

State Contingent Liabilities in South Africa: An Actuarial Perspective

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1. Introduction

- 1.1 The actuarial profession prides itself on its focus on risk identification, measurement, management, and monitoring. Actuaries have a nuanced appreciation for the challenges related to measuring and managing liabilities. However, most actuaries work in the private sector¹ and although they are likely to have a high-level appreciation for the challenges in the public sector, they might not have a detailed understanding of contingent liabilities in that sector. This working paper intends to introduce contingent liabilities in the public sector and will focus on contingent liabilities related to insurance-like risks.
- 1.2 During the 2021 State of the Nation Address^[1], South African president, Mr Matamela Cyril Ramaphosa, highlighted the hardships faced by citizens in the face of the national lockdown imposed to manage the coronavirus (COVID-19) pandemic. He outlined the following interventions that the South African Government (further referred to as the “Government”) would be implementing to provide relief:
- A COVID-19 vaccination programme aimed at curbing the impact of the virus.
 - Additional grant payments, tax relief, loans and more to support those most in need.
 - Various new infrastructure projects related to energy, water, transport, and telecommunications.
 - Addressing the challenges around Eskom and electricity generation.
- 1.3 Government interventions and projects such as those announced in the 2021 State of the Nation Address provide insight into the important role the Government plays in society. One such project is South Africa’s 2030 National Development Plan^[2] (NDP) which has the ambitious goal of eliminating poverty and reducing inequality by 2030. The NDP states that one of the critical components of this plan is the improvement in the delivery of public services.
- 1.4 South Africa is a constitutional democracy; therefore, it is appropriate to reflect on the constitution when discussing the role of Government. Chapter 2 of the Constitution of the Republic of South Africa^[3] is known as the Bill of Rights. The Bill of Rights highlights the rights of everyone in South Africa and gives insight into the responsibilities of the state. It states that every person should have access to water, food, healthcare, education, a safe environment, and adequate housing. Should any of these rights be infringed upon, a person may approach a court for appropriate relief.
- 1.5 From the above, it is evident that the South African Government has important responsibilities to fulfil. However, to do so, the Government requires funding. Funding is obtained through tax collections (which include personal income tax, company tax, value added tax, customs, and excise), income from state-owned entities (SOEs), returns on financial assets, aid, donations, and debt funding. The South African Government has specifically made use of debt funding to supplement its tax revenue as is a common practice worldwide^[4].

¹ The Actuarial Society of South Africa estimates that, at present, less than 2% of South African Fellow actuaries are working in the public sector.

- 1.6 To meet the needs of the population and to fulfil many of its responsibilities, the Government provides services or develops infrastructure. For other responsibilities, the Government plays the role of an insurer of last resort, where it assumes the risk for potential outflow that will only occur at a later stage. Historically, the South African Government has used SOEs, such as the Road Accident Fund (RAF), the Unemployment Insurance Fund (UIF) and the Compensation Fund (CF), to manage these insurance-like risks. Some of these entities are operated on a funded-basis (sufficient assets to cover liabilities) whereas others are operated on a pay-as-you-go or unfunded basis (claims are paid from revenue).
- 1.7 For large infrastructure projects, the Government might not have sufficient reserves to fully fund the project or it might not want to deplete its available reserves. Nonetheless, because the Government believes that the benefit of such additional economic growth/social benefits generated by the project, will exceed the cost of the debt, it may decide to supplement revenues through debt financing. However, large infrastructure projects are often plagued with delays in implementation and cost overruns and when financing must be repaid and operational expenses covered, challenges arise. Thus, if these projects are not appropriately managed, they become unsustainable. If the Government is unable to cover such additional costs from its revenue, the subsequent budget deficit causes the Government to use reserves or debt funding to service interest, debt repayment, and operating expenses. If kept unchecked, such an increasing budget deficit can lead to what is known as a debt spiral. This risk was highlighted in Chapter 1 of the National Treasury's 2021 Budget Review^[5].
- 1.8 Over time, the South African Government has entered into borrowing arrangements with various funders. As alluded to above, the cost of debt repayment is a crucial factor when considering the long-term sustainability of South Africa's public finances. Difficult decisions must be made to ensure that debt financing remains under control. In order to reduce the cost of debt, the state has various levers that it could consider, such as increasing taxes, reducing expenditure, or renegotiating the terms of financing. Ideally, economic growth will increase tax revenue and, in turn, lead to a budget surplus. According to the 2021 Budget Review^[5], the Government aims to achieve a fiscal surplus by 2024/2025.
- 1.9 Ensuring a fiscal surplus over the long term requires that income exceeds outflows. Outflows are dependent on capital expenditure, operational expenditure, debt-servicing cost, and risk retention. In the current economic environment, accelerating economic growth without incurring additional debt or risk, can be particularly challenging. Presently a substantial portion of Government's debt is located in the liability section of the Government's financial statements. For the purposes of this paper, these liabilities are referred to as 'direct explicit liabilities', and include domestic and foreign debt.
- 1.10 In contrast, contingent liabilities are not shown on the balance sheet and are only included in the notes to the financial statements. These liabilities are formally recognised in the financial statements as liabilities upon the occurrence of a specific event or trigger (such as a default by an SOE). These triggers depend on the nature of the contingent liability and end up manifesting as a form of cash transfer, such as a loan or grant (also referred to as a bailout in certain cases). A significant risk is that the quantum of these contingent liabilities become unbearable to the public finances,

even before they are formally recognised as liabilities on the balance sheet and managed accordingly. Therefore, to ensure sustainable public finances, it is critical to identify, measure, manage, and monitor such risks.

- 1.11 This working paper provides an overview of the Government's contingent liabilities. The paper starts with some important theoretical aspects and accounting principles relating to contingent liabilities in Sections 2 and 3. It then continues with a discussion of the Government's liabilities in Section 4. Section 5 delves into an analysis of contingent liabilities in five South African SOEs. This is followed by Section 6 that provides an overview of the risk management process and frameworks currently in use. Section 7 discusses some of the findings of this paper and Section 8 provides suggestions for further research.

2. Contingent liabilities: An overview

- 2.1 In November 1988, the World Bank released a note on economic policy titled "Contingent liabilities - a threat to fiscal stability"^[6]. This note introduced a useful framework for categorising liabilities. The intention of introducing this framework was not to reflect the accounting treatment of liabilities but rather to provide a general framework for discussion purposes. In this working paper this conceptual framework was applied in order to group the various Government liabilities and to facilitate a discussion related to them.
- 2.2 According to the above-mentioned framework, liabilities are split into two broad categories: (i) direct and (ii) contingent liabilities. Direct liabilities are characterised by predictable obligations, whereas contingent liabilities accrue as a result of specific trigger events. Direct and contingent liabilities are then further split into two subcategories: (i) explicit and (ii) implicit liabilities. Liabilities are considered explicit when an entity is "legally responsible" for settling these liabilities, whereas implicit liabilities imply that the entity would be responsible due to a moral obligation, political pressure, or guarantee. Explicit liabilities are typically disclosed in the financial statements of the entity whereas implicit liabilities are often not. The framework of the 1988 World Bank note is illustrated in Table 2.1 below.

Table 2.1: Liability framework

	<i>Direct liabilities</i>	<i>Contingent liabilities</i>
<i>Explicit liabilities (disclosed)</i>	Sovereign debt (both domestic and foreign)	- A portion of the liabilities of Government insurance schemes (such as the Road Accident Fund) - Guarantees for SOEs
<i>Implicit liabilities (undisclosed)</i>	- Future social security (e.g., old person's grants) - Future healthcare funding	- Bank failures - Disaster relief - Unexpected environmental restoration

- 2.3 As mentioned in Section 1 above, direct explicit liabilities are relatively well-documented, disclosed and understood (the upper left section of Table 2.1). However, the details of the other three types of liabilities, namely direct and contingent implicit liabilities, and contingent explicit liabilities are less readily understood. This working paper will investigate explicit contingent liabilities; those seen in the top right section of Table 2.1 above. The concept of implicit liabilities is an important subject for future research.
- 2.4 The notion of a trigger event on a contingent liability with the subsequent formal recognition of the liability on the balance sheet was introduced in Section 1. In some cases, a contingent liability can be settled without being formally recognised as a 'direct liability'. For example, if a portion of an SOE's debt is repaid using a debt-to-equity swap, that portion of the contingent liability is effectively settled. This is what was considered with Eskom. Rating agencies commented that this approach to debt restructuring was "tantamount to a default"^[7] and potentially inappropriate accounting.

3. Accounting for state contingent liabilities in South Africa

3.1 Purpose

- 3.1.1 The intended use of a set of financial statements should be the foremost consideration when developing accounting principles and frameworks. Public sector entities in South Africa publish financial statements for the use case known as 'general-purpose'^[8], rather than 'specific purpose'. These financial statements are not tailored to a specific party but provide broad accountability to service recipients and resource providers as well as their respective representatives.
- 3.1.2 According to Pratt,^[9] financial accounting has four core principles that are typically embedded in reporting frameworks, namely:
- objectivity
 - matching
 - revenue recognition
 - consistency

3.2 Public and private sector accounting

3.2.1 Context

- 3.2.1.1 Globally there are two accounting frameworks in use in the private sector, namely Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS).
- 3.2.1.2 Each jurisdiction can either adopt an international accounting standard, such as International Financial Reporting Standards (IFRS) or develop its own standards to be implemented locally along the frameworks of IFRS or GAAP. For example, in the United States of America, the Financial Accounting Standards Board (FASB) develops and issues GAAP standards, whereas internationally, the International Accounting Standards Board (IASB) is responsible for setting the International Financial Reporting Standards (IFRS).
- 3.2.1.3 Worldwide, the reporting landscape is dominated by IFRS. In a 2018 report^[10] the IFRS Foundation states that 87% of jurisdictions require IFRS for "most domestically accountable companies". Nine jurisdictions, however, have their own national standard or are moving towards IFRS. It is important to note that the United States of America (USA) and China are two of those nine countries that do not mandate the use of IFRS. US firms typically report under US GAAP whereas Chinese companies often report under China GAAP, US GAAP and IFRS. IFRS and GAAP have different approaches to specifying reporting requirements; GAAP is largely rule-based, whereas IFRS is principle-based. Both GAAP and IFRS are aimed at private sector companies (typically large, listed entities).

3.2.2 International accounting for the private sector

- 3.2.2.1 To appreciate any potential future changes in accounting policies, it is important to understand the history of the various accounting frameworks. The Institute of Chartered Accountants in England and Wales provides an insightful history of accounting on their website^[11] and the following section is largely based on information gleaned from their website.
- 3.2.2.2 The International Accounting Standard Committee (IASC) was established in June 1973. Between 1973 and 2000, the IASC published various accounting standards, numerically listed from 1 to 41 and known as International Accounting Standards (IAS). Upon establishment of the International Accounting Standards Board (IASB) in 2001, the IASB adopted the IAS from the IASC. Over time, the IAS are being replaced by IFRS of which the first, IFRS 1, was published in 2003.
- 3.2.2.3 The Standing Interpretations Committee (SIC) was established in 1997 to assist with guidance on the interpretation of the various accounting policies issued by the then IASC. Between 1997 and 2001 the SIC released 31 SIC interpretations. With the transition of the IASC to the IASB in 2001, the SIC was restructured into the International Financial Reporting Issues Committee (IFRIC), and in 2010, the IFRIC was renamed to the IFRS Interpretations Committee.
- 3.2.2.4 The IFRS framework comprises the full scope of IASB standards and interpretations including:
- International Financial Reporting Standards (IFRS)
 - International Accounting Standards (IAS)
 - SIC and IFRIC interpretations
- 3.2.2.5 The purpose of the IASC and later the IASB was to develop a single set of rigorous principle-based international standards and to promote the use and adoption of these standards^[12].

3.2.3 International accounting for the public sector

- 3.2.3.1 The International Federation of Accountants (IFAC) was founded in 1977 and its website lists its aim as, "enhancing the relevance, reputation, and value of the global accountancy profession"^[13]. IFAC^[14] provides a concise history of the public sector accounting standards. In 1986, the IFAC Public Sector Committee was formed to deal with public sector accounting policies, and between 1997 and 2003 the committee released 20 International Public Sector Accounting Standards (IPSAS). In 2004, the IFAC Public Sector Committee was renamed to the International Public Sector Accounting Standards Board (IPSASB).
- 3.2.3.2 The IPSASB develops accounting standards (IPSAS) applicable to governments and other public sector entities based on a combination of IFRS and IAS. The IPSASB takes responsibility for the development of standards, but each jurisdiction retains responsibility for deciding whether to adopt those standards, how to adopt them and how to enforce them.

3.2.4 South African accounting for the private sector

- 3.2.4.1 The South African Institute of Chartered Accountants (SAICA) provides a history of accounting on their website^[15] in which they state that the roots of South Africa's accounting profession dates back to 1652, when Frederick Verburgh acted as bookkeeper for the Dutch East India Company. The first professional body for accountants in South Africa, the Institute of Accountants and Auditors, was formed in 1894. Much later, in 1966, the National Council of Chartered Accountants (NCCA) was formed, and in 1980, the South African Institute of Chartered Accountants (SAICA) was formally founded with the intention of creating one centralised cohesive body for accounting in South Africa.
- 3.2.4.2 During the past 50 years, several policy changes around accounting standards were made in South Africa. Both Smith^[16] and Verhoef^[17] provide insightful accounts of these changes and the following section is largely based on their research. The Companies Act of South Africa was promulgated in 1973. This act required "conformity with generally accepted accounting practice". In response to this requirement, the NCCA established the Accounting Practices Board (APB) in the same year (1973) with the goal of issuing a South African version of GAAP, known as SA GAAP^[18]. The NCCA worked closely with the IASC in developing SA GAAP and the first statement was issued in 1974. Then, following a 1993 recommendation from the APB, SA GAAP was aligned with the IAS published by the IASC (effective from 1995). This alignment led to IFRS being fully adopted with amendments as SA GAAP from 2003. Since 2005, firms listed on the JSE were required to comply with IFRS.
- 3.2.4.3 The Financial Reporting Standards Council (FRSC) was established in terms of section 203 of the 2008 Companies Act^[19]. The FRSC is responsible for adapting international regulations to South African circumstances. The 2008 Companies Act Regulations permitted the application of either IFRS or GAAP, depending on the classification of the company^[16]. This did not bring any significant changes to JSE-listed firms, as since 2005, they were already IFRS-compliant. The FRSC, together with the APB, then agreed that, for the financial years following December 2012, SA GAAP must be withdrawn^[20].

3.2.5 South African accounting for the public sector

- 3.2.5.1 The Accounting Standards Board (ASB) is a public entity that reports to the Minister of Finance. In terms of the Public Finance Management Act (PFMA) of 1999^[21], the ASB is required to "determine generally recognised accounting practice referred to as Standards of Generally Recognised Accounting Practice (GRAP)"^[22].
- 3.2.5.2 The Accounting Standards Board (ASB) developed a framework for 'general purpose' financial reporting for public sector entities in South Africa. The ASB defined this general purpose financial reporting as a framework in which the information provided responds "to the information needs of service recipients and resource providers who do not possess the authority to require a public sector entity to disclose the information they need for accountability and decision-making purposes"^[8].
- 3.2.5.3 Public entities (as defined in the PFMA schedules) have historically applied GRAP unless the ASB has approved GAAP for a specific entity. Due to the withdrawal of

GAAP in 2012, an alternative reporting framework for public entities had to be chosen. In this regard, the ASB issued Directive 12^[22] in 2015 on which the following section draws heavily from. Directive 12 outlined the criteria that public entities had to use when "selecting and applying an appropriate reporting framework". However, Directive 12 was only applicable to public entities that were previously reporting under SA GAAP and not to those applying GRAP. Whilst early application was permitted, compliance with Directive 12 became compulsory for all financial periods since April 2018.

3.2.5.4 Public sector entities publish 'general purpose' financial statements that contain information intended to meet the needs of a wide range of users. However, these general purpose financial statements could never meet the needs of **all** users. That is why each entity must do a self-assessment to ensure that their financial statements also meet the needs of its specific users. For example, paragraph 11 of Directive 12 details that an entity should apply IFRS if:

- (a) it is a financial institution;
- (b) it has ordinary shares or potentially ordinary shares that are publicly traded on capital markets; or
- (c) its operations are such that they are:
 - 1) commercial in nature; and
 - 2) only an insignificant portion of the entity's funding is acquired through government grants or other forms of financial assistance from government.

3.2.5.5 Directive 12 further establishes that any entity under the control of an entity that satisfies the above criteria must also apply IFRS.

3.2.5.6 Once an entity has chosen a reporting framework, that entity will not be able to change the framework, unless it no longer meets the criteria outlined above^[22] as a result of some significant change.

3.2.5.7 In some cases, a public entity may have historically reported under the GRAP framework historically and thus remained under the GRAP framework, even after the release of Directive 12. However, there may be entities that would still be required to supplement the GRAP framework. In such cases, the entity would develop accounting policies based on IFRS (or another source depending on circumstances) in the absence of a Standard of GRAP dealing with a particular event/condition/transaction. This has historically been the case with the Road Accident Fund, whereas SASRIA has fully adopted IFRS as its accounting framework. In a recent review report^[23], the ASB highlighted the changes in reporting frameworks for certain entities listed in the PFMA schedules.

3.2.5.8 In a technical committee meeting of the ASB^[24], held in March 2021, a point was raised around accounting for activities similar to insurance in the public sector. It was explained that the IPSASB has completed their work on a social benefits project. As part of their social benefits project, a new standard, IPSAS 42 (Social Benefits), was issued in January 2019 with an effective date of January 2022^[25]. This effective date was later extended to 2023. IPSAS 42 provides guidance on accounting for social benefits' liabilities and expenditure, including state retirement benefits, disability benefits, income support, and unemployment benefits^[26]. The ASB technical committee agreed that a letter should be sent to entities that carry on insurance-like

activities informing them not to change their accounting policies until they have been provided with clear accounting guidance.

- 3.2.5.9 Locally, the ASB has embarked on a project aiming to provide guidance on accounting for social benefits in South Africa. According to feedback obtained from the ASB, IPSAS 42, as it currently stands, is not supported in South Africa, partly because of the requirements for the recognition of liabilities under IPSAS 42. The ASB plans to depart from IPSAS 42 in certain areas to align with the needs of South African entities. It is recommended that actuaries with the appropriate experience and insight should contribute to this process by committing some of their time to provide the ASB with an actuarial perspective on these matters.

3.3 State accounting for public sector entities in South Africa

- 3.3.1 When discussing contingent liabilities, it is useful to understand how liabilities are accounted for by the Government. In South Africa, the ASB is responsible for publishing "Standards of GRAP" and "Interpretations of the Standards of GRAP" that are used for the compilation of the annual financial statements (AFS) of government departments, public entities, constitutional institutions, municipalities and their respective entities, provincial legislatures, and parliament. Refer to Schedules 1, 2, 3A, 3B, 3C and 3D of the PFMA^[21] for a list of these entities.
- 3.3.2 The PFMA requires that public sector entities prepare financial statements in accordance with GRAP. According to the ASB, financial statements under GRAP are to be prepared on an accrual basis^[27]. Although the ASB sets the applicable standards, the Auditor-General of South Africa (AGSA) is responsible for their enforcement. Government departments currently report on a modified cash basis (MCS) whereas other public sector entities typically report on an accrual basis. Due to these different reporting bases, National Treasury prepares separate sets of Consolidated Financial Statements (CFS) for departments and public entities^[4]. Under the MCS, transactions or events are recognised when cash is paid or received, whereas, under the accrual basis, transactions or events are recognised when earned or incurred. Regardless of the recognition basis for the statement of financial position and statement of financial performance, disclosure notes are prepared on an accrual basis.
- 3.3.3 Although GRAP requires public sector entities to prepare financial statements on an accrual basis, Government Departments are temporarily exempt from this requirement and report under the MCS basis described above. Government Departments are to be transitioned from the MCS basis to an accrual basis and the Office of the Accountant General (OAG) manages this transition. In this regard, the OAG issued the following:
- Accounting Guidelines on GRAP to support entities in the practical implementation of GRAP standards.
 - Modified cash standards and related Accounting Manuals for Departments for the practical interpretation of the standards for various Government departments.
- 3.3.4 For purposes of financial reporting of liabilities, the ASB differentiates between provisions, payables, accruals, and contingent liabilities. GRAP 19^[30] specifically deals with provisions, contingent liabilities and contingent assets. To provide

guidance on the identification and disclosure of provisions, contingent liabilities, contingent assets, and commitments for the various state departments, the OAG released Chapter 14 of the Accounting Manual for Departments^[28] for entities that report under the MCS standard. The OAG further released the GRAP 19 Accounting Guideline^[29] that provides guidance on the recognition and measurement of provisions, contingent liabilities, and assets for public sector entities that report under the accrual standard.

- 3.3.5 GRAP 19 indicates that provisions are formally recognised in the statement of financial position whereas contingent liabilities are seen as secondary information and only shown in the notes to the financial statements. For purposes of this working paper, our focus will be on provisions and contingent liabilities as defined in the GRAP 19 Accounting Guideline^[29].

3.4 GRAP 19 Standard

- 3.4.1 GRAP 19 provides the following definitions and clarifying statements^[30]:

- **Provisions** are recognised as liabilities (assuming that a **reliable estimate** can be made) because they are **present obligations**, and because it is **probable** that an outflow of resources embodying economic benefits or service potential will be required to settle the obligations.
- **Contingent liabilities** are defined as:
 - **possible obligations**, as it has yet to be confirmed whether the entity has a present obligation that could lead to an outflow of resources embodying economic benefits or service potential; or
 - **present obligations** that do not meet the recognition criteria in this Standard (because either it is **not probable** that an outflow of resources embodying economic benefits or service potential will be required to settle the obligation, or a **sufficiently reliable estimate** of the amount of the obligation **cannot be made**).
- In a general sense, provisions are contingent because they are uncertain in timing or amount. However, within the GRAP 19 Standard the term 'contingent' is used for liabilities and assets that are not recognised because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

- 3.4.2 The GRAP 19 Accounting Guideline^[29] provides further detail and examples relating to the practical estimation and recognition of provisions and contingent liabilities. Further details from the Accounting Guideline are discussed in Section 3.5 below.

3.5 GRAP 19 Accounting Guideline

- 3.5.1 Under GRAP 19, provisions, payables, and accruals are recorded in the statement of financial position. Contingent liabilities are not recognised as liabilities and are recorded in the notes to the financial statements. For the remainder of this paper, **payables will only be referred to in passing** as the focus will be on provisions and contingent liabilities. The GRAP 19 Accounting Guideline^[29] provides a decision tree relating to payables, provisions, and contingent liabilities.

- 3.5.2 For a provision to be recorded there are three criteria that must be met^[29], namely:

- the provision must be a present obligation arising from a past event;
- it must be probable that there will be an outflow of resources to settle the obligation;
- and
- it must have a reliable estimate.

3.5.3 The above points are illustrated in the decision tree in Figure 3.1, below.

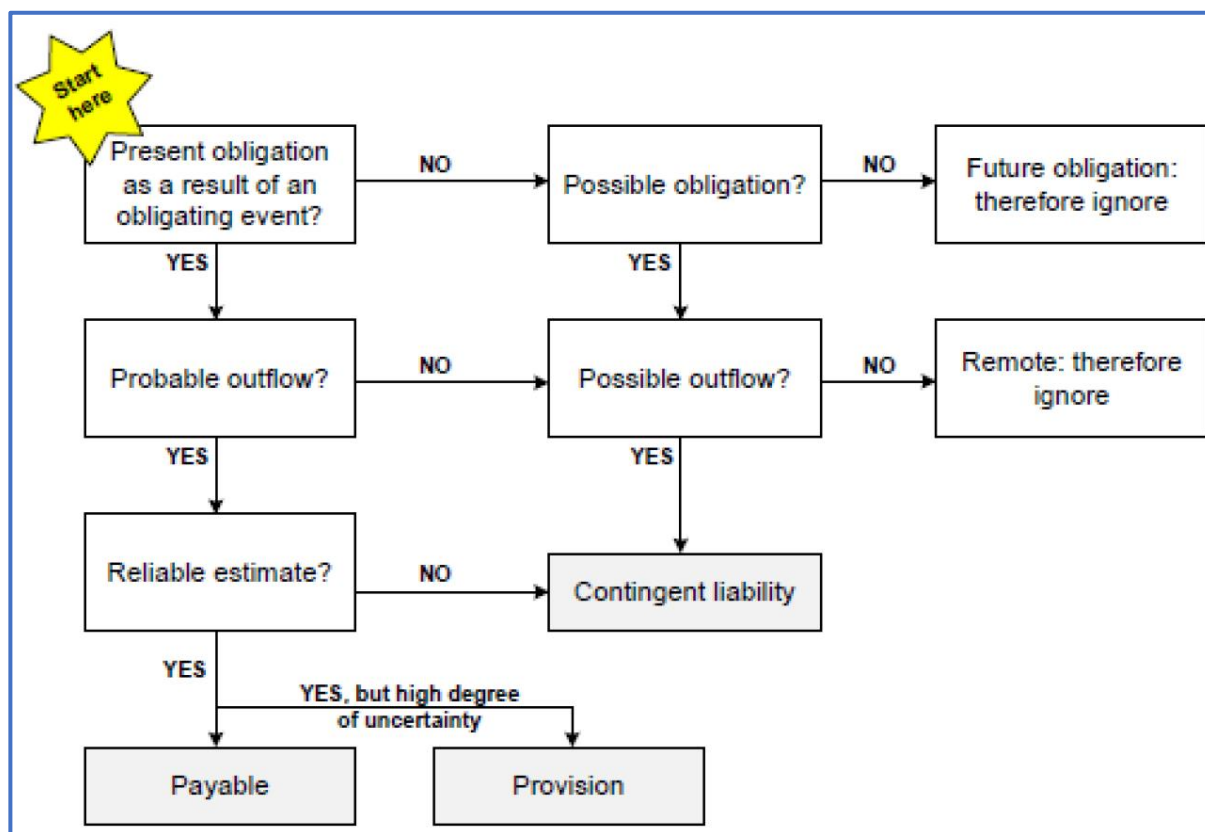


Figure 3.1: A decision tree illustrating payables, provisions, and contingent liabilities^[29]

Recognition

3.5.4 The recognition criteria of the past event and the eligibility criteria for future events are particularly important when considering provisions and contingent liabilities. Depending on the nature of their business, entities apply different approaches in this regard which can significantly impact the overall liabilities.

Obligation

3.5.5 An obligating event is defined as a past event that leads to a present obligation (an existing duty or responsibility to perform). Obligating events can occur as a result of obligations enforced by law or constructive obligations (based on past practices creating a valid expectation).

3.5.6 Figure 3.2 is a diagram referenced from the GRAP 19 Accounting Guideline^[29] that aims to provide further insight into the categorisation of contingent liabilities, provisions and payables from a timing and quantum perspective:

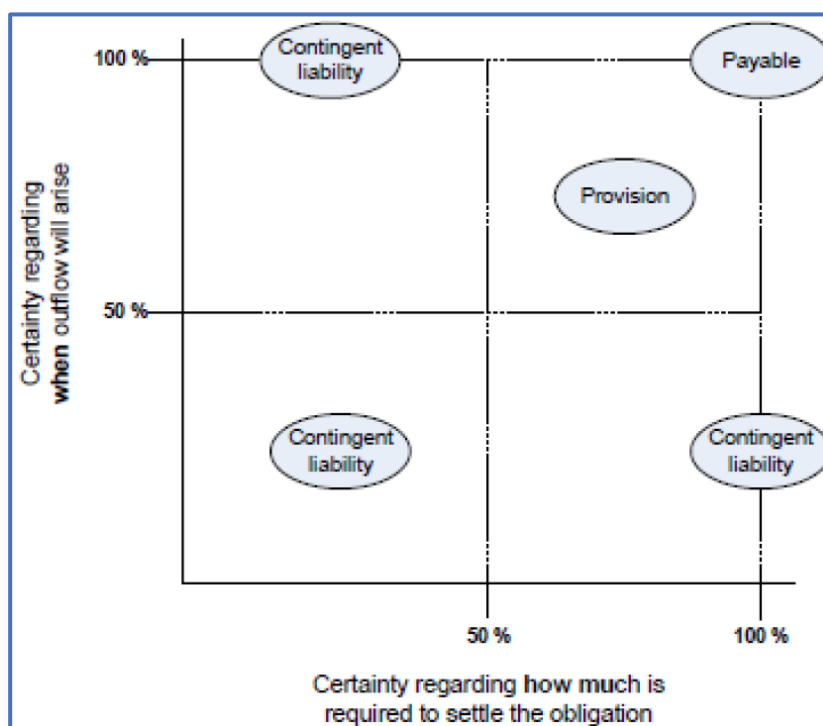


Figure 3.2: The categorisation of contingent liabilities, provisions, and payables from a timing and quantum perspective^[29]

3.5.7 Figure 3.2 above illustrates that the defining features of contingent liabilities, provisions and payables relate to certainty in terms of timing and amount. Contingent liabilities are defined as the "most uncertain" whereas payables have the least amount of uncertainty. As contingent liabilities (sometimes referred to as "contingents") become more certain they are reclassified as provisions and later as payables.

3.5.8 In terms of the GRAP 19 Accounting Guideline^[29], a contingent liability would be recorded if an obligation is defined as possible (as opposed to probable) and if the likelihood is less than, or equal to, 50%.

3.5.9 There are various types of provisions and contingent liabilities, for example:

- Provisions:
 - Payments for damages claims when they are probable, such as commuters claiming against PRASA.
 - Costs of office repairs at the end of a lease.
- Contingent liabilities:
 - Guarantees, such as for loans to Eskom.
 - Claims against departments, such as certain medical negligence claims against the Department of Health (where outflows are possible, not probable).

Measurement and estimation

3.5.10 Financial statements generally rely on point estimates for disclosure purposes. In some cases, sensitivity testing is done to illustrate the variability of such point

estimates. For disclosure purposes under GRAP 19, public sector entities need to record their **best estimate** of provisions and contingents^[29].

3.5.11 GRAP 19^[30] and the associated Guideline^[29] provide the following additional detail on best estimates:

- The best estimate is normally the amount that an entity would rationally pay to settle the obligation or to transfer the obligation to a third party at the reporting date. These estimates are based on judgements by management which judgements are supported by experience of similar transactions and, in some cases, reports from independent experts. Any events occurring after the reporting date should also be considered and included, if applicable.
- The range of outcomes and level of uncertainty should be considered in calculating the best estimate of a provision. The department should therefore consider all possible outcomes in calculating the best estimate. A risk adjustment may be applied in certain cases to ensure that the liability is appropriately allowed for.
- Future events that could impact a provision should be allowed for in the calculation of the best estimate, assuming that sufficient objective evidence is available.
- The appropriate technique used to calculate the best estimate depends on the nature of the provision or contingent liabilities. The following approaches are suggested by the GRAP 19 Guidelines:
 - Single item: For a single item, the most likely outcome should be considered the best estimate.
 - Continuous range: In cases where a continuous range of possible outcomes are equally likely, the midpoint of the range is used.
 - Large population: In cases where a large number of outcomes are possible, the obligation is estimated by calculating an "expected value" - weighting all outcomes by their respective probabilities.

3.5.12 The GRAP 19^[30] states that a provision should be discounted if the time value of money is material for the specific provision. The discount rate should be pre-tax and should consider both the "current market assessment of the time value of money" and "risk specifically associated with the liability".

3.6 Exceptions

3.6.1 GRAP 19 is not applicable to the following transactions^[29]:

- Social benefits provided in non-exchange transactions, such as the delivery of health, education, housing, transport, and other social services.
- Executory contracts
- Transactions covered by other standards, including:
 - Financial Instruments: GRAP 104
 - Construction Contracts: GRAP 11
 - Leases (except leases that are onerous): GRAP 13
 - Employee Benefits: GRAP 25
 - Transfer of Functions Between Entities Under Common Control: GRAP 106
 - Insurance Contracts: IFRS 4 (*to be replaced by IFRS 17*)
 - Income Taxes: IAS 12

- 3.6.2 It is important to take note of these exceptions, specifically because some entities report liabilities in their statement of financial position under a certain framework (e.g., the Road Accident Fund under GRAP) which are seen as contingent liabilities under National Treasury's CFS. Our research includes the contingent liabilities under National Treasury's CFS even though they are formally recognised as liabilities under the specific entity's financial statements.

3.7 Limitations

- 3.7.1 In some cases, where liabilities are immaterial in the context of this working paper, they were excluded in the analyses. For example, guarantees relating to office space for the RAF were not included as they constitute less than 0.001% of the RAF's liability.

3.8 Contingent liabilities in the context of insurance

- 3.8.1 For purposes of this working paper, contingent liabilities can be split into liabilities that are insurance-like (such as the Road Accident Fund) and other liabilities (such as loan guarantees to SOEs). This working paper largely focuses on insurance-like liabilities.
- 3.8.2 At its core, insurance is a promise to compensate the insured if a certain event occurs, in exchange for a premium. In many cases, premiums are paid for an extended period before the event occurs and a claim is made against the insurer. To ensure that there are sufficient funds to pay claims, an insurer needs to build up a fund over time. This amount (fund) is known as a technical reserve or technical provision. A technical reserve is an amount that is estimated to meet all liabilities from both expired (past) and unexpired (future) risks.
- 3.8.3 A technical reserve is usually calculated for a specific purpose and is generally communicated as a point-estimate. These point-estimates are calculated using specific methodologies, data, and assumptions.
- 3.8.4 Reserves are estimated for various purposes, including regulatory returns, disclosures in financial statements, valuations, and taxation. The purpose for which a reserve is calculated is material in determining the assumptions and the methodology used. For certain purposes (such as regulatory returns), the methodology and assumptions used are largely prescribed by regulation. For other purposes, such as public disclosures under IFRS, the actuary should apply judgement and disclose the methodology and assumptions that will provide the necessary insight for the user of the financial statements.
- 3.8.5 Many of the approaches used for calculating reserves for the SOEs, listed in Section 5 below, are standard actuarial techniques that are also applied in the private sector. Techniques such as the Bornheutter Fergusson method for run-off estimates are often used in the private sector for the same purpose.

4. The South African Government's provisions and contingent liabilities

4.1 Overview

4.1.1 National Treasury is mandated to prepare and table CFS for public sector entities, including national departments, state-owned entities, constitutional institutions and more^[4]. As noted in Section 3.3 above, separate sets of financial statements are prepared for government departments (MCS) and other public sector entities (GRAP). It is challenging to obtain an overall position of the State's finances as the two financial statements are based on different accounting policies. Table 4.1 below provides a few metrics of interest from the CFS. Care should be taken when making these comparisons as the MCS-based financial statements exclude many accrual-based provisions.

Table 4.1: Selected financials from the CFS of the South African Government as at 31 March 2020

Metric	Public Entities (GRAP)	Government Departments (MCS)
Revenue	R720 bn	R1.35 tn
Expenses	R738 bn	R1.73 tn
Liabilities	R2.73 tn	R3.59 tn ²
Contingent liabilities	R549 bn	R463 tn
Contingent liabilities as percentage of recognised liabilities	20%	13%
Liabilities + contingent liabilities	R3.28 tn	R4.06 tn

4.1.2 As at 31 March 2020, liabilities for 'public entities' totalled R2.73 trillion as shown in the public entities' statement of financial position. This is close to four times the total revenue (R720 billion) collected. When compared to South Africa's Gross Domestic Product (GDP), these liabilities constitute 53% of GDP (R5.1 trillion).

4.1.3 As mentioned in Section 2, the liabilities formally recognised in the CFS do not include contingent liabilities. Contingent liabilities are included in the notes to the CFS. Table 11 in the Statistical Annexure of National Treasury's Budget Review^[5] provides an overview of the contingent liabilities of the South African State. The total contingent liability was recorded as R1.06 trillion³ as at 31 March 2020^[5]. This is equivalent to 20% of GDP.

4.1.4 Contingent liabilities of Public Entities comprised close to 20% of its recognised liabilities whereas contingent liabilities of Government Departments comprised close to 13% of its recognised liabilities. Considering the above, it is evident that contingent

² This number excludes amounts that would have been included if financial statements were compiled under the accrual principle. Some of these excluded amounts represent employee benefits, post-retirement benefits and provisions. For purposes of this working paper, we have not attempted to adjust the MCS figures to represent an accrual basis.

³ This number differs slightly from the sum of contingent liabilities in Table 4.1. It was assumed that this difference arises due to differences in reporting and consolidation between the CFS and the Budget Review.

liabilities are significant in the context of the South African public sector entities' balance sheets.

4.2 Contingents and provisions

4.2.1 The contingent liabilities recorded in National Treasury's Budget Review^[5] are categorised as follows:

- Guarantees: R584 billion
- Other contingent liabilities: R472 billion

4.2.2 The guarantees section is dominated by Eskom (R327 billion) and Independent Power Producers (IPPs) (R161 billion). Together Eskom and the IPPs constitute 84% of the guarantees. The remainder are split between 26 other categories or SOEs of which the notable guarantees include the South African National Roads Agency (R39 billion) and South African Airways (R17 billion).

4.2.3 The "other contingent liabilities" section is split as follows:

- Claims against government departments: R41 billion
- Export Credit Insurance Corporation of SA Limited: R20 billion
- Post-retirement medical assistance: R70 billion
- Road Accident Fund: R332 billion
- Other: R8 billion

4.2.4 In order to understand the liabilities underlying the contingent liabilities, Section 5 delves into the liabilities of the following five South African SOEs:

- Road Accident Fund (RAF)
- Unemployment Insurance Fund (UIF)
- Compensation Fund (CF)
- National Home Builders Registration Council (NHBRC)
- South African Special Risks Insurance Association (SASRIA)

4.2.5 Other entities that could be considered for future research include:

- The Electricity Supply Commission (better known as Eskom)
- The Department of Health (DOH)
- The Department of Education (DOE)
- Passenger Rail Agency of South Africa (PRASA)
- The South African Police Services (SAPS)
- National Student Financial Aid Scheme (NSFAS)
- South African Revenue Services (SARS)
- The Export Credit Insurance Corporation of South Africa
- South African National Parks (SANParks)
- The Estate Agents Affairs Board (EAAB)
- Detonics, Numerous, Electronics (DENEL)
- The Development Bank of Southern Africa
- The Land and Agricultural Bank of South Africa

- The South African Broadcasting Corporation (SABC)
- SA Forestry Company Limited
- South African Airways (SAA)
- Telkom
- Transnet

4.2.6 It should be noted that although this working paper focuses on insurance-like liabilities, the risk and potential impact of other contingent liabilities (such as guarantees) should not be underestimated. Currently, guarantees are included within the scope of GRAP 19. However, the ASB has revised its Financial Instruments standard (GRAP 104) and once implemented, will include guarantees within the scope of GRAP 104. These changes may increase Government liabilities as guarantees currently disclosed in the notes as contingent liabilities would be recognised in the statement of financial position as financial liabilities. The revision of GRAP 104 is planned to become effective in 2025. Future research could focus on GRAP 104 and highlight the risks related to utilities (such as Eskom) that are of national importance.

5. Detailed analysis of SOEs

5.1 Overview

5.1.1 Section 4 provided a high-level overview of contingent liabilities from the Government's perspective. To understand the nature of these contingent liabilities, it is necessary to consider the underlying liabilities in the various SOEs. In this section, we consider the liabilities on the financial statements of five SOEs that provide insurance-like benefits.

5.1.2 The following will be considered for each entity:

- Its purpose
- Methodologies used to estimate its various liabilities
- Examples of risk management tools and approaches used

5.2 The Road Accident Fund (RAF)

5.2.1 **Purpose:** "Our core business is to assist road victims by receiving, processing and paying claims effectively."^[31]

5.2.2 The RAF compensates individuals that are injured, or the dependants of individuals that are killed, in motor vehicle accidents. The RAF operates according to a fault-based system whereby a negligent driver needs to be party to the accident for a claim to be filed against the RAF. The compensation is categorised into what is known as heads of damages. In the 2019 RAF Annual Report^[31], the heads of damages were categorised as follows:

- General damages
- Loss of earnings
- Loss of support
- Medical compensation
- Funeral costs
- The RAF's legal and other costs
- Claimants' legal and other costs

5.2.3 All heads of damages other than future medical expenses are typically compensated by means of a lump-sum payment. Medical expenses are compensated through what is known as an undertaking (on a reimbursement basis). The RAF does not provide any cover for property damage – individuals typically insure property damage separately with a private commercial insurer.

Table 5.1: List of RAF Liabilities as at 31 March 2019^[31]

Liability	Description	Amount (2019)	Disclosure
Liability for outstanding claims recorded (OCR)	Claims reported to the RAF, but uncertainty exists relating to timing and amount.	R173 bn	Note 12 (Claims Liabilities)
Liability for claims incurred but not yet reported (IBNR)	Claims for accidents that had occurred, but that have not yet been reported.	R87 bn	
Claims requested for payment but not paid at year-end	Claims that must still be paid (payables).	R11 bn	
Contingent liability ⁴	Commercial and labour-related litigious disputes	R88 m	Note 33 (Other Contingencies)

5.2.4 Methodology

OCR and IBNR

- 5.2.5 In the 2019 RAF Annual Report^[31], the methodology for estimating outstanding claims recorded (OCR) and claims incurred but not yet reported (IBNR) are detailed under section 1.17 (Claims Payments) as well as under Note 12 (Claims Liabilities). Claims are split into various groups, taking into account the heads of damages. Nil claims, small claims, injury claims and death claims are separated and split into further subgroups.
- 5.2.6 The splitting of these claims into appropriate groups aims to achieve greater homogeneity and improve accuracy in the estimation of the specific group's liability. This is standard practice when estimating reserves in short-term insurance and is highlighted in paragraph 3.6 of the Actuarial Society of South Africa's (ASSA) Advisory Practice Note (APN) 401 in respect of valuation of technical provisions for non-life insurers.^[32]
- 5.2.7 In addition to the above groupings, claims are further split between Personal claims, Undertakings and Supplier claims. Section 17 of the RAF Act 56 of 1996^[33] details the different forms of compensation payable by the fund. Section 17(5) of the RAF Act states that a third party may claim compensation if they have provided accommodation, treatment, or rendered a service. These are known as Supplier claims. Undertakings and Personal claims relate to the remainder of compensation and represent the greater part of the liability.
- 5.2.8 Different methodologies are used for different subsets of claim types. The liability calculation methodology for undertakings is formula-driven and based on high-level averages as follows:

$$\text{Liability} = \text{Number of undertakings} \times \text{Average future annual payments} \\ \times \text{Life expectancy of recipients}$$

⁴ "Other contingencies" were not significant relative to the other liabilities listed above and were not investigated in further detail.

- 5.2.9 OCR is determined using previous claims experience and claims settlement patterns. Estimates of claim payments on open claims, closed claims (that could be reopened), as well as external claims handling expenses, are taken into account.
- 5.2.10 IBNR is calculated using a combination of approaches. An adjusted Bornheutter Fergusson method (also known as the chain-ladder BF method) is used to estimate the number of claims.
- 5.2.11 The chain-ladder BF method is a well-known actuarial reserving technique for calculating IBNR reserves. The average claim amount on outstanding claims is estimated based on the assumed proportion of claims paid in each group (the 2019 Annual RAF report^[31] notes that larger claims have taken longer to finalise than smaller claims).
- 5.2.12 Claims inflation is assumed to be equivalent to the Consumer Price Index (CPI) plus 2% (where CPI is assumed to be 6%). Both IBNR and OCR are discounted at CPI plus 2%.

Claims requested for payment but not paid at year-end

- 5.2.13 Amortised cost measurement is used for claims requested for payment but not paid at year-end. It is assumed that these claims would be paid within 12 months and are not discounted.
- 5.2.14 **Examples of risk management tools used**
- 5.2.15 The PFMA^[21] requires that public entities have risk management and financial control systems in place. The RAF has a risk management governance framework overseen by the RAF's Risk Management Committee. The RAF identifies strategic risks, estimates their potential impact and likelihood, and takes action to mitigate the potential impact of each of these risks^[31].
- 5.2.16 Some of the ways in which the RAF manages its risks include risk management committees, risk assessments, risk monitoring, risk reporting, scenario analysis, reinsurance, training, and communication with stakeholders^[31].

5.3 Unemployment Insurance Fund (UIF)

- 5.3.1 **Purpose:** "The Fund provides unemployment, illness, maternity, adoption and dependant benefits as prescribed by the Unemployment Insurance Act [36 of 2001]." Benefits are only available to employees if contributions have been made to the UIF during employment^[34].
- 5.3.2 The UIF applies GRAP. Under section 8 of the Auditor-General's report in the UIF's AFS^[35], it was stated that the UIF did not account for its liabilities in accordance with GRAP 1 (Presentation of financial statements). Both the IBNR as well as the "reported but not approved" claims were reported as contingent liabilities whereas these items should have been disclosed as liabilities in the statement of financial position. The auditor-general further noted that this was "contrary to the update from the Accounting Standards Board to entities that undertake insurance type activities." This reference ties into the discussions in Sections 3.2 and 3.5 above.

Table 5.2: List of UIF Liabilities as at 31 March 2020^[35]

Liability	Description	Amount (2020)	Disclosure
Benefits payable – outstanding claims liability	This represents the Approved But Not yet fully Paid (ABNP) claims.	R9 bn	Statement of financial position
Unexpired Premium Reserve (UPR)	Premium income already received and held to pay for future benefits.	R44.7 bn	Note 16 (accumulated surplus and reserves)
Unexpired Risk Reserve (URR)	Premium inadequacy reserves relating to future claims.	R27.3 bn	
Additional Unexpired Risk Reserve (AURR)	Premium inadequacy reserves on future unearned premiums.	R9 bn	
Incurring But Not Approved Claims (IBNA)	IBNA: the sum of Incurred But Not Reported Claims (IBNR) and Reported But Not Approved Claims (RBNA) IBNR: "incident occurred, but the claim was not received by the Fund to be paid to any beneficiary" RBNA: "claim was received by the Fund, but not yet approved for payment"	IBNA: R7.6 bn (IBNR + RBNA) IBNR: R4.6 bn RBNA: R3 bn	

- 5.3.3 The UIF's total technical reserves were R88.6 billion as at 31 March 2020. These reserves were not recognised as liabilities in the statement of financial position. Note 39 of the AFS shows the total insurance risk liability to be R97.6 billion (R88.6 billion of technical reserves plus payables of R9 billion). To reiterate, less than 10% of the total insurance risk liability was formally recognised in the UIF's statement of financial position.

5.3.4 Methodology

- 5.3.5 In order to estimate the technical reserves of the UIF, a chain-ladder BF methodology was used. The AFS notes that claim development patterns were investigated over

the period from 2012 until 2020 and that the run-off of pattern of claims remained stable^[35].

- 5.3.6 Claims handling expenses (CHE) were explicitly included in both the premium reserve and the incurred but not approved (IBNA) claims. Both CHE and IBNA were discounted. The claims inflation rate was assumed equal to the discount rate and by implication a net discount rate of 0% was used^[35].

5.3.7 **Further discussion**

- 5.3.8 After considering the comparison between different social security funds in National Treasury's 2021 Budget Review^[5], the following was noted:

- The UIF is listed as having total liabilities of R9.8 billion in the 2019/2020 year and R102.5 billion in the 2020/2021 year. It was unclear whether this 10-fold increase reflects the impact of COVID-19 on the UIF's liabilities, or whether part of the contingent liability was formally recognised in the statement of financial position in the later years.
- The assets and liabilities of the UIF, CF and RAF were compared on page 99 of the Budget Review^[5]. Without the appropriate context, this comparison could be misinterpreted. For instance, it was stated that the RAF represented 86% of the liabilities. However, this comparison is potentially misleading as it only includes the liability of R9.8 billion from the UIF (the UIF would constitute 2.5% of the liability on this basis). If adjusted to reflect the full insurance liability of the UIF, the RAF would represent 70% of the total liability (previously 86%) and the UIF would represent 21% (previously 2.5%).

- 5.3.9 It is understood that the Government is not the explicit guarantor to the UIF. The Minister of Employment and Labour can however request financial support for the UIF, but this does not compel the Minister of Finance to provide such assistance^[4]. It was stated in Note 40 of the UIF's AFS^[35] that:

Where the Fund reflects a financial position that is insufficient or not increasing at a sufficient rate to meet payments for benefits that may be reasonably anticipated, the Director-General (Accounting Officer of the Fund) must report and make recommendations to the Minister of Employment and Labour.

- 5.3.10 Projections made by the Fund's actuaries indicate a significant decline in the solvency ratio due to COVID-19 lay-offs. This raises the question as to whether the full UIF liability shortfall can be considered a contingent liability from the State's perspective given the public policy nature of the Temporary Employer/Employee Relief Scheme (TERS).

5.3.11 **Examples of risk management tools used**

- 5.3.12 The UIF Act limits the maximum unemployment benefit to 238 days in a four-year period^[35]. Therefore, there is a prescribed maximum benefit for each contributor.

- 5.3.13 The UIF manages its insurance risk by following^[35]:

- strict claim review processes with externally verified controls;
- regular detailed reviews of claim handling procedures; and
- ongoing investigations into fraudulent claims.

- 5.3.14 The UIF manages its financial risk through Asset and Liability Modelling studies and appropriate diversification in its investment portfolio.
- 5.3.15 The UIF manages its operational risk through "a rigorous control framework and by monitoring and responding to potential risk".
- 5.3.16 The UIF manages its model/valuation risk is managed through model audits and benchmarking to external models.

5.4 Compensation Fund (CF)

5.4.1 **Purpose:** "... to provide for compensation for disablement caused by occupational injuries or diseases sustained or contracted by employees in the course of their employment, or for death resulting from such injuries or diseases."^[36]

5.4.2 The benefits provided by the CF are summarised as follows^[37]:

- Temporary Total Disablement (TTD): loss of income for a period of less than 24 months
- Permanent Disablement (PD):
 - Lump sum payable: If PD is assessed as between 1% and 30%
 - Pension payable for life: If PD is assessed above 30%
- Medical Costs: payment of medical costs for a maximum period of 24 months from date of injury or diagnosis of disease
- Death benefits:
 - Surviving spouse: lump sum plus 40% pension for life
 - Children: remaining 60% of pension is spread amongst surviving children
 - Funeral costs

5.4.3 The CF is based on a no-fault principle and pays out compensation according to specific formulae. There are also various limits and rules for each benefit. The compensation for occupational injuries is furthermore split along different industries. For instance, Federated Employers Mutual (FEM) compensates those injured in the construction industry, Rand Mutual Assurance (RMA) compensates those injured in the mining industry whereas the CF covers the remainder of the industries. This working paper focuses only on CF and does not delve into FEM or RMA (apart from their inclusion in the financial statements of the CF)^[37].

Table 5.3: List of CF Liabilities as at 31 March 2020^[36]

Liability	Description	Amount (2020)	Disclosure
Provisions for outstanding claims	Comprised of: • Temporary total Disablement (TTD) • Permanent Disablement (lump sum) (PD) • Medical costs • Death benefits (funeral)	R13.9 bn	Statement of financial position
Capitalised value of pensions	Comprised of: • Permanent Disablement (pension) • Death benefits (pension)	R25.2 bn	Statement of financial position
Contingent liabilities	- Mutual associations or exempted employers that fail to meet their liabilities (R182 m) - Court motions and summons (R39 m) - SARS dispute (R2.3 m)	R223.5 m	Note 29 (Contingents)

5.4.4 **Methodology**^[36]

Overview

- 5.4.5 Non-pension benefits are referred to as benefits that were valued with methods other than a discounted cashflow approach, for example, triangulation or exposure-based methods.
- 5.4.6 For both non-pension and pension valuations, compulsory margins were based on ASSA's Standard of Actuarial Practice (SAP) 104 guidelines^[38].

Non-pension benefits

- 5.4.7 The liability for each of the non-pension benefits was estimated separately. An adjusted version of the BF triangulation method was used for claims up until September 2019 and an exposure-based method was used to estimate the remaining claims for the months of October 2019 to March 2020.
- 5.4.8 A tail factor was applied to the reserves to allow for claims in respect of events that occurred more than 10 years ago.

Pension-based benefits

- 5.4.9 A discounted cashflow (expected present value) approach was used to calculate the reserves for the pension-based benefits.
- 5.4.10 A data reserve of 25% of the pension-based benefits was raised due to "data discrepancies which could not be verified". In addition to the data reserve, an "additional contingency reserve" was set to "cater for minimum and maximum pensions as per revised schedule 4 of the COID Act".

5.4.11 **Further discussion**

- 5.4.12 The Auditor-General provided commentary on measurements and controls in the "Report of the Auditor-General to Parliament on the Compensation Fund" which reads as follows:
- "Management did not implement effective systems of internal control to maintain proper accounting records and information relating to the movement in the provision for outstanding claims resulting from payments and the measurement of estimates in accordance with GRAP 19, Provisions, contingent liabilities and contingent assets."^[36]
 - "The public entity did not have a proper system of record management that provided for the maintenance of information to support revenue management, expenditure management, as well as financial and performance reporting. This included information relating to supporting documentation for prior year misstatements, investments, consolidations, revenue, benefits, irregular expenditure, fruitless and wasteful expenditure, receivables, payables, contingent liabilities and performance information."^[36]

5.4.13 **Examples of risk management tools used**

- 5.4.14 The CF has a risk management governance structure which they depict as a pyramid, starting at the base with each manager in the fund and reaching the Director-General at the apex of the pyramid. The CF has a Risk Management Unit which is responsible for "facilitating the implementation of risk management, compliance and business continuity management policies". The CF has a Risk Management Unit which is responsible for "facilitating the implementation of risk management, compliance and business continuity management policies". In addition, the CF has a Risk and Control Assurance Forum that "adopts a collaborative approach which involves management and assurance providers"^[36].
- 5.4.15 The CF monitors the following principal risks in their risk management governance structure^[36]:
1. Strategic risk
 2. Core Business risk
 3. Operational risk
 4. Technology risk
 5. Investment and Actuarial risk
 6. Regulatory, Compliance and Legal risk
- 5.4.16 The CF's financial risk is managed through appropriate asset allocation, diversification, and sensitivity testing^[36].

5.5 National Home Builders Registration Council (NHBRC)

- 5.5.1 **Purpose:** The NHBRC is mandated to protect the interests of housing consumers and to regulate the homebuilding industry. The NHBRC operates a warranty fund that compensates homeowners for "the rectification of defects which arose as a result of the failure by home builders to honour their obligations to rectify defects"^[39].
- 5.5.2 The Housing Consumers Protection Measures Act (95 of 1998) requires that a home builder submit documents and pay enrolment fees to the NHBRC prior to construction of a home.

Table 5.4: List of NHBRC Liabilities as at 31 March 2020^[39]

Liability	Description	Amount (2020)	Disclosure
Outstanding claims provision (OCP)	The sum of Notified Outstanding Claims Provision (claims reported but not settled) and Incurred But Not Reported Claims (IBNR).	R29 m	Statement of financial position
Unearned premium provision (UPP)	Premium income already received and held for future periods of cover.	R1.2 bn	
Unexpired risk provision (URP)	Claims, expenses, and deferred acquisition costs that exceed the UPP with respect to premiums already received.	R341 m	
Claims for damages and cost	Contingent liabilities	R528 m	Note 26 (Contingent Liabilities)
Contractual payments		R12 m	
Liability of the warranty fund		R2 m	

5.5.3 Methodology

Overview

- 5.5.4 The NHBRC's 2020 AFS noted that the APN 401 valuation methodology recommendations were followed in preparing their disclosures^[32].
- 5.5.5 The Department of Human Settlements provides housing subsidies to first-time homeowners subject to certain requirements^[40]. It seemed that the underlying assumptions for reserving were determined separately for homes qualifying under the subsidy as opposed to those not linked to the subsidy (referred to as "non-subsidy").

OCP

- 5.5.6 A BF triangulation method was used to estimate the outstanding claims provision (OCP) "at a 99.5% sufficiency level". The run-off triangle was based on the number of complaints. Note 9 of the NHBRC annual report^[39] lists the key assumptions used.

An interesting point to note here is the significant increase (16%) in the non-subsidy average claim cost between the 2019 and 2020 financial years.

UPP

- 5.5.7 The unearned premium provision (UPP) was estimated based on what is referred to as the "enrolment fee earnings curve". Occupation (start of cover) is assumed to be two quarters following enrolment date. Initial costs are also deducted from the UPP.

Contingent liabilities

- 5.5.8 Significant contingent liabilities were disclosed under Note 26 of the AFS. The majority of the contingent liabilities were described as "Claims for damages and cost". These are assumed to be outstanding litigation against the NHBRC, however limited information was available in the NHBRC's AFS relating to these matters.

5.5.9 Examples of risk management tools used

- 5.5.10 The NHBRC has adopted an "integrated risk-based approach" to risk management. It is the responsibility of the Chief Risk Officer of the NHBRC to provide "specialist expertise to assist in embedding risk management into the NHBRC". The NHBRC's Audit and Risk Committee monitors strategic risks through a strategic risk register. Once the strategic risk register is compiled, management uses this register to compile an operational risk register. The NHBRC implemented its risk-based approach grounded in the following principles^[39]:

- Promoting a positive risk culture
- Making decisions that account for both real and potential risks
- Embedding risk management into daily operations
- Taking the micro and macro environment into account when considering risk management
- Taking accountability for risk management
- Balancing risk and control

- 5.5.11 As per their 2020 annual report^[39], the NHBRC was implementing automated auditing software allowing them to monitor compliance and risk activities in a "near real-time manner". In addition, the NHBRC was looking at using more advanced data analytics tools to be able to generate "frequent reports that will provide better insight and foresight and trends".

5.6 South African Special Risks Insurance Association (SASRIA)

5.6.1 **Purpose:** "Sasria is the only short-term insurer in South Africa that provides cover against special risks such as civil commotion, public disorder, strikes, riots and terrorism."^[41] SASRIA is wholly owned by the South African Government.

Table 5.5: List of SASRIA Liabilities as at 31 March 2020^[41]

Liability*	Description	Amount (2020)	Disclosure
Claims reported and loss adjustment expenses (OCR)	"A provision for claims resulting from loss events that occurred prior to year-end that have not been paid by the insurer by the end of the accounting period."	R1.1 bn	Statement of financial position
Claims incurred but not yet reported (IBNR)	"Claims resulting from loss events that occurred prior to year-end, for which the insurer has not yet received notices or reports of loss by the end of the accounting period."	R0.1 bn	
Unearned premium provision (UPP also known as UPR)	"The portion of premium attributable to the periods of risk that relate to subsequent accounting periods, and which are carried forward to such subsequent accounting periods."	R0.5 bn	
Unexpired risk provision (URP also known as URR)	"... a provision for losses arising from liability adequacy tests..."	R0.03 bn	

* The above liabilities are shown as a gross of reinsurance recoveries. Reinsurance receivables are typically shown as an asset in the statement of financial position rather than netted off against the liabilities.

5.6.2 Note 29 of SASRIA's AFS^[41] references contingent liabilities in the form of litigation but state that they do not "believe that such litigation will have a material effect on its profit or loss and the financial condition at year-end".

5.6.3 Civil unrest and accompanying riots in July 2021 resulted in significant claims against SASRIA. An article on SASRIA's website notes that 14 051 claims were submitted with an estimated total claim amount of R32 billion^[42]. For context, SASRIA incurred close to R1 billion in gross claims in its 2020 financial year^[41]. The interested reader could study SASRIA's 2021 AFS to determine the impact of these claims (the 2021 AFS were unavailable at the time of writing this paper).

5.6.4 Methodology

OCR

5.6.5 The Outstanding Claims Reserve (OCR) is calculated using standardised claims assessment policies and procedures. It is understood that the Incurred But Not Enough Reported (IBNER) reserve is included in the OCR estimate.

IBNR

- 5.6.6 Claims incurred but not yet reported (IBNR) is calculated separately for each line of business. A combination of the basic chain-ladder, chain-ladder BF, and average cost per claim methods were used to calculate the IBNR. Stochastic approaches are used to model an IBNR distribution; the upper quartile (75th percentile) of this distribution is used as a point estimate for reserving purposes.

UPR

- 5.6.7 Unearned premium provision (UPR) is calculated on a straight-line basis using the 365th method. With this method the outstanding risk is estimated based on the number of calendar days over which the risk was covered during the year.

URR

- 5.6.8 Unexpired risk provision (URR) is calculated using the liability adequacy test based on best estimates of future cashflows and claims handling and administration expenses whilst allowing for investment income on assets backing the associated liabilities.

5.6.9 **Examples of risk management tools used^[41]**

- SASRIA has an internal Risk Committee that assumes oversight responsibility for overall risk management as set out in its Enterprise Risk Management Framework. This framework consists of the following components:
 - Business platform
 - Business management
 - Business strategy
- Both solvency capital required (SCR) as well as economic capital required (ECR) are monitored. SASRIA aims to hold adequate capital for a 1-in-200-year event and targets an economic capital coverage ratio of between 180% and 230%.
- SASRIA uses the following two "earnings at risk" measures to monitor performance:
 - Difference between actual Earnings Before Interest, Depreciation and Amortisation (EBITDA) and budgeted EBITDA
 - Probability of underwriting loss
- SASRIA aims for the difference between actual EBITDA and budgeted EBITDA to be less than 15% and the probability of an underwriting loss to be less than 20%. Both these limits were breached in the 2020 financial year.
- An own risk and solvency assessment (ORSA) is used to identify appropriate management actions and make decisions based on certain trigger events. Stress testing and scenario analysis are done as part of the ORSA process. The most critical risks were identified in 2020 and classified under the following categories:
 - Underwriting risk
 - Operational risk
 - Strategic risk
 - Market risk
- Risk is retained based on SASRIA's risk appetite, and any additional risk is transferred through reinsurance coverage. Reinsurance is spread between local

and international markets and coverage is provided by five different reinsurers, including Lloyd's of London.

- Underwriting risk is managed by setting suitable underwriting strategies, developing appropriate pricing, ensuring adequate reinsurance coverage, and proactively managing claims. SASRIA offers cover on a non-refusable basis and covers risks up to R500 million without any direct underwriting. SASRIA directly underwrites risks above R500 million up to a maximum cover amount of R1.5 billion.
- Events that are likely to result in claims are monitored daily.
- OCR is monitored monthly with the purpose of identifying matters likely to become litigious.
- Liability adequacy testing is done annually.
- In-house claims department processes are monitored and reviewed on an annual basis.
- Fluctuations in premium income and reversals are monitored monthly.
- Premium income and reversals are compared over time to detect trends and exceptions.

6. The risk management process

6.1 Enterprise risk management

- 6.1.1 Risk management is at the heart of managing contingent liabilities. Managing enterprise-wide risk and the interplay between these risks is often seen as the domain of those in the Enterprise Risk Management (ERM) space.
- 6.1.2 The concept of ERM has been increasing in popularity over the last few years. The actuarial profession has embraced the role that actuaries can play in this area and the actuarial profession responded by introducing the qualification of Certified Enterprise Risk Actuary (CERA). Between 2012 and 2021, the number of CERAs have increased from 20 to 212⁵.
- 6.1.3 Robust ERM is crucial for SOEs. In 2015, the Organisation for Economic Co-operation and Development (OECD) published Guidelines on Corporate Governance of State-Owned Enterprises^[43]. In this document the OECD provides recommendations on how to ensure that SOEs operate in an efficient, transparent, and accountable way. Although not a formal member of the OECD, South Africa participated in discussions when this document was formulated. The following points from the document are worth reiterating:
- Passive ownership vs excessive state intervention: The OECD argues that governments should provide the management of SOEs with the appropriate level of autonomy and not fall into the traps of passive ownership or excessive intervention.
 - In some cases, SOEs face interference due to political motivations. There should be political accountability, but an SOE should not be used as a political tool.
 - Many SOEs have protection against takeover and bankruptcy. This protection is usually not explicitly provided in the private sector. The fear of takeover or bankruptcy is an effective tool for policing management in private entities. This is not typically recognised in SOEs.
 - Some SOEs must strive to achieve a dual purpose, such as maintaining economic activity whilst fulfilling a public policy role. The cost component linked to fulfilling a public policy role should be clearly disclosed and directly funded by the state.
 - Three principles that are fundamental to efficient decision-making and good corporate governance are: transparency, evaluation, and policy coherence.
 - SOEs should not be provided with undue advantage over private sector competitors, should not be exempt from general laws, taxes, and regulations, and should not obtain any unfair advantage over private sector operators.
- 6.1.4 The OECD document listed above highlights the complexity in managing SOEs. SOEs often have an intricate web of agents responsible for their management and strategic direction. In South Africa, these agents include the management and board of directors of the SOE, the department responsible for the SOE, the Minister leading the respective department, National Treasury, the National Council of Provinces, the broader Presidency, and Parliament.

⁵ Based on feedback from the Actuarial Society of South Africa.

- 6.1.5 When considering SOEs in the context of contingent liabilities, it is useful to consider a subset of the agents listed above. The following agents are typically involved from a risk management perspective:
1. The management and board of directors of the SOE
 2. The Minister of the department responsible for managing the SOE
 3. National Treasury
- 6.1.6 Each party listed above might have a different and valuable perspective of the range of risks faced. These parties should together consider the various risks faced by each SOE and take the necessary actions to manage those risks to ensure the long-term sustainability of the respective SOE. This would entail following a comprehensive risk management process for robust risk identification, measurement, management, and monitoring. In this regard, section 51(1)(a)(i) of the PFMA requires that "a public entity has and maintains effective, efficient and transparent systems of financial and risk management and internal control".
- 6.1.7 In their 2018 discussion paper^[44], Bachmair and Bogoev modelled the impact of contingent liabilities on the South African balance sheet based on certain trigger events. They concluded that monitoring and managing SOEs are the keys to ensuring long-term sustainability. The steps that can be taken to improve the sustainability of these SOEs include corporate governance reform, financial management reform, as well as regulatory and sector reforms.

6.2 Risk management frameworks

- 6.2.1 A risk management framework is an integral tool in the larger ERM process. The OAG has developed a Public Sector Risk Management Framework with the intention of supporting "Institutions to improve and sustain their performance by enhancing their systems of risk management to protect against adverse outcomes and optimise opportunities"^[45]. Many industry risk management frameworks have been developed, including the Casualty Actuarial Society's ERM Framework, the COSO ERM Integrated Framework and the ISO 31000 ERM Framework. For example, the ISO 31000 Risk Management Guidelines^[46] can be outlined in terms of the following components:
1. Principles: This component sets out the overarching purpose of risk management. The high-level principles are value creation and protection. These are supplemented by eight principles that further expand on these high-level principles. Throughout the risk management process, any discussion can be linked to the specific principles that have been decided in advance.
 2. Framework: This is a conceptual idea about the activities where risk management can be integrated and used.
 3. Process: This is the "systematic application of policies, procedures and practices to the activities of communicating and consulting, establishing the context and assessing, treating, monitoring, reviewing, recording, and reporting risk."
- 6.2.2 Although the principles behind risk management are important, the next section will focus on the process of risk management.

6.3 Risk management process

6.3.1 A risk management process is integral to an overall risk management framework. Lewis and Mody (1997)^[47] classified six functions that an integrated risk management process should perform:

1. Identify an SOE's risk exposures
2. Measure or quantify the risk exposures
3. Assess the SOE's risk appetite (or tolerance for risk-bearing)
4. Make strategic decisions on capital allocation
5. Implement appropriate mitigation and control measures to prevent unintended losses
6. Monitor and reassess risk exposure continually

6.3.2 The integrated risk management process highlighted above is reminiscent of a conceptual framework known to most actuaries as the Actuarial Control Cycle (ACC). In the book *Understanding Actuarial Management*^[48], the ACC is defined as a "simple problem-solving algorithm". The ACC is summarised in Figure 6.1 below:

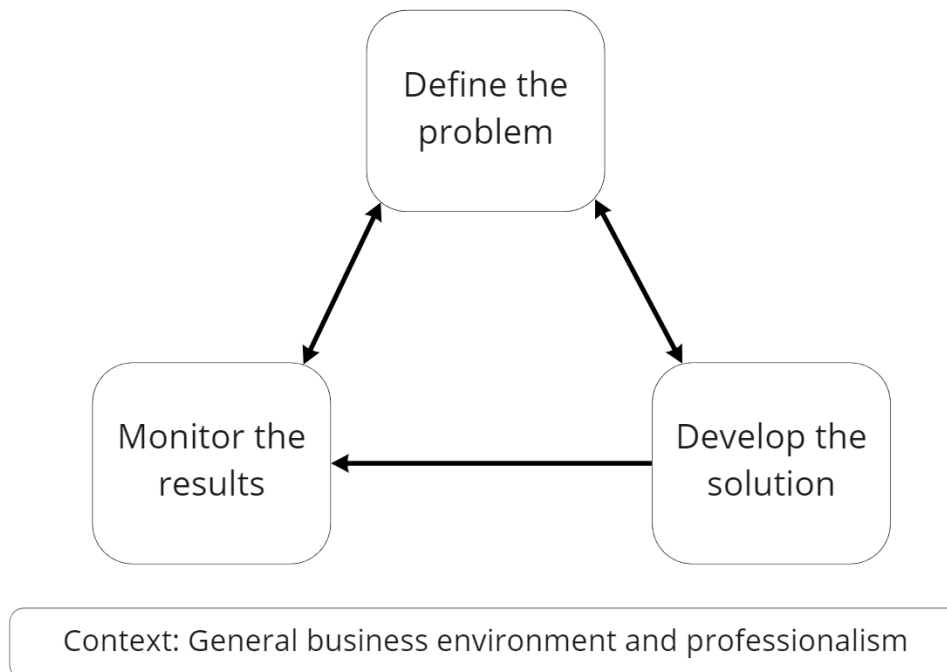


Figure 6.1: The Actuarial Control Cycle^[48]

6.3.3 Most problem-solving approaches should start by first identifying the underlying problem to be solved. In the case of managing contingent liabilities, one should start by identifying various risks faced by SOEs. An ERM public policy practice note^[49] published by the American Academy of Actuaries provides some ways of thinking about risk identification:

- Risk management should be seen as a shared responsibility in an organisation.
- Risk committees and subcommittees should have clearly defined responsibilities.
- A "common risk language" should be used to obtain an enterprise-wide perspective of the risks faced by an organisation.

- A risk taxonomy can be developed where sub-risks are associated with broad risk categories. With an appropriate risk framework, these sub-risks can be further extended to achieve an appropriate level of granularity.
- Characteristics of a risk identification process should include being:
 - comprehensive, so that all significant risks are included;
 - inclusive, where the risk identification process is organisation-wide with involvement from all risk-taking functions;
 - efficient with time and effort that are spent on material risks;
 - consistent, by using a common framework for risk identification and by considering the impact of mitigation strategies; and
 - focused, by using both qualitative and quantitative approaches for risk identification.

6.3.4 Lewis and Mody (1997)^[47] provide an illustrative risk identification lattice with four broad risks that are each further broken down into sub-risks. The broad risks listed by Lewis and Mody included financial, business, operational and event risk. For entities providing insurance-like benefits, insurance (or underwriting) risk should be added to the broad risk categories. Sub-risks in this case would typically include severity and frequency risks. Only once an entity has developed an appropriate risk identification framework, can it develop a risk management approach.

6.3.5 Once the planning and assessment of risk exposures have been completed, certain actions can be taken to mitigate the identified risks. Some of the possible risk management tools include:

- Repricing the risk and adjusting the premium to reflect the actual risk accepted by the entity. This is not always feasible for a public entity.
- Performing technical modelling, including:
 - scenario analysis to determine the impact of changes in the economic environment as well as the impact of various stakeholder actions on contingent liabilities;
 - stochastic modelling of underlying contingent liabilities; and
 - using risk-adjusted disclosures and allocating capital in risk-adjusted terms.
- Transformation of data and systems to improve quality and quantity of data.
- Having reporting and disclosure tools to provide oversight, such as:
 - a disclosure policy;
 - tools for regular monitoring and compliance;
 - tools to report specific events immediately (e.g., deterioration in solvency levels); and
 - ways of disclosing material transactions with related entities.
- Clearly stating objectives and targets, including financial and debt structuring and risk tolerance, such as setting limits on credit exposure (e.g., credit quotas).
- Managing implicit guarantees via clear communication to set expectations as to whether these are payable.
- Setting budgets around maximum exposure or growth in exposure to certain contingent liabilities.
- Developing SOE ownership policies.
- Defining voting rights and responsibilities clearly.
- Requiring an external independent audit.

- Setting remuneration policies with appropriate long-term incentives for SOE boards and executives.
 - Selecting board members based on pre-defined criteria.
 - Providing a public view of SOEs (e.g., regularly updated website).
 - Restricting investment policies by reducing the risk of correlated events (e.g., equity market crash and claims).
- 6.3.6 It is useful to compare the list of risk management tools above with some of the examples provided in Section 5 for the respective SOEs. The lists provided in Section 5 are non-exhaustive but provide some insight into the various approaches followed by each SOE. It should be noted here that the information in Section 5 was drawn from annual reports and is perhaps not entirely reflective of each entity's broader ERM approach.
- 6.3.7 In closing, future research could consider the Public Sector Risk Management Framework^[45] and how this compares to other ERM frameworks. Additional analyses could be done to determine how each SOE's risk management framework is aligned to that suggested by the OAG.

7. Conclusion and the way forward

- 7.1 This working paper touches on various issues relating to contingent liabilities. It is intended to provide a starting point for further in-depth research.
- 7.2 The broad conclusions that can be drawn from this paper are summarised as follows:
- Globally there are two main accounting frameworks that are in use in the private sector, IFRS and GAAP. For public sector entities in South Africa, the standard issued by the ASB in South Africa is GRAP. Implementation of GRAP requires appropriate interpretation, application, and communication.
 - Changes in international standards are automatically applied under IFRS (being a global framework). However, international public sector accounting standards are not automatically applied to public sector entities in South Africa and are adapted for use locally by the ASB. The ASB is currently busy with a process to develop a local standard for SOEs based on IPSAS 42.
 - For South African SOEs the appropriate categorisation and communication of results is particularly important. The UIF's practice of disclosing most of its insurance reserves as contingent liabilities in its notes should be taken into account when making comparisons (such as those made in the Budget Review). This is also important when results are consolidated in National Treasury's CFS.
 - Without appropriate risk-management controls and practices in place, figures provided in financial statements might not be reliable (see Section 5.4 with regard to controls at the Compensation Fund). This should be read in the context of ERM frameworks (see Section 6).
 - Contingent liabilities are significant in the context of the South African public sector entities' balance sheets. From the Government's perspective, these off-balance sheet items constitute between 10% and 20% in addition to liabilities recognised in the statements of financial position. The Government needs to actively manage its contingent liability exposure and take the appropriate actions to ensure long-term sustainability of the country's finances.

- 7.3 Lewis and Mody's 1997 article^[47] states that governments should budget for contingent liabilities. One way to do this is to move away from cash-based budgeting towards a present value basis of accounting. This will assist in understanding the true expenditure incurred each year. If a government ignores the cost of issuing guarantees and the potential impacts of contingent liabilities, it could result in serious fiscal challenges and accompanying political criticism.
- 7.4 As previously mentioned, some SOEs need to fulfil both a public policy role as well as a purely economic role. Care should be taken not to ignore the public policy role and to appropriately fund and monitor these components separately.

8. Future research

- 8.1 Given the broad nature of this working paper, future research could take various forms. One approach would be to focus on a single entity and provide a detailed analysis of the various approaches it uses for risk identification, measurement, management, and monitoring. Such research could be used to assist oversight entities, such as National Treasury, with their policymaking.
- 8.2 A further approach would be to investigate the potential size of the implicit liabilities (such as social welfare) that the South African Government has committed to. Alternatively, research could delve into GRAP 104 with a focus on utilities that are of national importance (e.g. Eskom). This area of research could highlight the risks and costs related to guarantees provided to public sector entities.

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