A very large majority is of the opinion that cash source data would be acceptable as proxies of deliveries for military equipment expenditure if these data are corrected for reliable data on payables and receivables.

A large majority is of the opinion that cash source data would be acceptable as proxies of deliveries for military equipment expenditure if cash recording concerns small deliveries only.

A majority is of the opinion that cash source data would be acceptable as proxies of deliveries for military equipment expenditure if these data are corrected for large deliveries.

- 3.5 Taking into account the replies received and the associated comments, there is no majority of the opinion that a time lag of less than one year between the cash payment and the delivery is a sufficient condition for cash source data to be acceptable as proxies for deliveries, unless the cash payment and the delivery take place in the same budgetary year.

4. Further details on these accounting treatments are provided in the background document prepared by the Task Force in support of this CMFB consultation.
5. This opinion has been transmitted to Eurostat and will be kept in the records of the CMFB secretariat.

(Signed)

Bill KEATING
CMFB Chairman

Dublin, 30 January 2006