

NORTHERN
CAPE
EDUCATION
DEPARTMENT

2008

[This policy outlines the identification, recording, disclosure and treatment of lease commitments of the department according to the requirements of the PFMA]

LEASE COMMITMENTS POLICY

1. GENERAL

Section 38(1) (a) (i) of the PFMA stipulates the following:

The accounting officer for a department must ensure that the department has and maintains effective, efficient and transparent systems of financial and risk management and internal control.

Section 9.1.1 of the Treasury Regulations stipulates the following:

The accounting officer of an institution must exercise all reasonable care to prevent and detect unauthorised, irregular, fruitless and wasteful expenditure, and must for this purpose implement effective, efficient and transparent processes of financial and risk management.

LEASE COMMITMENTS

2. DEFINITION

Lease commitments represent amounts owing from the reporting date to the end of the lease contract.

A **lease** is a contract that gives the lessee (the renter) the right to use an asset for an agreed period of time in return for a payment or series of payments.

A **finance lease** is a lease that transfers substantially all risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred.

An **operating lease** is a lease other than a finance lease.

Economic life is the period over which an asset is expected to yield economic benefits or service potential to one or more users.

Useful life is the estimated remaining period, from the beginning of the lease term, without limitation by the lease term, over which the economic benefits or service potential embodied in the asset are expected to be consumed by the entity.

3. PURPOSE

To outline policy and procedures for officials to have an understanding of lease commitments and the accounting treatment thereof.

4. OBJECTIVE

The objectives of the policy include -

- emphasising the accountability of employees for Departmental resources;
- ensuring that employees have a clear and comprehensive understanding of the procedures they must follow for lease commitment transactions;
- ensuring that resources made available to employees are utilised efficiently, effectively, economically and for authorised official purposes; and ensuring that the Department's resources are managed in compliance with the Public Finance Management Act, the Treasury Regulations and other relevant legislation
- ensure that lease transactions is detected, processed and recorded appropriately.

5. RECOGNITION

ACCOUNTING POLICY

5.1 Lease commitments are not recognised in the statement of financial position as a liability or as expenditure in the statement of financial performance but are included in the disclosure notes.

5.2 Operating and finance lease commitments are expensed when the payments are made. Assets acquired in terms of finance lease agreements are disclosed in the annexures and disclosure notes to the financial statements.

6. PROCEDURES

The terms of a lease are such that the department is substantially in the same economic position as it had borrowed money to buy the asset (even though legal title may not pass to the lessee). For example, this may be the case if the lease payments effectively are paying for the whole asset or if the lease term is such that the department can use the asset for the major part of its economic life.

Unfortunately the PFMA prohibits borrowing by Provincial Departments and the Treasury Regulations makes it clear that finance leases are deemed to be borrowings and are therefore not permitted.

Although the department is not permitted to enter into finance leases, all finance leases that they do have should be disclosed as finance leases. It will however mean that the department will not be complying with the Treasury Regulations (TR 13). Finance leases may not (incorrectly) be disclosed as operating leases even when the lease is condoned by the National Treasury.

Practice Note 5 of 2007/08 (as indicated in (a) and (b) below), issued by the OAG seeks to provide the following circumstances where the department may enter into finance leases without additional approval required:

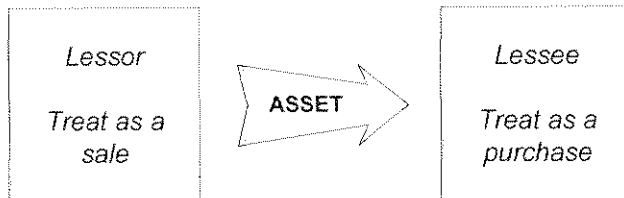
- (a) Finance leases where:
- A Finance lease is more economical than an operating lease; and
 - The period of the finance lease does not exceed 60 months in respect of motor vehicles and 36 months for equipment except with written approval by Treasury; and
 - The finance lease was entered into in terms of RT3 of 2006 or a transversal contract entered into by the National Treasury.
 - For land and buildings, prior approval must have been obtained from the relevant executive authority and treasury. There are no limits to the lease period. authority and treasury.
- (b) Blanket approval for any irregular expenditure incurred as a result of RT3 of 2000 and RT3 of 2003 Transversal contracts entered with various suppliers for the supply, delivery, installation, commissioning and maintenance of office equipment and labour saving devices.

The definition of a lease includes contracts for the hire of an asset, which contain a provision giving the option to acquire title upon the fulfilment of agreed conditions. These contracts are sometimes known as hire purchase contracts.

It is important to note that the payment of a lump sum amount (rather than regular periodic payment such as monthly payments) does not preclude lease accounting; as such arrangements may still meet the definition of a lease.

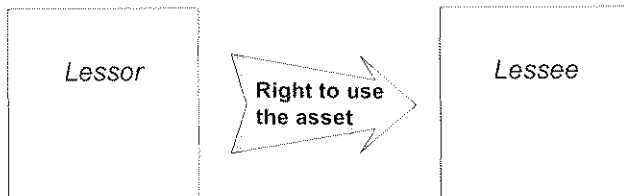
Finance lease vs. Operating lease

FINANCE LEASE



Lease that transfers substantially all the risks and rewards of ownership

OPERATING LEASE



Lease that does not transfer substantially all the risks and rewards of ownership

It is common practice for contracts to be termed rental agreements. This therefore does not mean that this is excluded from being a lease. One still needs to go through the conditions of the contract to determine whether it is a finance lease or an operating lease.

The classification of leases is based on the extent to which risks and rewards incidental to ownership of a leased asset lie with the lessor or the lessee rather than on which party has legal ownership over the asset.

Risks include the possibilities of losses from idle capacity, technological obsolescence or changes in value due to changing economic conditions.

Rewards may be represented by the expectation of service potential or profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.

Although the following are examples of situations, which would normally lead to a lease being classified as a finance lease, a lease does not need to meet all these criteria in order to be classified as a finance lease:

- The lease transfers ownership of the asset to the lessee by the end of the lease term;

- The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable, so that at the inception of the lease it is reasonably certain that the option will be exercised;
- The lease term is for the major part of the economic life of the asset even if title is not transferred;
- At the inception of the lease the present value of the minimum lease payments amounts to at least 90% of the fair value of the asset.
- The minimum lease payments are the payments that the department is, required to make to the lessor over the lease term.

This includes

- Non-cancellable lease payments
- Guaranteed residual value
- Purchase option (if reasonable certainty of exercise)

And excludes:

- Contingent rent
- Cost for services (such as maintenance & insurance)
- Taxes (if paid by and reimbursed to the lessor)

With regard to motor vehicles the value includes the “base” vehicle cost, any accessories, stamp duty and any dealer or delivery charges. VAT, registration costs, insurance, roadside assistance and borrowing costs are excluded.

The interest rate to be used in the calculation of the net present value is the government’s borrowing rate or the rate of the contract.

- The leased assets are of a specialised nature such that only the institution can use the assets without modifications being made;
- The lessor’s losses associated with cancellation of the lease by the lessee is borne by the lessee; or
- The leased assets cannot easily be replaced by another asset.

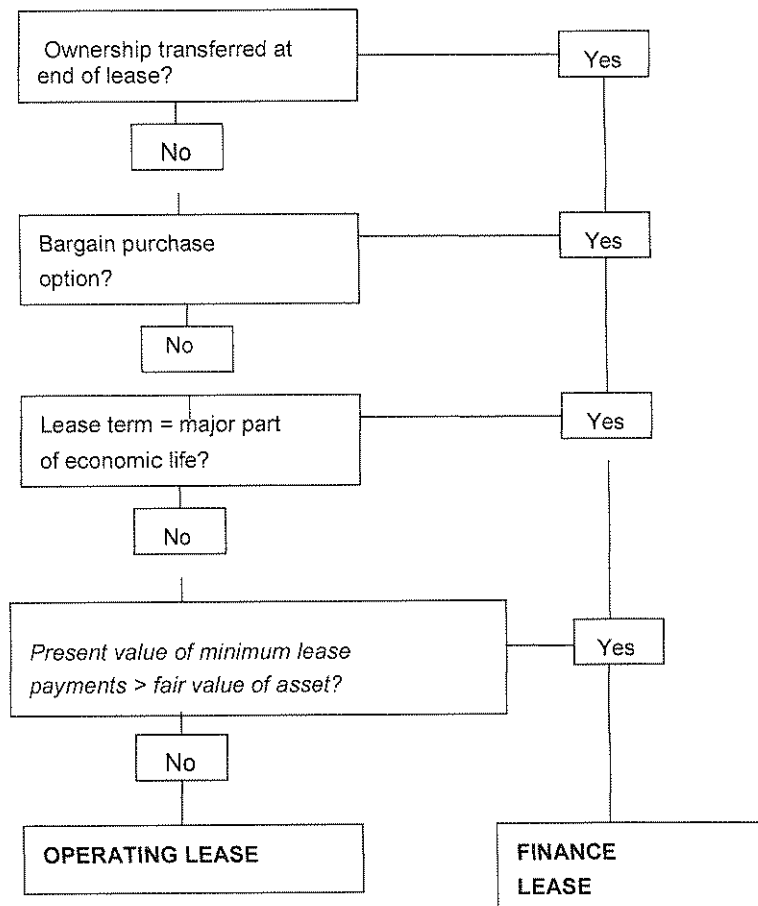
Transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with legal form. While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance lease the substance and financial reality are that the lessee acquires the economic benefits or service potential of the use of the leased asset for the obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

Leases of land and building are classified as operating or finance leases in the same way as leases of other assets. However, a characteristic of land is that it normally has an indefinite economic life and, if title is not expected to pass to the lessee by the end of the lease term, the lessee does not receive substantially the entire risks and rewards incident to ownership.

Buildings have a finite useful life and therefore may be the subject of either a finance lease or an operating lease. Because land normally has an indefinite economic life, a lease of land usually will be classified as an operating lease if title does not pass to the lessee by the end of the lease and if the benefit of the residual value is not passed to the lessee by other means.

If it is not possible to separate the agreement between land and the buildings, then the entire lease is classified as a finance lease unless it is clear that both elements qualify as operating leases.

Classification of a lease agreement



Finance Leases

The finance lease liability is disclosed in the disclosure notes with a split between amounts payable:

- within 12 months after the reporting date;
- 1 year after the reporting date but not later than 5 years;
- later than 5 years.

This information can be obtained from the amortisation schedules supplied with the lease agreement or calculated from the information within the lease agreement.

7. EXAMPLE

Lease of a photo copier assuming that the lease is a finance lease

The lease term is for 36 months starting 1 April 2006. The contract requires payments of R334.22 to be paid at the beginning of each month. The photo copier's market value is R10, 500. Assume that the interest rate implicit in the lease agreement is 6 %. The net present value is R11, 041.

Calculation of the net present value:

Pmt = 334.22 (payment per month)

i = 6% / 12 (interest rate per month)

n = 36 (number of lease instalments over the period of the lease)

Therefore the net present value = R11, 041

The amortisation schedule is shown below:

Date	Payment	Interest	Capital	Balance	2006/07	2007/08	2008/09
				11,041.08			
1/4/2006 1	334.22		(334.22)	10,706.86	Y1 Expenditure for the 2006/07 financial year		
1/5/2006 2	334.22	53.53	(280.69)	10,426.18			
1/6/2006 3	334.22	52.13	(282.09)	10,144.09			
1/7/2006 4	334.22	50.72	(283.50)	9,860.59			
1/8/2006 5	334.22	49.30	(284.92)	9,575.67			
1/9/2006 6	334.22	47.88	(286.34)	9,289.33			
1/10/2006 7	334.22	46.45	(287.77)	9,001.56			
1/11/2006 8	334.22	45.01	(289.21)	8,712.34			
1/12/2006 9	334.22	43.56	(290.66)	8,421.68			
1/1/2007 10	334.22	42.11	(292.11)	8,129.57			
1/2/2007 11	334.22	40.65	(293.57)	7,836.00	Y2 "Not later than 1 year" Expenditure for the 2007/08 financial year		
1/3/2007 12	334.22	39.18	(295.04)	7,540.96			
1/4/2007 13	334.22	37.70	(296.52)	7,244.45			
1/5/2007 14	334.22	36.22	(298.00)	6,946.45			
1/6/2007 15	334.22	34.73	(299.49)	6,646.96			
1/7/2007 16	334.22	33.23	(300.99)	6,345.98			
1/8/2007 17	334.22	31.73	(302.49)	6,043.49			
1/9/2007 18	334.22	30.22	(304.00)	5,739.48			
1/10/2007 19	334.22	28.70	(305.52)	5,433.96			
1/11/2007 20	334.22	27.17	(307.05)	5,126.91			
1/12/2007 21	334.22	25.63	(308.59)	4,818.32	Y3 "Later than 1 year and not later than 5 years" "Not later than 1 year" Expenditure for the 2008/09 financial year		
1/1/2008 22	334.22	24.09	(310.13)	4,508.20			
1/2/2008 23	334.22	22.54	(311.68)	4,196.52			
1/3/2008 24	334.22	20.98	(313.24)	3,883.28			
1/4/2008 25	334.22	19.42	(314.80)	3,568.48			
1/5/2008 26	334.22	17.84	(316.38)	3,252.10			
1/6/2008 27	334.22	16.26	(317.96)	2,934.14			
1/7/2008 28	334.22	14.67	(319.55)	2,614.59			
1/8/2008 29	334.22	13.07	(321.15)	2,293.44			
1/9/2008 30	334.22	11.47	(322.75)	1,970.69			
1/10/2008 31	334.22	9.85	(324.37)	1,646.32			
1/11/2008 32	334.22	8.23	(325.99)	1,320.33			
1/12/2008 33	334.22	6.60	(327.62)	992.72			
1/1/2009 34	334.22	4.96	(329.26)	663.46			
1/2/2009 35	334.22	3.32	(330.90)	332.56			
1/3/2009 36	334.22	1.66	(332.56)	(0.00)			

It is not a requirement for the 2008/09 financial year to include leased assets in the asset register of the department.

Operating Leases

All lease payments are expensed as and when the payment is made in terms of the lease agreement. The note disclosure is similar to the above example.

Statement of Financial Performance

Lease payments are expensed when payment is made for both finance and operating leases.

Statement of Financial Position

No entry is made to the statement of financial position since the transaction is recognised on the cash basis of accounting.

8. LEGISLATION

TR 13.2.2	A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.
TR 13.2.4	The accounting officer of an institution may, for the purposes of conducting the institution's business, enter into a lease transaction without any limitations provided that such transactions are limited to operating lease transactions.
TR 13.2.5	With the exception of agreements concluded in terms of Treasury Regulation 16, the accounting officer of an institution may not enter into finance lease transactions.

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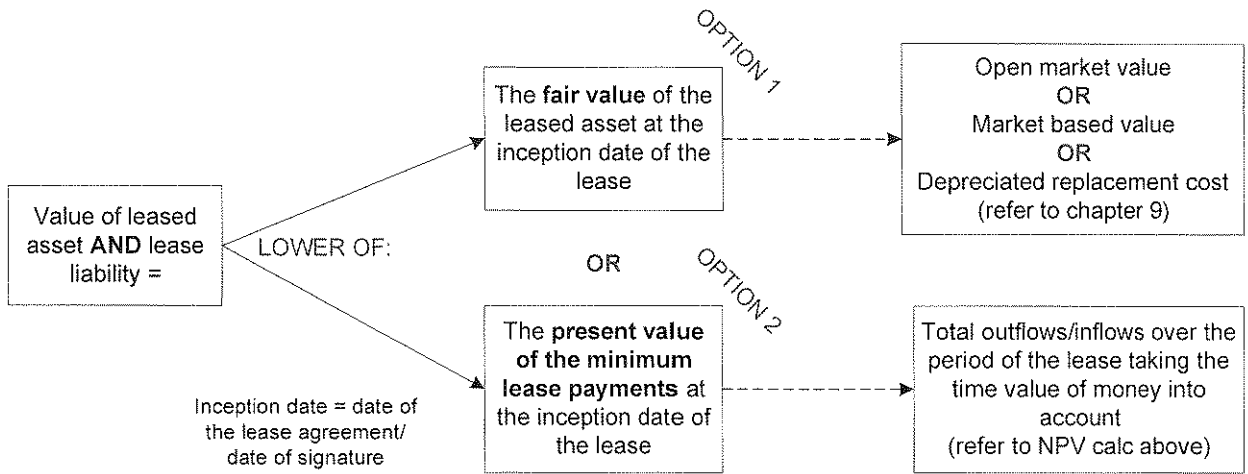
LEASE REGISTER

NORTHERN CAPE EDUCATION DEPARTMENT

Asset description	Contract number	Asset number	Asset location	Contract start date	Contract end date	Lease installments (value)	Interest rate	Lease term	Value of asset

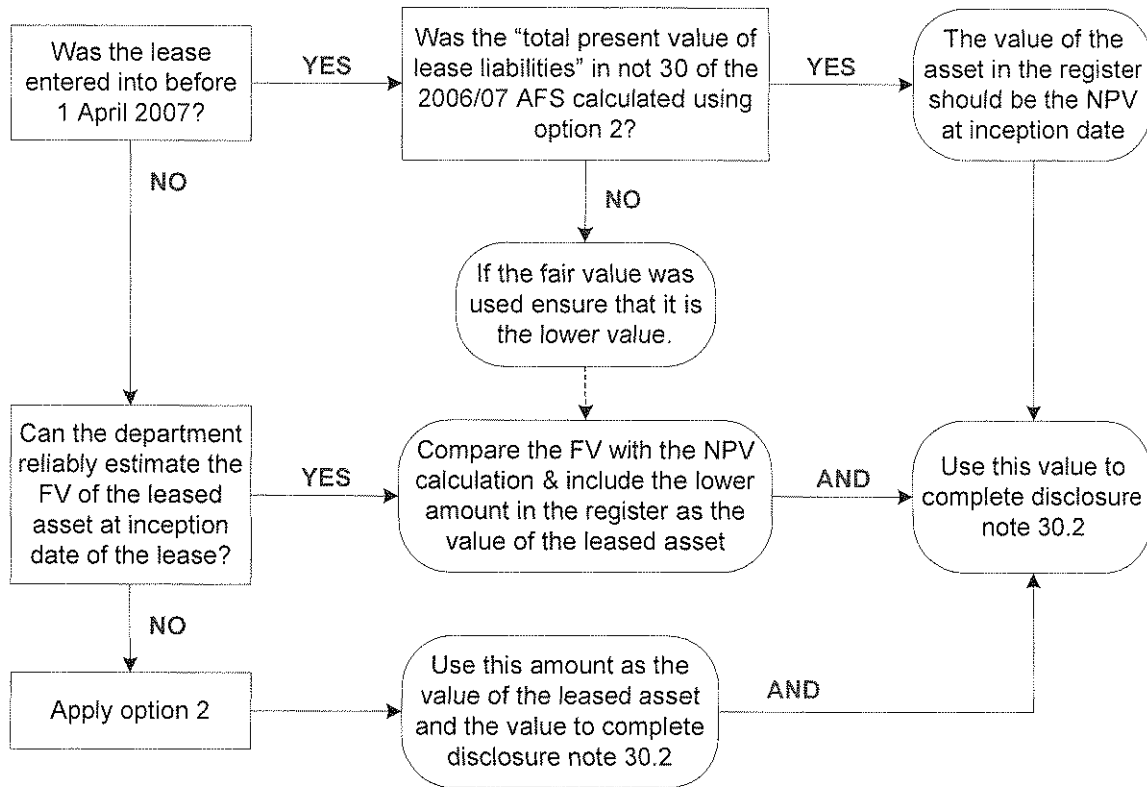
GUIDANCE ON LEASE VALUATION

How is the value of the leased asset determined?



How and when should these options be applied?

Both options should be considered at the inception of the lease agreement. However a concession has been made for lease agreements entered into prior to 1 April 2007 (due to the possible lack of information pertaining to the fair values of these assets at the inception of the lease agreement). Refer to the diagram below:



9. ADDITIONAL

- All leases entered into by the department should be recorded in the departmental lease register by the Supply chain management unit.
- The total of the lease schedules should agree to the leases disclosed in the annual financial statements.
- The lease schedule supporting the figure in the disclosure note should be reviewed by the Chief Financial Officer.
- The opening balance of lease commitments in the financial statements should at all times agree to the closing balance of the prior year’s financial statements.
- The accumulative lease commitments incurred at financial year end should be adequately and appropriately disclosed in the financial statements of the department.

Approved

[Signature] 09/06/08

Head of Department