Working Party of Senior Budget Officials

GAAP-SNA/GFS TREATMENT OF MILITARY ASSETS

Policy Note by Australia

For further information, please contact Jon R. BLONDAL at OECD Headquarters in Paris
Tel: +33 1 45 24 76 59; Fax: +33 1 45 24 85 63; Email: jon.blondal@oecd.org
Mr Jon Blondal
Budgeting and Management Division
OECD
2 rue Andre Pascal
F-75775 Paris Cedex 16
France

Dear Mr Blondal,

SNA Destructive Weapons Paper

This letter is written in response to your invitation to submit an issues paper on the topic of destructive weapons for consideration at the late April meeting of the OECD National Accounts Division. The attached issues paper explores the treatment of destructive weapons under generally accepted accounting principles (GAAP) and SNA/GFS.

In the interests of convergence, we would encourage the movement of accrual basis GFS to capitalising these weapons (while the munitions used by these items would continue to be treated as consumables). On the basis of advice from the Australian Bureau of Statistics we understand that such a movement is only likely to occur if the principles set out in SNA93 change.

Thank you for the invitation to assist with consideration of this issue.

Yours sincerely,

Ian McPhee
General Manager
Financial Management Group
11 April 2003
DESTRUCTIVE WEAPONS

The treatment of destructive weapons is one of the treatment differences between generally accepted accounting principles (GAAP) and SNA/GFS.

Summary of Treatments

Accounting - Destructive weapons are treated as an asset and capitalised on acquisition. Items are then depreciated as consumed (over their useful lives), written off when destroyed (or consumed), and / or recognise a profit or loss on disposal.

SNA/GFS - All destructive weapons are treated as non-productive assets. Acquisition costs are expensed in the year of acquisition, on the basis that these are non-productive items and assuming that consumption takes place in that year. The GFS Balance Sheet therefore excludes destructive weapons with a resultant reduction in GFS net worth.

Accounting treatment

Accounting standards do not differentiate between destructive weapons and other assets. Accounting standards primarily describe assets in terms of two key characteristics (a) control or ownership and (b) the item’s potential to produce future economic benefits, or service potential. The generation of future cash flows (in a commercial context) is not necessary to the concept of service potential. Instead, the ability of an item to contribute to organisational objectives over time is relevant when determining whether service potential exists. The organisational objectives of national armed forces normally include national security roles for destructive weapons in use or ready for use and, to a lesser extent, ceremonial roles.

Destructive weapons are considered to provide benefits over their useful lives and are included in property, plant and equipment. Destructive weapons provide future economic benefits, (which includes ‘service potential’) and thus meet the accounting definition of an asset. In addition to their active or operational use, destructive weapons have an on-going role in deterring armed conflict.

Accountants would distinguish between the delivery device (e.g. weapon, ship, aircraft) and the munitions. The delivery device or platform can be used again and again (indeed some ships and planes have been refitted for use long beyond their initial anticipated lives), but the munitions are a single use item. Consequently, accountants would capitalize the device or platform and amortise its value over its expected life whilst expensing the munitions as a consumable.

IFAC’s IPSAS 17, “Property, Plant and Equipment”, paragraph 3, supports this. It states that: “This standard applies to property, plant and equipment including:

(a) Specialist destructive weapons; and

(b) Infrastructure assets.”

Paragraph 20 also states that:

“Specialist destructive weapons will normally meet the definition of property, plant and equipment and should be recognised as an asset in accordance with the standard.”
IPSAS 17 suggests that destructive weapons be treated as a separate asset class.

The general accounting rules for assets apply to destructive weapons, which means:

- Assets are capitalised at their cost of acquisition as they are purchased.
- Useful lives of the assets are estimated and the asset is depreciated as they are consumed over their useful lives.
- Assets can be revalued to fair value (a market value).
- Assets must be written off as a result of obsolescence, destruction, or other detriment.

In addition to the above, the following explanations have been given in support of the accounting treatment:

1. Classifying weapons as assets provides a more accurate view of the financial position of the entity at a point in time. As these items are used by the entity over more than one reporting period, their value should be charged (as depreciation in the Statement of Finance Performance) over the corresponding periods.

2. Treating defence weapons as assets minimises opportunities for income smoothing (intentionally minimising fluctuation in earnings over a period of time). If the assets are to be expensed in the period of purchase, rather than capitalised, decisions to purchase destructive weapons might primarily occur in “good years”, with deferral of weapons replacements in “bad years”.

3. The current period cost of military operations would be reflected in the financial statements, i.e. the carrying value of assets damaged or destroyed would be recognized as an expense in the period of occurrence. This more closely reflects the timing and consequences of current government decisions.

4. Treatment of defence weapons is by the nature of the item rather than its use. In GFS the distinction between weapons and other assets may be unnecessarily arbitrary. That is to say, treating the police and internal security as a service generator and military or national security as non-productive appears to create artificial distinctions. It may present some governments with opportunities to manipulate financial reports as items could be purchased by the military and loaned to the police forces or vice versa, depending on the bottom line impact desired. We note that many countries have paramilitary forces that are neither police nor military, but with some of the characteristics of each.

**GFS Treatment**

The GFS system records (in keeping with SNA93) acquisitions of destructive weapons and weapon delivery systems as current expenses. Destructive weapons are not treated as capital assets because they are not used repeatedly or continuously in production (although durable, they are viewed as single-use goods). By extension, weapons platforms or delivery systems (warships, submarines, military aircraft, tanks, missile carriers and launchers, etc.) with the function of launching such weapons are treated by convention as having been consumed in the period during which they are acquired.¹

¹ System of National Accounts 1993 paragraphs 10.65 to 10.68 and Government Finance Statistics Manual 2001 paragraphs 6.26, 7.36, and 7.152. We have been told that there was considerable international debate about
Non-weaponry used by the military such as airfields, docks, roads, and hospitals (and the equipment associated with them) are treated as capital assets in SNA93 and the GFS system. These assets are continuously used in production in the same way as similar civilian structures (they are often switched from military use to civilian use and back again). Where it is difficult to distinguish between weapons delivery platforms from other equipment (such as transport equipment, computers and communications equipment), SNA 93 recommends that the whole cost default to immediate consumption.\(^2\)

Where light weapons and armoured vehicles are used for non-military activities, such as police or internal security forces, then SNA93 would treat these as assets.\(^3\) However, where the same light weapons and armoured vehicles are used for national security purposes, they are not capitalised.\(^4\)

__Convergence rationale__

**Accounting Standards**

- It is not possible for accounting to treat one class or category of fixed assets differently to other fixed assets on the basis of use or purpose. If an item meets the definition of an asset, is material in value, and has a useful life extending beyond a single financial period, accrual accounting has long held that that item’s value should be apportioned to the periods during which it is consumed. Accounting treats any destruction as a disposal for no return.

- Consumables, which are expensed in the period acquired, are items that are either for a single use or immaterial in value.

**SNA/GFS**

- The current treatment is inconsistent between different uses of the same asset—the same item used by the military for national security is expensed on acquisition, but capitalized if used by internal security deliverers such as police departments.

- The current treatment can result in inter-period manipulation of results.

- The current treatment is effectively that of a cash-basis framework, although the items in question are used over multiple periods.

- One of the arguments used to support the current treatment is that destructive weapons are non-productive because they are used to destroy lives or property. However, such use is done with the intention of preserving national security. In this context national security is no different to internal security—it is a service to the citizens of the country.

- A further argument for the current treatment may be that there is a much higher risk that destructive weapons will be destroyed than other assets, such that governments are effectively incurring an expense by purchasing these weapons. However, these items are used over multiple periods by governments around the world indicating that this risk of destruction is overstated.

\(^3\) System of National Accounts 1993 paragraph 10.68.
\(^4\) System of National Accounts 1993 paragraph 10.68.
Finally, the current treatment is conceptually inconsistent with accounting principles and standards without an adequate justification of the difference.

**Conclusion**

To achieve convergence between GAAP and SNA/GFS, the treatment of destructive weapons in accrual basis SNA/GFS should be changed to capitalize items that embody service potential, are material in value, and have a multi-year useful life. That is, the SNA/GFS position of relying on “use” to determine the classification should be altered.