national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

CLASSIFICATION CIRCULAR 21

CLASSIFICATION OF TRANSFERS AND SUBSIDIES VERSUS GOODS AND SERVICES OR CAPITAL ASSETS

1 Purpose

1.1 The purpose of this circular is to provide national and provincial departments with an understanding on how to classify budgeted and actual expenditure with a specific focus on the distinction between the goods and services, payments for capital assets; and transfers and subsidies expenditure categories in line with the Constitution of the Republic of South Africa (1996), the Public Finance Management Act (1999), Treasury Regulations (issued in terms of the Public Finance Management Act) and the Economic Reporting Format (September 2009).

2 Legislative mandate

2.1 According to Section 216(1)(b) of the Constitution of the Republic of South Africa (Constitution), "*National legislation must establish a national treasury and prescribe measures to ensure both transparency and expenditure control in each sphere of government, by introducing uniform expenditure classifications."*

2.2 Section 216(2) of the Constitution states that *"The national treasury must enforce compliance with the measures established in terms of subsection (1)…"*

2.3 Section 6(2)(b) of the Public Finance Management Act (PFMA) further supports the Constitution in that the National Treasury must enforce the PFMA and any prescribed norms and standards, including any prescribed standards of generally recognised accounting practice and uniform classification systems.

2.4 In terms of section 38(1)(j) of the PFMA *"The accounting officer for a department, trading entity or constitutional institution before transferring any funds (other than grants in terms of the annual Division of Revenue Act or to a constitutional institution) to an entity within or outside government, must obtain a written assurance from the entity that that entity implements effective, efficient and transparent financial management and internal control systems, or, if such written assurance is not or cannot be given, render the transfer of the funds subject to conditions and remedial measures requiring the entity to establish and implement effective, efficient and transparent financial management and internal control systems".*

2.5 Treasury Regulations 6.7.1 states that *"For purposes of ensuring alignment between the new Economic Reporting Format, the Public Finance Management Act, 1999 and the Treasury Regulations, the following terms must be used interchangeably:*

(a) Personnel expenditure referred to in the Act is the same as compensation of employees in the new Economic Reporting Format;
(b) Transfer referred to in the Act is the same as transfers in the new Economic Reporting Format for entities of government, but excludes public entities listed in Schedules 2, 3B and 3D to the Act;
(c) Transfers referred to in the Act that are made to public entities listed in Schedules 2, 3B and 3D to the Act are the same as transfers and subsidies in the new Economic Reporting Format; and
(d) Capital expenditure referred to in the Act is the same as payments for capital assets in the new Economic Reporting Format."

2.6 In terms of Treasury Regulation 3.2.8 *"An internal audit function must assess the operational procedure and monitoring mechanisms over all transfers made and received, including transfers in terms of the annual Division of Revenue Act."*

3 Economic Reporting Format

3.1 In compliance with section 6(2)(b) above, the National Treasury developed and issued the new economic reporting format and standard chart of accounts for application from the 2004/2005 budgeting and reporting cycle. The ERF introduced reporting tables for government receipts and payments. These tables were designed according to economic, statistical and accounting principles and were supported by definitions for each category included therein.

3.2 The ERF provided definitions for each category of revenue and expenditure. Departments began applying the principles and definitions for budgeting purposes in 2004, and at the same time the National Treasury introduced this classification structure in the financial reporting environment. Departments therefore applied this new classification regime in the preparation and presentation of budgets and financial statements. Compliance with these requirements was facilitated by way of the SCOA embedded within the financial systems environment.

3.3 The latest version of the ERF was published in September 2009 and is still effective.

4 The Modified Cash Standard

4.1 Section 76 of the PFMA requires the National Treasury to make regulations or issue instruction applicable to departments concerning specified matters. Sections 76(2), (3) and (4) empower National Treasury to make regulations or issue instructions applicable to departments concerning certain matters.

4.2 Treasury Regulations (2005), 18.2 states that "In the absence of any implementation dates set for the standards of generally recognised accounting practice issued by the Accounting Standards Board, the following reporting standards comprise generally recognised accounting practice and must be adhered to for the preparation of annual financial statements, unless otherwise approved by the National Treasury……"

4.3 The above regulation further states that "The annual financial statements must be prepared on a modified cash basis in accordance with the formats prescribed by the National Treasury and must be accompanied by the audit opinion of the Auditor-General".

4.4 The National Treasury, in compliance with the above legislation, developed and issued the Modified Cash Standard (MCS) for application by all government departments with effect from 1 April 2013. The classification structure and principles used by departments for planning and budgeting was adopted and required by the MCS for application in the annual financial statements.

4.5 Expenditure categories are derived from the ERF. When expenditure meets the recognition requirements, it is classified into the following broad classifications in the general ledger and the financial statements of a department:

a) Current expenditure;

b) Transfers and subsidies;

c) Expenditure for capital assets;

d) Payments for financial assets.

The above categories are listed in Chapter 3 (Financial Statement Presentation) of the MCS.

5 Classification principles

5.1 SCOA uses the item segment to identify the goods, services and other payments made in achieving the legislative mandate of a department. A principle discussed in the ERF focusses on the immediate use of funds. It identifies "what is being bought". The payment categories show either what has been bought or to whom funds have been transferred.

5.2 When items are bought (or services are paid for), the payment is classified as goods and services and or payments for capital assets.

5.3 Goods, services or capital assets that are purchased by government but later transferred in kind to beneficiaries, are recorded as part of goods and services or payments for capital assets respectively, as the national and provincial departments are currently using the modified cash basis of accounting and not accrual. An example of goods transferred in kind would be blankets distributed to households in a flood-stricken area. These goods are either distributed immediately (i.e. they are delivered directly to the beneficiaries) or are distributed by the department after taking delivery of the items at their own warehouses. Despite the department not taking possession of the goods, they are responsible for acquiring those goods and these should be classified as goods and services.

5.4 Where funds are transferred to another entity for the entity to further its operations in line with the entity's mandate, these are classified as transfers and subsidies. The funds for operations would be requested by the entities through the budget process.

5.5 If the department is responsible for a transaction or an activity and requested another entity (within or outside government) to perform such transaction or activity for the department, the payment should be classified as goods and services and or payments for capital assets by the department.

5.6 Immediate use of cash distributed to identified beneficiaries does not involve buying of goods, buying of capital assets or paying for services and thus such cash distribution is classified as transfers and subsidies.

5.7 The type of funding received by a department does not determine the classification of the expenditure. The department should classify the actual expenditure incurred in line with the ERF.

5.8 The execution of the activity for the department by service providers or agents should not determine the classification of the expenditure.

5.9 If the department pays management fees to another entity that acquires goods and services or capital assets, the department should classify such acquired items or services as goods and services or payments for capital assets, respectively.

6 Goods and services and capital assets

6.1 The item goods and services includes payments for all goods and services to be used by a government unit, excluding purchases of capital assets.

6.2 Where a department uses another organ of state or an agent (within or outside government) for acquisition of goods and services or capital assets, this payment is classified as goods and services or payments for capital assets, respectively. For example, if a department pays the Council for Scientific and Industrial Research to carry out research for which the department is responsible, the transaction is recorded as goods and services.

6.3 Capital assets are goods that are expected to be used during more than one reporting period and from which future economic benefits or service potential are expected to flow, provided that their value exceeded the capitalisation threshold when originally purchased.

7 Transfers and subsidies

7.1 For a payment to be classified as transfers and subsidies the department does not buy any item or pay for a service.

7.2 Following from this, cash grants offer beneficiaries discretion in that beneficiaries can subsequently spend the cash received on any good and/or service according to their individual needs. The department does not buy an item or pay for a service when making cash grant payments.

7.3 Transfers to departmental agencies and accounts is a sub-category of transfers and subsidies. Such transfers include payments to national public entities listed in the PFMA, such as South African Social Security Agency (SASSA) and Sector Education and Training Authority (SETA) to further the operations of these public sector entities.

7.4 When department funds the operations of its entity, the accounting officer must, in terms of section 38(1)(j) of the PFMA and paragraph 8.4 of the Treasury Regulations, ensure that the entity has sufficient internal controls in place to utilise and safeguard the funds when received. The public entity on the other hand is responsible for the way in which the funding is utilised in accordance with its operational plans.

7.5 The item, transfers, is sub-divided into the various sectors receiving funding from government. This will provide clear information on the targeted recipients or beneficiaries of departmental spending. The ERF distinguishes between the following transfer categories which will be discussed separately:

7.5.1 transfers to provinces

7.5.2 transfers to municipalities

7.5.3 transfers to departmental agencies and accounts

7.5.4 transfers to universities and technikons[1]

7.5.5 transfers to public corporations and private enterprises:

- subsidies on products and production
- other transfers to public corporations and private enterprises

7.5.6 transfers to foreign governments and international organisations.

7.5.7 transfers to non-profit institutions.

7.5.8 transfers to households:

- social benefits
- other transfers to households.

8 Transfers to provinces

8.1 Transfers to provinces includes the Provincial Revenue Fund; provincially owned entities like hospitals, clinics and other entities engaged in providing health services, as well as provincially owned development organisations, but excluding Higher Education Institutions.

8.2 In a case that the national department requests a provincial department to acquire goods or capital assets or pays for a service for the national department, the national department should classify this transaction as goods and services or payment for capital assets.

9 Transfers to municipalities

9.1 Transfers to municipalities include development organisations owned by municipalities and other municipal entities. Rates and taxes and vehicle licences should be recorded here. They are classified as transfers because the payer does not get anything of similar value directly in return.

9.2 Payments to the municipality for municipal services such as electricity and water should be classified as goods and services.

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[1]Universities and Technikons have been renamed. They are currently referred to as Higher Education Institutions.

9.3 If the municipality is responsible for constructing a road using funds provided by a department, the department will classify the transaction as transfer and subsidies as the department is only funding the operations of the municipality.

9.4 In a case that the department is responsible for construction of roads and appoints a municipality to construct the road for the department, the department will classify the transaction as goods and services or payments for capital assets.

10 Transfers to departmental agencies and accounts

10.1 Departmental agencies and accounts include public entities listed in the Public Finance Management Act (1999).

10.2 Where a department makes a payment to its entity in order for the entity to conduct its operations in accordance with its legislative mandate and not to acquire any goods or deliver any services for the department, the transaction is classified as a transfer.

10.3 In an event that a department makes a payment to its public sector entity for acquisition of goods, services or capital assets, this payment is classified as goods and services or payments for capital assets, respectively.

10.4 The Accounting Standards Board (ASB) is an example of a juristic person established by the National Treasury where the Board is given powers to conduct its operations in developing the generally recognised accounting practice (GRAP). This is in accordance with the PFMA section 87(2) read with section 91(1)(a). National Treasury provides the ASB with funding as required by section 52 and 53 of the PFMA and as such is classified as a transfer.

10.5 National Treasury is responsible for prescribing the Modified Cash Standard (MCS) which is the framework for preparation of department's financial statements. Should the National Treasury request ASB for assistance in developing the MCS the National Treasury will classify the payment made as goods and services.

11 Transfers to Higher Education Institutions

11.1 Funds are transferred to Higher Education Institutions, for these to carry out their operations. These are classified as transfers and subsidies.

11.2 When the department contracts a university as a service provider to conduct research and development or other services for the department the transaction is classified as goods and services.

12 Transfers to public corporations and private enterprises

12.1 Transfers to public corporations and private enterprises is made up of subsidies on products and production and other transfers to public corporations and private enterprises.

12.2 Subsidies on products and production comprise all current, unrequited payments to businesses (both government and privately owned) on the basis of their level of production or quantity, or values of products produced, sold, imported or exported. Subsidies influence the level of production and/or pricing policies of the recipient.

12.3 A subsidy assists the recipient to keep the price of goods or services sold low and/or to keep the cost of production low. An example is a subsidy given in terms of Division of Revenue Act to commuter bus services for public transport operations to ensure lower price of bus fare.

12.4 Similar to transfers, subsidies are a form of cash payment whose immediate use is not buying of goods or services and thus are classified as transfers and subsidies.

12.5 Other transfers to public corporations and private enterprises consist of current and capital transfers. An example of a capital transfer is a payment that is conditional on the recipient unit using the funds to acquire capital assets. Another example is a transfer to enterprises (publicly or privately owned) to cover large operating deficits accumulated over at least two years or to finance their cost of purchasing capital assets.

12.6 There may be instances where public corporations or private enterprises are used as service providers or agents. If a department buys an item or pays for a service from the public corporations or private enterprises, this should be classified as goods and services.

12.7 Treasury Regulations 5.2.3(f) states that for a department *"The strategic plan must include details of proposed acquisitions of financial assets or capital transfers and plans for the management of financial assets and liabilities*".

13 Transfers to foreign governments and international organisations

13.1 Subscription fees to international organisations if the payment is in proportion to the benefit and the purpose is to obtain something in return. If the department gets something in return for the payment, for example, gains access to a network or gets information in return for subscribing to the international organisation, the transaction should be classified as goods and services, provided that the cost is in proportion to the benefit. If the purpose is to support the organisation or the cost of subscribing far exceeds the benefit, the transaction should be classified as a transfer to foreign governments and international organisations.

14 Transfers to non-profit institutions

14.1 Non-profit institutions falling under this category are privately owned, self-governing, voluntary organisations operating, not for commercial purposes but in the public interest, for the promotion of social welfare and development, religion, charity, education and research for furtherance of their operations are classified as transfers to non-profit institutions.

14.2 Public non-profit institutions are part of government and payments for their operations should be classified under the relevant transfers and subsidies category above.

14.3 In instances where a non-profit institution receives funds to acquire goods or deliver services for the department, the arrangement is not that of funding the operations of the non-profit institution. Accordingly, the payment should be classified as goods and services or payment for capital assets.

15 Transfers to households

15.1 Transfers to households comprises of social benefits and other transfers to households. Social benefits are current transfers to households. Included are the transfers made to households to protect them against events or circumstances that may adversely affect their social welfare.

15.2 Examples include the child support grant, payments for medical, convalescent and dental care, and home care. Social benefits also encompass the cost to provide free housing and housing below market prices. Also included is the leave gratuity paid in the event of an employee's demise or early retirement on medical grounds. It is payable to protect employees or their households against an event that has adversely affected their social welfare.

15.3 Should the department buy food parcels that will ultimately be distributed to beneficiaries, these will be classified as goods and services.

16 Agents and Service Providers

16.1 Public sector entities often work together to achieve common objectives. As a result, public sector entities can undertake activities on behalf of one another. For financial statements purposes, decisions should be made on which entity should account for the activities (or the utilisation of the funds) and how these should be reflected by applying this classification circular.

16.2 Service providers or agents are at times appointed to support departments in achieving the department's service delivery objectives. The use service providers or agents to acquire, construct or distribute goods or services should not change the classification from goods and services or payments for capital assets to transfers and subsidies.

16.3 Payments made to reimburse a service provider or an agent for services delivered for the department are requited and classified as goods and services or payments for capital assets. Similarly, expenditure pertaining to prepayments or advances, which should be in line with the Treasury Regulations, should be classified as goods and services or payments for capital assets and not transfer and subsidies.

17 Enquiries

17.1 All documentation issued by the SCOA Technical Committee can be accessed from http://scoa.treasury.gov.za/Pages/Main.aspx.

17.2 Please contact the SCOA Technical Committee via the SCOA call centre at (012) 315 5311 or by sending a concise email to scoa@treasury.gov.za if further clarity or discussion is required regarding the classification guidance highlighted above.

SCOA Technical Committee
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