

**NORTHERN
CAPE
EDUCATION
DEPARTMENT**

2008

[This policy outlines the identification, treatment, recognition and reporting of Related party transitions in the department according to the requirements of the PFMA]

RELATED PARTY TRANSACTIONS POLICY

GENERAL

Responsibility of the accounting officer [Section 38(1) (a) (i) of the PFMA] and Treasury regulation section 8.1

The accounting officer of an institution must ensure that internal procedures and internal control measures are in place for all payment approval and processing including related party transactions. These internal controls should provide reasonable assurance that all expenditure is necessary, appropriate, paid promptly and is adequately recorded and reported.

Purpose

The purpose of this policy is to:

- Ensure that related party transactions are recorded accurately and completely in the annual financial statements;
- ensuring that employees have a clear and comprehensive understanding of the procedures they must follow to record these;
- ensuring that only valid related party transactions are recorded in the annual financial statements

Related party transactions

Definition

Related party transaction is a transfer of resources or obligations between related parties, regardless of whether a price is charged.

Related party – parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions or if the related party entity and another entity are subject to common control.

Related parties include:

- (a) entities that directly, or indirectly through one or more intermediaries, control or are controlled by the reporting entity;
- (b) associates and joint ventures;
- (c) individuals owning, directly or indirectly, an interest in the reporting entity that gives them significant influence over the entity, and close member of the family of any such individual;
- (d) key management personnel, and close members of the family of key management personnel; and
- (e) entities in which a substantial ownership interest is held, directly or indirectly, by any person described in (c) or (d), or over which such a person is able to exercise significant influence.

Significant influence is the power to participate in the financial and operating policy decision of an entity, but not control those policies.

Control is the power to govern the financial and operating policies of another entity so as to benefit from its activities.

Joint control is the agreed sharing of control over an activity by a binding arrangement.

Key management personnel are:

- (a) all directors or members of a governing body of the entity;
- (b) other persons having the authority and responsibility for planning, directing and controlling the activities of the reporting entity. Where they meet this requirement key management personnel include:
 - (i) where there is a member of the governing body of a whole-of-government entity who has the authority and responsibility for planning, directing and controlling the activities of the reporting entity, that member [e.g. MEC];
 - (ii) any key advisors of that member; and

unless already included in (a), the senior management group of the reporting entity, including the chief executive or permanent head of the reporting entity [e.g. Accounting Officer]

Recognition

Accounting policy

Specific information with regards to related party transactions is included in the disclosure notes.

Notes

Information about related party transactions is required for accountability purposes and to facilitate a better understanding of the financial position and performance of the department. The principle issues in disclosing information about related parties is identifying which parties control or significantly influence the department and determining what information should be disclosed about transactions with those parties.

Disclosure of:

- The types of the related party relationship
- The types of transactions that have occurred
- The elements of the transactions necessary to clarify the significance of these transactions to its operations and sufficient to enable the Annual Financial Statements to provide relevant and reliable information for decision-making and accountability purposes.

The above excludes transfer payments and subsidies, as that is disclosed in the annexures to the Financial Statements.

Procedures

Related party relationships may have an impact on the performance of an entity because:

- the department are subject to the direction of Provincial Legislatures to achieve the policies of the provincial government;
- the department sometimes conduct certain activities necessary for the achievement of its objectives through controlled entities.
- the MEC and Accounting Officer exert significant influence over the operations of the department.

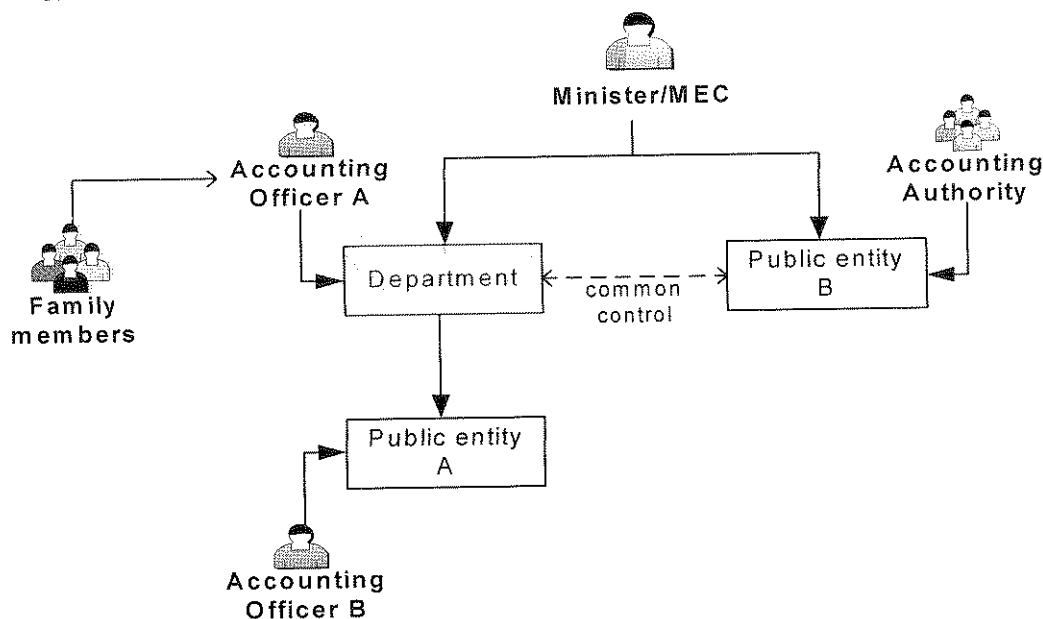
Information about related parties and related party transactions is required for accountability purposes and to facilitate a better understanding of the financial position and performance of the department because:

- related party relationships can influence the way in which an entity operates with other entities in achieving its objectives, and the way in which it co-operates with other entities in achieving common or collective objectives;
- related party relationships might expose an entity to risks or provide opportunities that would not have existed in the absence of the relationship;
- related parties may enter into transactions that unrelated parties would not enter into, or may agree to transactions on different terms and conditions than those that would normally be available to unrelated parties (e.g. sale of goods/services at less than cost).

Refer to Practice Note 4 of 2006/07 issued by the OAG. (Attached as annexure A)

The principle issues in disclosing information about related parties are identifying which parties are controlled or significantly influenced by the department and determining what information should be disclosed about transactions with those parties.

Identifying related parties



EXAMPLE 1: In the illustration above the related parties to the department and public entities are as follows:

Department:

- The MEC – this person is accountable for the way in which a particular policy for which he/she is responsible, has been carried out. He/she has the authority and responsibility for planning, directing and controlling the activities of the department.
- Public entity B – if the MEC can affect the policies of both entities in their mutual dealings then the department and the entity are related parties (i.e. the MEC has control over both the department and public entity B).
- Public entity A – if the department “controls” public entity A or if public entity A is an associate or joint venture of the department then they are related parties.

Ownership control, in relation to an entity, means the ability to exercise any of the following powers to govern the financial and operating policies of the entity in order to obtain benefits from its activities:

- To appoint or remove all, or the majority of, the members of the entity’s board of directors or equivalent governing body;
- to appoint or remove the entity’s chief executive officer;
- to cast all, or the majority of, the votes at meetings of that board of directors or equivalent governing body; or
- to control all, or the majority of, the voting rights at a general meeting of that entity;

In addition to the indicators provided in the above definition, when one or more of the circumstances listed below either individually or collectively can be indicative of the existence of control:

- ✓ the entity has the ability to veto operating and capital budgets of the other entity;
 - ✓ the entity has the ability to veto, overrule, or modify the board of directors or equivalent governing body decisions of the other entity;
 - ✓ the entity has the ability to approve the hiring, reassignment and removal of key personnel of the other entity;
 - ✓ the mandate of the other entity is established and limited by legislation;
 - ✓ the entity holds a “golden share” (or equivalent) in the other entity that confers rights to govern the financial and operating policies of that entity;
 - ✓ the entity holds direct or indirect title to the net assets of the other entity;
 - ✓ the entity has a right to a significant level of the net assets of the other entity in the event of a liquidation or in a distribution other than a liquidation;
 - ✓ the entity is able to direct the other entity to co-operate with it in achieving its objectives;
 - ✓ the entity is exposed to the residual liabilities of the other entity.
- Accounting Officer A – this person is responsible to the MEC to manage the resources of the department and for the overall achievement of the department’s service delivery objectives. He/she also has the authority and responsibility for planning, directing and controlling the activities of the department.
 - Family members of Accounting Officer A – these individuals may influence Accounting Officer A with regard to the dealings of the department.
 - These individuals are only considered when there is a related party relationship between the department and the family members. For example a spouse is a member of the key management personnel of the department or a brother-in-law is the accounting officer of a controlled public entity.

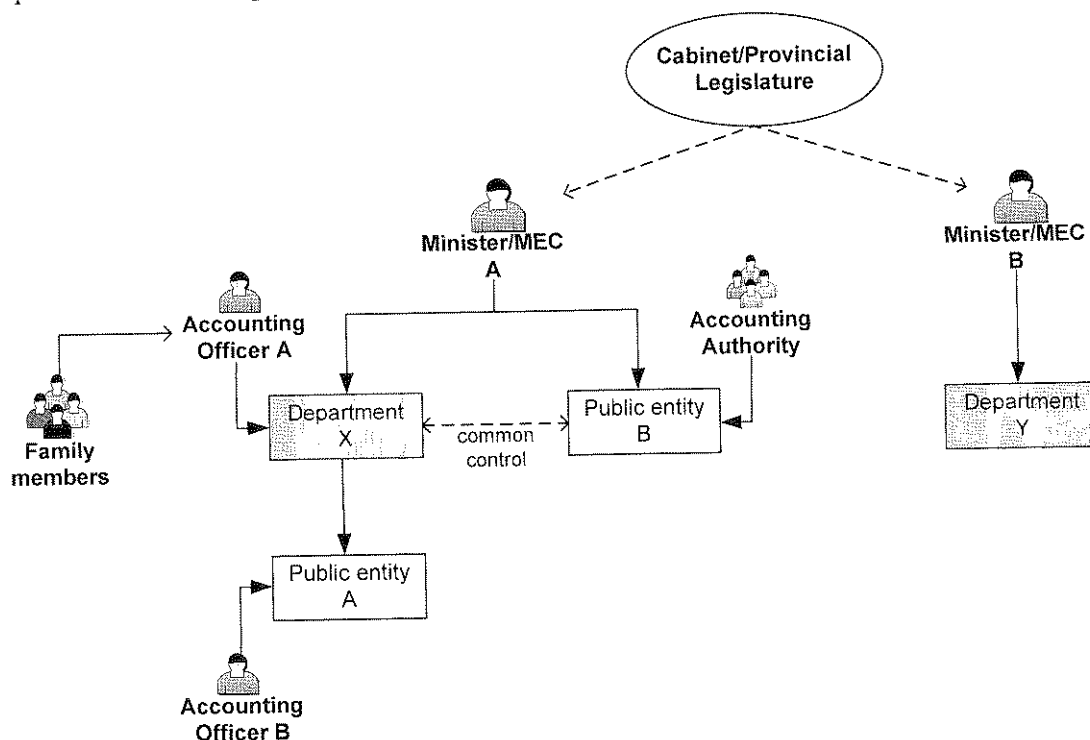
Public entity A:

- The MEC – if this person is able to affect the operating and financial policies (i.e. directly or indirectly controls the entity) then he/she is a related party;
- The Department – if the department controls or has significant influence or joint control over the public entity;
- Accounting Officer B - this person is responsible manage the resources of the entity and for the overall achievement of the entity’s objectives. He/she also has the authority and responsibility for planning, directing and controlling the activities of the department;
- Public Entity B – both public entities are commonly controlled and are therefore related parties;

Public entity B:

- The MEC – He/she has the authority and responsibility for planning, directing and controlling the activities of the department.
- The department – if the MEC can affect the policies of both entities in their mutual dealings then the department and the entity are related parties (i.e. the MEC has control over both the department and public entity B).
- The Accounting Authority – this body is responsible to the MEC to manage the resources of the entity and for the overall achievement of the entity's objectives. This body also has the authority and responsibility for planning, directing and controlling the activities of the department.
- Public Entity A - both public entities are commonly controlled and are therefore related parties;

EXAMPLE 2: Consider the illustration below, is there a related party relationship between Department X and Department Y?



Departments are related parties because they are subject to common control (they operate together to achieve common objectives determined by Provincial Legislature). However, a department in one province is not “related” to another department in a different province. In addition a municipality is not a related party to a department.

All departments and public entities in each province are related parties. Provincial Treasury will provide a list of the related parties in the provincial sphere of government.

Related party disclosures – related party relationships

As a general rule ALL related party relationships should be disclosed irrespective of whether there has been any transactions between the department and the related party. However, for the 2008/09 financial year the following applies:

- (a) the disclosure of the related party relationships of a department shall be limited to the entities falling under the MEC's portfolio (e.g. the National Institute for Higher Education); **but**
- (b) where a department transacts with another party other than those under (a) above and these transactions were not at arms length (see ***Related party disclosures – related party transactions***) then the relationship must be disclosed.

Related party disclosures – related party transactions

As a general rule, a department should disclose all transactions with its related parties other than those undertaken at arm's length (i.e. where the transactions are consistent with a normal supplier or client/recipient relationship and are undertaken on terms and conditions that are normal for such transactions in the circumstances). For example, a provincial department would not need to disclose the total amount paid to Telkom for 2008/09 for its telephone lines and calls unless the department was granted a discount that's not ordinarily available to other entities.

However for the 2008/09 financial year the following applies:

- (a) the department will only disclose those related party transactions that in terms of the above qualify for disclosure, between itself and the public entities falling under its MEC's portfolio. The disclosures exclude transfers & subsidies paid to public entities where these have been included in the annexures to the financial statements. However, the fact that the public entity is a related party should be included in this note; **but**
- (b) where the department transacts with another party other than those under (a) above and these transactions were not at arms length then the relationship and the transaction must be disclosed.

The disclosure of any related party transactions is limited to transactions between the department and another related party and will not include transactions between the related parties of the department.

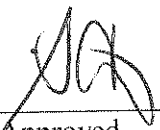
Examples of indications of related party transactions:

- ✓ arrangements where one party expenses on behalf of another party (these costs may or may not be recovered);
- ✓ lease arrangements at more or less than market value or for no consideration;
- ✓ sales without substance (funds are transferred to an entity for goods or services that were never rendered/delivered);
- ✓ services or goods are purchased at nominal or no cost;
- ✓ transactions that have abnormal terms of trade, such as unusual prices, interest rates, guarantees and repayment terms;

- ✓ transactions that lack an apparent logical business reason for their occurrence;
- ✓ transactions in which substance differs from form;
- ✓ transactions processed in an unusual manner;
- ✓ high volume or significant transactions with certain customers or suppliers as compared with others; and
- ✓ unrecorded transactions such as the receipt or provision of management services at no charge.

Additional

- ✓ Related party transactions recorded on the schedule supporting the financial statements should agree to supporting documentation
- ✓ The aforementioned schedule should be reviewed by the Chief Financial Officer for the complete and accurate recording of related party transactions.
- ✓ The schedule drawn up should agree to the disclosure note of the annual financial statements.



Approved
Head of Department

Date 09/06/08

Annexure A

All Accounting Officers

All Accounting Authorities

All Chief Financial Officers

All Heads of Provincial Treasuries

All Provincial Accountants-General

OFFICE OF THE ACCOUNTANT-GENERAL PRACTICE NOTE 4 OF 2006/07

ILLEGAL USE OF RESOURCES BY DEPARTMENTS AND PUBLIC ENTITIES

1. Purpose

The purpose of this practice note is to provide a policy framework for the transfer of funds between a public entity and its parent department.

2. Background

2.1 Departments receive funding through the budget process whereby funds are appropriated by the relevant legislature. The relevant legislature approves such appropriations per vote and per main division/programme within the vote in order for these departments to deliver on their legislative mandates within such appropriations.

2.2 The Adjustment Budget process may be utilised where departments experience the incurrence of unforeseen and unavoidable expenditure during a specific financial year for which additional funds may be required to meet such expenditure.

2.3 Public entities either receive their funds:-

- Through the budgetary process, in which case funds are made available by means of transfers from the votes of their parent departments; or
- By way of a tax, levy or money imposed in terms of legislation; or
- Through the sale of goods or rendering of services.

2.4 These revenue streams are meant for public entities to effectively deliver on their legislative mandates and to exercise functions related to these mandates.

3. Public entities effecting payments on behalf of departments

3.1 Whilst it is incumbent on departments and public entities to spend in accordance with their legal mandate and approved budgets, it has come to light that certain departments are making use of public entities reporting to their executive authority to fund departmental functions (over and above those provided for in budgetary appropriations) and to employ personnel on their behalf, the personnel costs related thereto is met by the public entity.

3.2 By performing departmental functions and employing personnel on their behalf, these public entities are in essence funding departmental programmes for which money was not appropriated and which might have resulted in unauthorised expenditure for the department, which is not permitted in terms of the Public Finance Management Act, 1 of 1999 (PFMA).

3.3 Further, by making use of their funds to perform departmental functions, these public entities are also not spending in accordance with their legal mandate and budgets as approved by their respective executive authorities.

3.4 Such expenditure amounts to irregular expenditure for the public entity as defined in section 1 of the PFMA. The PFMA defines irregular expenditure as being expenditure that is incurred in contravention of or that is not in accordance with a requirement of any applicable legislation.

4. Gifts, donations and sponsorships

4.1 In terms of Treasury Regulation (TR) 21.2.1, only the Accounting Officers may approve the acceptance of gifts, donations and sponsorships to the state, whether such donations are offered in cash or in kind.

4.2 The intention of the aforementioned Treasury Regulation was to make provision for external bodies to grant gifts, donations and sponsorships to departments not accommodated within the budget process and to allow these departments to adhere to requests of the donors in furthering interests of the State. In all instances, gifts, donations and sponsorships received in cash is required to be deposited either into the Reconstruction and Development (RDP) Fund or the relevant Revenue Fund. Money surrendered to the relevant Revenue Fund will be dealt in the normal budget process whereas RDP money will be treated in terms of the RDP Act and established prescripts.

4.3 It has, however come to light that public entities are making donations or granting sponsorships to their parent departments with a view to augmenting the budgets of these departments. In this regard, it must be emphasized that although not legislated or regulated against, it was never intended that public entities make donations or grant sponsorships to their parent departments, whether in cash or in kind, to augment the budget of the respective department.

5. Illegal transfer payments by departments

5.1 In terms of Treasury Regulation 15.10.3.1, departments may not open bank accounts without written approval of the relevant treasury. The Regulation further states that only bank accounts approved after 1 April 2001 shall be considered as being valid.

5.2 Despite the aforementioned Treasury Regulation, it has come to light that departments are still operating bank accounts that have not been approved by the relevant treasury. It would appear that some departments are transferring funds to these unauthorised bank accounts to circumvent the PFMA and Treasury Regulation requirements that unspent funds or money received be deposited into the relevant Revenue Fund.

5.3 In the past few years a trend of excessive spending in the last month of the financial year has been noticeable. This expenditure often relates to transfer payments that are intended to create an impression that actual expenditure has been incurred when in fact no goods and services are received in return. Such payments are sometimes for goods and services receivable in the future which conceals under-spending by a department.

5.4 This arrangement supports TR 15.10.1.2(b) & (c) which discourages the use of funds earlier than necessary and the payment for goods/services in advance.

5.5 These practices do not only constitute bad financial management but also contravene an essential principle in the PFMA that is of transparency.

6. PFMA and Treasury Regulations

6.1 Whilst the relevant legislation does not cover every eventuality, departments, public entities, constitutional institutions and other government institutions should not devise strategies or schemes to circumvent the norms and standards set out in the PFMA and the Treasury Regulations. Such practices are in conflict with the ethos and spirit of the PFMA and are therefore illegal.

7. Policy

7.1 This practice note therefore serves to inform stakeholders that:

- Departments may not request public entities to undertake departmental functions on their behalf nor shall they request public entities to employ personnel on their behalf, the expenses for which are to be met by the public entity;
- Public entities may not grant donations and sponsorships to departments, whether in cash or in kind, to augment the budget of the department;
- Departments may not transfer funds to a bank account that has not been approved by the relevant treasury and only bank accounts approved after 1 April 2001 shall be regarded as valid, as per Treasury Regulation 15.10.3.1; and

- Departments may not transfer funds to another department, public entity, constitutional institution and any other government institution other than as prescribed by Parliament through the Appropriation Act or through the virement process.
- Any irregular expenditure must be dealt with in accordance with the prescripts issued by the National and provincial treasuries.

8. Auditor-General

8.1 This practice note will be brought to the attention of the Auditor-General for inclusion in their audit scope.

8.2 The National Treasury may request the Auditor-General to conduct special investigations on any matter dealt with in this practice note.

9. Effective date

9.1 This practice note applies to all National and Provincial Departments and Public Entities (including Constitutional Institutions) and takes effect immediately.

S F Nomvalo

Accountant-General: National Treasury

Date: 7 September 2006