Factors Affecting Contingent Liabilities in the Public Sector

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Abstract

Inappropriately accounted-for contingent liabilities could result in government departments having to make enormous payouts. The purpose of this study was to evaluate factors affecting contingent liabilities in the public sector, using the audited financial statements of four national government departments in South Africa as the data set. The four departments are Education, Correctional Services, South African Police Services, and Health. Data from 12 years, 2007/8 to 2018/19, for each department were analyzed. The paper applied a quantitative approach using positive accounting theory to explain accounting practices on the effects of litigation claims and intergovernmental payables on the departments' contingent liabilities. In addition, a Spearman correlation analysis was used to evaluate factors affecting the contingent liabilities of litigation claims (LC) and interdepartmental payables (IP). The study results indicated a statistically significant positive relationship between litigation claims and interdepartmental payables. The results further confirmed that both variables significantly impacted the growth of contingent liabilities in the public sector. The benefit of this study is that determining the escalation and quantum of contingent liabilities may encourage government departments to implement policies that promote efficient management and accounting practices to contain and eventually reduce contingent liabilities accounts' transactions. Achieving this will significantly reduce government departments' unproductive cash outflows, measured in millions of rands annually.

Keywords : **contingent liabilities; litigations, claims, public sector; financial loss, financial statements**

JEL Classification Codes : H83, K41, M41, M42

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This paper builds on and contributes to research in the public sector accounting field. Although several studies have examined the financial well-being of individuals and organizations, determinants of financial inclusions, financial policies, and financial performances in both private and public sector environments (see Joshi, 2021; Kuri & Laha, 2011; Shukla, 2016; Shobha & Chakraborty, 2017), there has not been a strong focus on the evaluation of factors affecting contingent liabilities in the public sector. This study provides insight into key factors that could contribute to contingent liabilities in the public sector. The term "contingent liability" refers to the most likely outcome and most likely cost that will be incurred (National Treasury, 2012) for a process that is not yet complete or which cannot be fully determined until completed. This research differs from previous studies in that it identifies and evaluates specific factors affecting contingent liabilities, such as litigation claims (LC) and interdepartmental payables (IP) in selected government departments in South Africa. In doing this, it draws strongly on the work of Pirdal (2017), who described contingent liabilities in government as a direct obligation to be managed.

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Overview of the Study

During the last decade, several attempts and initiatives have been undertaken to manage public financial expenditure more effectively and efficiently in the South African public sector. These initiatives have sought to make financial management concepts clear, accessible, agile, and understandable to accounting officers through the financial management cycle. Historically, the financial management cycle has been adopted to help public sector managers manage budgets, revenues, expenditures, assets, and liabilities. It also provides a basis against which they can be held accountable. However, these intentions have been increasingly challenged and/or ignored by accounting officers. Thus, National Treasury has become increasingly involved in public sector financial management as it attempts to facilitate the establishment of effective and appropriate systems of financial control. In the South African public sector, the accounting officer has a responsibility to prevent/identify fruitless and wasteful expenditures, and once identified, put processes and checks in place to avoid them. The accounting officer has additional duties to recover such expenditure, report it to the appropriate treasury, and disclose the situation in the department's annual financial statements. Such disclosures may result in the need for contingent liabilities. The widespread increase in fruitless and wasteful expenditure indicates ongoing weaknesses in internal controls. It motivates efforts to improve the effectiveness and efficiency of the systems required to prevent and detect such expenditures in the future.

The balance sheet provides an annual snapshot of each department's contingent liabilities, indicating significant cash outflows. South African government departments face financial uncertainty, mainly due to poorly managed contingent liabilities and their escalating consumption of departmental budgets. As a result, the total estimated contingent liabilities in all government departments from 2008/09 to 2018/19 are billions of rands. Since contingent liabilities typically comprise allowances for legal disputes and claims and intergovernmental payables, accounting for these liabilities in the financial statements shows them as either quantifiable or unquantifiable, depending on their characteristics (Currie, 2002). Within this catch-all category, contingent liabilities, government departments have registered enormous payouts arising due to poor operational and financial control and risk management processes (Currie, 2002).

Contingent liabilities can be complicated for an entity's management and investors. In the private sector, the concept of contingent liabilities relates to those transactions whose outcome is not quantifiable at the time of preparing the financial statements. These incidents involve litigation, claims, and court disputes (Currie, 2002), and the liabilities arising from such situations are reflected as contingent liabilities. In other words, a contingent liability is a future spending commitment with a recognizable degree of probability (Burnside, 2004). The International Monetary Fund (IMF) (2014) describes contingent liabilities as obligations that do not arise unless a discrete event(s) occurs in the future. However, these contingencies create financial risks, which may arise from deliberate public policy (particularly in public sector entities) or unforeseen events (Allen, 2018). Irwin (2022) stated that contingent liability is an important source of uncertainty, creating a potential (risk) that the entity may suffer financial loss. Contingent liabilities, therefore, affect the state's budget adversely (Pirdal, 2017). In the public sector environment in South Africa, billions of rands are lost because of these unsanctioned and unbudgeted financial indiscretions. Notwithstanding inclinations to ignore these items, the fact is that they should be analyzed with a serious and skeptical eye because these items have historically cost state and business entities several million (and increasingly billions) of rands annually. A contributing factor to the quantum of contingent liabilities is that, from the management's point of view, they happen suddenly and can be completely unforeseen.

Theory Underpinning this Study

Accounting plays an important role in supporting and coordinating various operational activities in the public

sector (Ellwood & Newberry, 2016; Lapsley, 1988). Therefore, there is a need to look at the specific effect of the public sector financial accounting role, hence, positive accounting theory (Sterling, 1990). Watts and Zimmerman (1978) described positive accounting theory as an explanation for observed accounting and auditing practices. In addition, a positive accounting theory is concerned with corporate social disclosures (Milne, 2002). Accordingly, positive accounting theory claims to explain accounting practice and provide scientific perspectives (Chambers, 1993). For example, the scientific part of the theory was used by Waweru et al. (2011) to investigate managers' decisions to choose accounting methods from a positive accounting theory perspective. Their study used a multiple regression analysis to determine the significant factors influencing the manager's choice of accounting methods and found a statistically strong association between the choice of accounting methods and income strategy.

Since the findings of this study suggest a significant relationship between the contingent liabilities (CL) and the variables litigation claims (LC) and interdepartmental payables (IP), the positive accounting theory calls for more good practices to mitigate the risks of contingent liabilities. Thus, with positive accounting theory, variables are often used to explain and predict accounting choices (Watts & Zimmerman, 1990). On the other hand, Cenar (2011) stated that all lawsuits related to contingencies should be treated as risks that need lawyers and legal advisers to act upon them. Therefore, the study is consistent with the theoretical circumstances in which contingent liability is recognized, assessed, and presented in notes to the financial statements.

Related Literature Review

This paper constructs a literature review on contingent liabilities building on the extant research literature. The contribution of this paper is twofold. Firstly, it suggests that contingent liabilities can be avoided if proper financial accountability is followed in the public sector. Secondly, it presents a focused contribution to public sector accounting. Thus, the analysis of these annual financial statements provides a guide to accounting scholars to identify existing research gaps in public sector accounting. Unfortunately, there is a gap in the literature review since there has not been a study in South Africa and elsewhere done to evaluate factors affecting contingent liabilities in the public sector.

Contingent Liabilities

Contingent liabilities are associated with major hidden financial risks (World Bank, 1998) — a view shared by the OECD (2017), which considers contingent liabilities major sources of financial risk due to their uncertain financial commitments. Accordingly, Kishore (2018) saw contingent liability as a possible obligation that arises from past events and whose 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 department. Thus, a contingent liability is a present obligation that arises from past events but was not previously recognized because :

- It was not probable that an outflow of resources (embodying economic benefits or service potential) would be required to settle the obligation; or
- The amount of the obligation could not be measured with sufficient reliability.

The phenomenon of contingent liabilities has recently gained prominence in the analysis of public finance (Cebotari, 2008). Where an entity is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. It increases the financial vulnerability of public entities (Brixi et al., 1999) and creates management problems for governments (Irwin & Mokdad, 2009).

Contingent liabilities are included in the disclosure notes to the financial statements when economic benefits may flow from the department or when an outflow of economic benefits or service is *probable but* cannot be measured reliably. Oladokun et al. (2019) agreed, suggesting that contingent liabilities place the integrity of the balance sheet at risk.

Public sector contingent liabilities emerge when governments try to limit the appearance of loss of public funds in their financial statements. Irwin (2022) also recognized contingent liability as a major indicator of financial distress. Compounding this lack of precision or completeness in the financial statements is the fact that contingent liabilities are frequently not recognized as liabilities because they are either (a) only *possible* obligations (the entity's present obligation and the potential outflow of resources or economic benefits have yet to be confirmed), or (b) the present obligations do not meet the recognition criteria in this IAS 37 Standard. The Standard requires that an outflow of resources/economic benefits must be anticipated as a contingent liability if it is *probable* and likely to require imminent settlement or if it is impossible to provide a sufficiently reliable estimate of the amount of the obligation (International Financial Reporting Standards Foundation (IFRS), 2017).

With a contingent liability, there is a significant measure of uncertainty about the fulfillment of the obligation (i.e., it is only possibly a liability), or there is uncertainty as to when the obligation will fall due or its likely cost to the entity. In the public sector environment, fruitless and wasteful expenditure refers to those expenses that, at best, could result from negligence and poor financial management. Either way, they increase the risk of claims and litigation against government departments. Such pending civil claims against a department and adverse judgments or litigation not yet settled by a court order must be included in contingent liabilities. Thus, contingent liabilities are indicators of the departments' financial health risks (Primorac & Poljak, 2018) and indicate operational uncertainties (Carini et al., 2019) because of unknown future demands on available finances and other resources. Departments often do not budget for litigation and the consequent payments of claims. Thus, successful claims are often settled with funds originally earmarked for service delivery, an unacceptable situation to which the AG has repeatedly drawn attention.

Lassou et al. (2018), attempting to understand how to restrain/contain losses, stated that transparency in government accounting should be an effective way of avoiding the risk of failure to spend public resources wisely. Harrison and Sayogo (2014) also called for complete and factual disclosure of government financial information, while Williams (2015) referred to it as a need for financial accountability. Transparency in the presentation of contingent liabilities increases the likelihood that these liabilities are assumed for sound financial and operational reasons and would help eliminate the negative light in which contingent liabilities are currently viewed (OECD, 2017). Financial transparency has become an internationally accepted principle, actively promoted by the International Federation of Accountants (IFAC). Contingent liabilities, thus, need to be captured in detail, showing all the underlying obligations for the benefit of users of financial statements.

For contingent liabilities arising from an uncertain future event to be reported in financial statements, at least two thresholds must be crossed. Most often, the qualifying contingent liabilities are recorded as an expense on the income statement and then as a liability on the balance sheet. These liabilities are recorded in an entity's accounting records and shown in the balance sheet when there is a *probable* and reasonably estimable contingency or worst-case financial outcome. The recording of contingent liability is shown in a footnote or notes to financial statements (specifically the balance sheet) with a description of the nature and extent of the individual contingent liabilities. The likelihood of loss is included in the note and described as *probable*, *reasonably possible*, or *remote*. Similarly, the ability to estimate a loss is described as *known*, *reasonably estimable*, or *not reasonably estimable*.

Alternatively, a contingent liability could be explained as an obligation that may arise from the occurrence or the non-occurrence of a certain future event. The company itself has no control over the said event. An obligation may thus arise in the future as a consequence of past events, triggering a contingent liability. The situation has been assessed as unlikely to require an outflow of funds to discharge the contingent liabilities; thus, no provision has

been made. In addition to the problem, no reliable estimate can usually be made for the legal obligation incurred when attempting to address the liability. There is simply no precedent to enable the company to make such an estimate.

Litigation Claims

Litigation presents a significant source of potential liability for public organizations (Koprowski et al., 2009). Lind (n.d.) recognized that litigation is one way to settle disputes between persons, organizations, and the state. Koprowski et al. (2009) drew attention to the fact that outcomes of litigation and settlement of claims are usually classified as contingent liabilities and appear on the balance sheet as a current liability if the debt obligation is reasonably expected to come due in a single operating cycle or one year. Kaur and van der Laan (2013) believed that when there are indications of litigation and claims against the entity in the entity's financial statements, the auditor should make inquiries about liabilities arising therefrom, including the likelihood of contentious litigation and payouts of claims that the audited entity may be facing. In addition to attempting to establish the facts surrounding the contingent liabilities, the auditors should also ensure that the entity has adequately followed the prescribed *accounting* treatment of contingent liabilities, including disclosure of any pending litigation in financial statements (Kaur & van der Laan, 2013).

Accordingly, Anderson (2005) affirmed that compliance with accounting principles and auditing standards is just one of the items an accountant must evaluate in reviewing a company's financial statements. Kunz (2015) clarified that statement, suggesting that with litigation and claims, the auditors should review and test the financial documents associated with litigation for accuracy and materiality. While lawyers analyze evidential facts and records to build sound legal arguments (Kunz, 2015), accountants and auditors need to verify the financial impact of these legal actions. It is reasonably common knowledge that many contingent liabilities recorded in public sector financial statements arise as the result of lawsuits. From the examples of the four national departments' annual reports examined for this research paper, notes to the financial statements reflect the defense of lawsuits brought against the department; guilt is not necessarily assumed or implied — the notes designate them as contingent liabilities.

Intergovernmental Payables

It is important to emphasize that accounts payable in government departments are more than just bills to be paid/that have been paid. The accounts payable figure on the financial statement represents the total of the unpaid bills (Schaeffer, 2002). In other words, the recipients of these intergovernmental payments are simply a subset of departmental creditors. Since the balance sheet provides a snapshot of the entity's financial health, contingent liabilities are shown in the notes section, thus recognizing that while they are both probable and have a value that can be estimated, this depends on an uncertain future event or series of events. National Treasury (2013) described intergovernmental balances as the sum of the amounts owing to or due from a department at month or year-end that arise from one or more interdepartmental transactions. These transactions occur when one department provides a good or service to another department for a fee; these transactions are recorded on a cost recovery basis or at the agreed free (National Treasury, 2013). Schaeffer (2002) stated that accounts payable is the total money a business owes to its suppliers and is shown as a liability on a company's balance sheet. Reasons for unconfirmed balances should also be provided (National Treasury, 2013). Recognized payables mainly comprise amounts owed to other governmental entities. These payables are carried at cost in the statement of financial position. Hence, inter-departmental transactions are used to track arm's length business transactions between two or more government departmental accounts.

Overall, the South African public sector spends a relatively large proportion of its budget on service departments. Thus, in the 2020 financial year, R229.7 bn on the health department, R217 bn for the peace and security cluster, R396.4 bn for both basic and tertiary education, and R309.5 bn for social development (National Treasury, 2020) were spent. Despite following a sound budget setting and approval process, government departments still face the threat of unquantified debts due to known liabilities the departments are (or will be) legally obliged to pay (Polackova, 1989). Brixi (2000) explained explicit liability as the outcome of procedures seeking to estimate the surplus required to stabilize public debt. However, contingent liabilities can be implicit and explicit (Brixi, 2000; Pirdal, 2017). Liability arises when the government is legally obliged to pay if a particular event occurs (Bachmair, 2016). Cebotari (2008) stated that explicit contingent liabilities are obligations based on contracts, laws, or clear policy commitments. Thorat and Roy (2004) agreed that explicit liabilities are contractual obligations of state governments; however, they also recognize implicit liabilities as non-contractual and reflect public expectations of expanded state support far beyond its legal obligation. Kayhan and Jenkins (2016) recommended that unjustified contingent liabilities be avoided.

Recently, Bachmair and Bogoev (2018) conducted a study to analyze and quantify the losses from implicit, non-contractual liabilities in South Africa and to assess their impact on debt dynamics. The findings arising from the application of their analytical method showed that estimated losses from contingent liabilities are significantly lower than calculated using the currently preferred methodology in the first year; however, when unresolved, these contingent liabilities increase over time. Thus, it is believed that contingent liabilities should not be relegated to a numbered footnote to the financial statement. Instead, they should be critically analyzed both from a financial perspective and concerning the specific situation or context, as each of these contingent liabilities has the potential to cost millions of rands.

Research Method and Results

Data Set

The quantitative approach was deemed suitable; hence, Spearman's correlation analysis was used for data analysis. The reason is that the research design is positivist and measures the relationship between the two variables. The study is positivist since there are two variables to measure using Spearman's correlation analysis to show the relationship between the contingent liabilities (CL) and the variables litigation claims (LC) and interdepartmental payables (IP). The positivist paradigm is usually used to search for cause-and-effect relationships (Kivunja & Kuyini, 2017). Coetsee (2011) added that the positivistic technique is more relevant to accounting research. The data sources are the annual reports of four national government departments. Data were sourced using secondary data from the disclosed annual financial statements. This analysis uses secondary data to draw theoretical support from certain public sector research studies. Hence, the study applied a secondary data approach (Andrews et al., 2020; Harris, 2001; Raipa & Giedraityte, 2014).

This paper uses the secondary data on the amounts presented in the notes comprising the contingent liabilities and the factors which make up those liabilities. The national departments included Education, Correctional Services, South African Police Services, and Health; the period surveyed was the 12 financial years between 2007/8 and 2018/19. The department selection was deliberate and based on their relatively high exposure to service delivery obligations. It should be noted that all departments present their annual financial statements and disclose their contingent liabilities by GRAP requirements. Any department's annual financial statements could have been sampled as they all conform to the GRAP requirements. In addition, all government departments are subject to lawsuits and claims, and to a greater or lesser extent, all are involved in intergovernmental payables. Thus, contingent liabilities are present in all departments and have become an important issue in public finance.

The breakdown of items is presented as footnotes in the financial statements as descriptions of the episodes necessitating provision for contingent liabilities.

Descriptive Analysis

The statistical model followed in this paper is Spearman's rank correlation (or Rho) which is used to measure the strength of association between two variables (litigation claims (LC) and interdepartmental payables (IP)). The model denotes the population value by ρ_s and the sample value by r_s. Ozer (1985) recorded that the model evaluates relationships involving ordinal variables. It was, thus, appropriate for this paper to use the Spearman correlation to evaluate factors affecting contingent liabilities in the public sector because it establishes if there is a correlation between two sets of ordinal data. The study makes use of data collected from the Departments of Correctional Services (Figure 1), Education (Figure 2), Health (Figure 3), and South African Police Services (Figure 4).

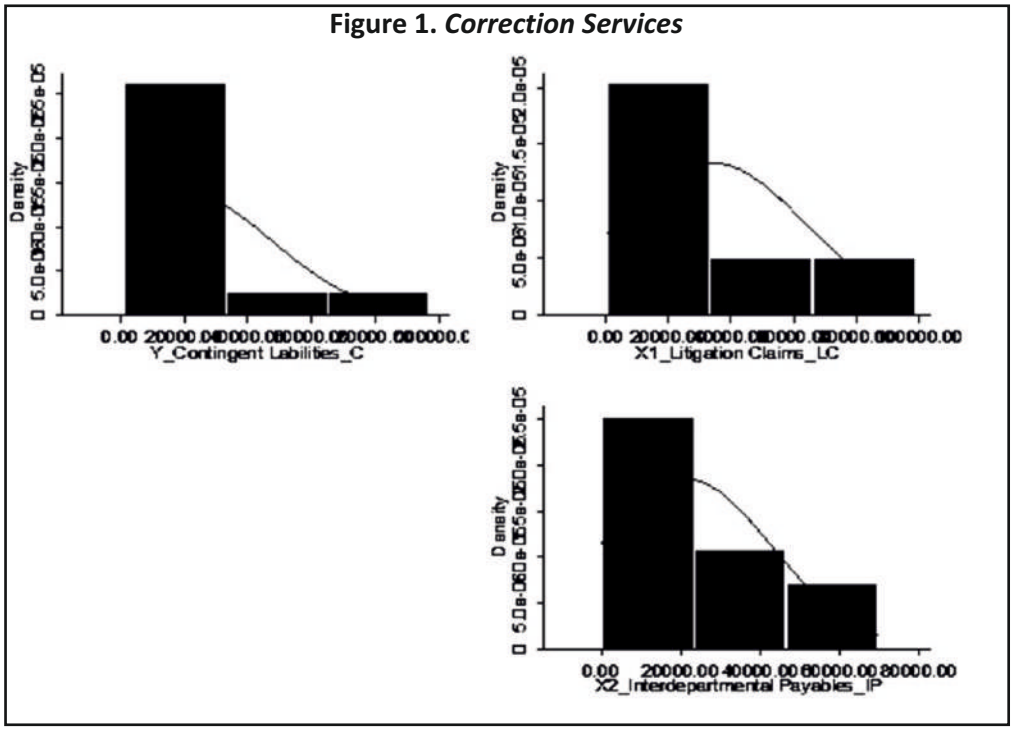
For determining a correlation between variables *x* and *y*, the formula used is:

$$\rho = 1 - \frac{6 \Sigma d^2_i}{n(n^2 - 1)} \qquad (1)$$

Histograms

To validate whether data is normally distributed, histograms are used to determine whether the observed data is skewed. If the normal curve is not skewed, then the data is normally distributed, and parametric statistical techniques can be used. However, the data is not normally distributed when the histogram's normal curve is

Figure 1. ***Correction Services***



skewed. This means non-parametric statistical techniques should be used. Each department's data was treated independently, and all histograms were run for each department and each variable (three variables per department). Figures 1– 4 demonstrate a skewed distribution curve indicating that the data are not normally distributed for any departments or variables, therefore, non-parametric methods were used.

Figure 2. ***Education***

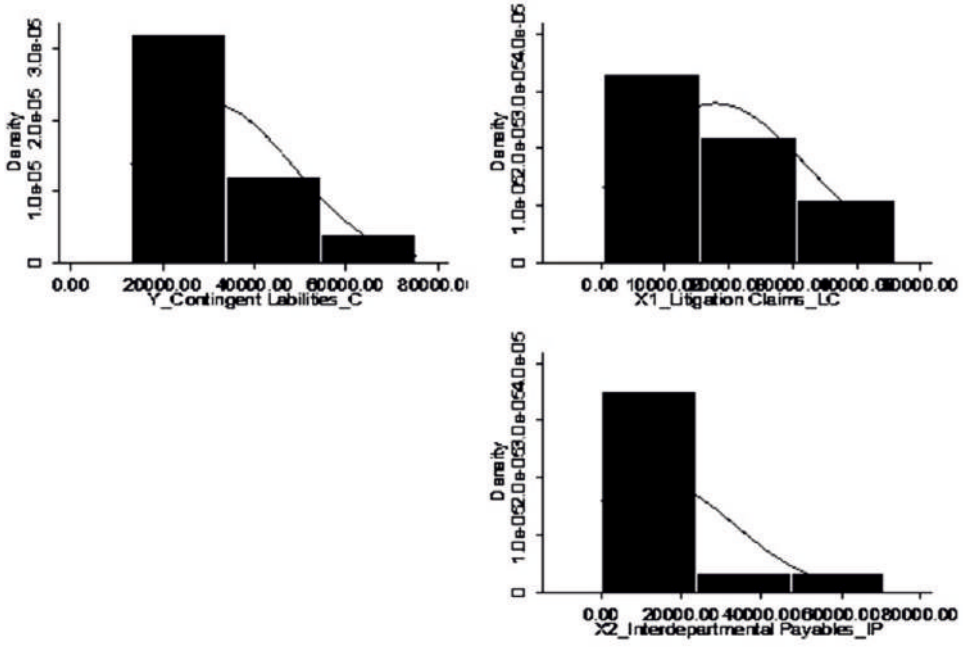


Figure 3. ***Health***

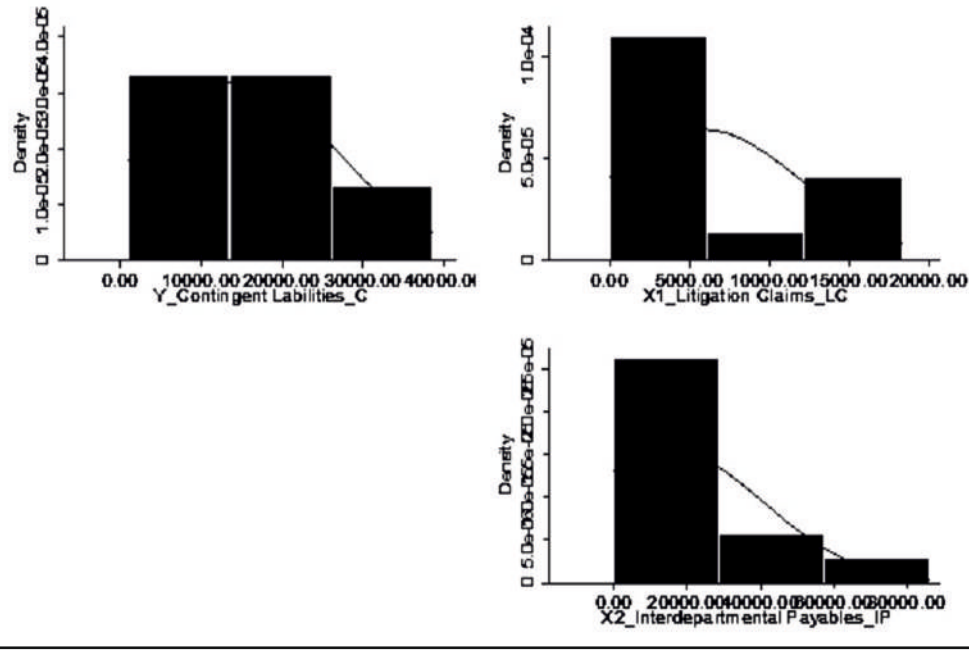
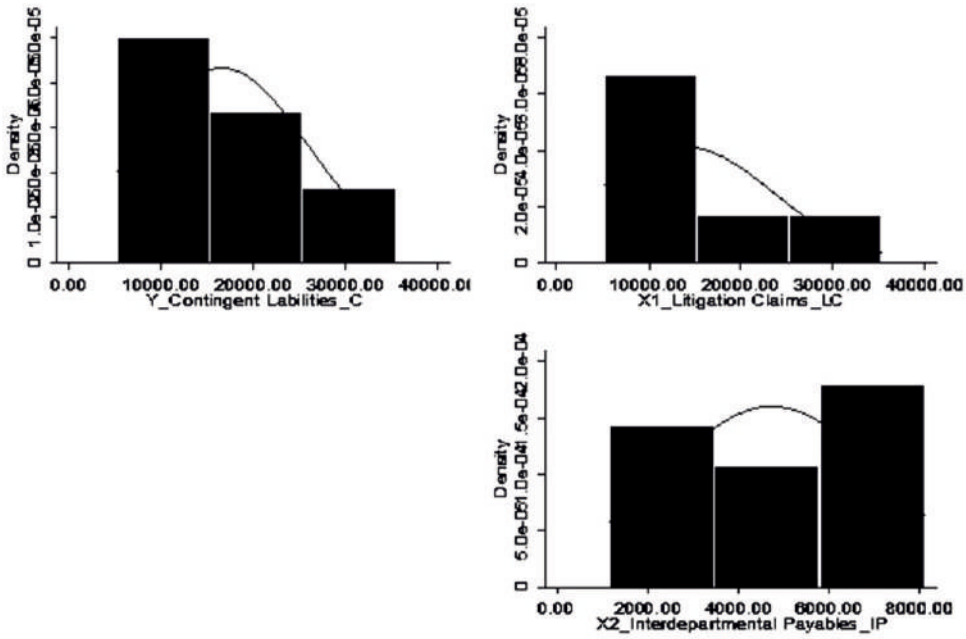


Figure 4. ***SAPS***



Furthermore, this paper examines the occurrences of contingent liabilities over 12 financial years for the four government departments. The data set comprises the contingent liabilities recorded in the departments' annual reports during 2007/8–2018/19. Table 1 presents a snapshot of Spearman's correlations on the effects of contingent liability in the public sector.

Table 1 shows the Spearman correlation coefficients between the contingent liabilities (CL) and the variables litigation claims (LC) and interdepartmental payables (IP). The results show some levels of significance in the relationships. The results indicate that the Spearman correlation coefficients are all significantly greater than zero, indicating a strong association between the *X*-litigation claims and intergovernmental payables with CL. Generally, the coefficient results have confirmed that all the relationships found using Spearman's correlation are positive and significant concerning contingent liabilities. Thus, this technique's results are "robust" and not 'meaningless.' Finally, there is a statistically strong positive relationship between contingent liabilities and all liability claims against the departments. This suggests contingent liabilities are positively and significantly correlated with LC and IP at the 5% significance level.

Table 1. ***Spearman's Correlations***

	Department			
	Correctional Service vs. CL*	**Education vs. CL***	**Health vs. CL***	**SAPS vs. CL***
	Rho	Rho	Rho	Rho
Litigation Claims *(LC)*	0.3427	0.1690	0.3754	0.9650**
Interdepartmental Payables *(IP)*	0.6643**	0.3993	0.2799	0.2081

Note. *Contingent Labilities; **Significant *p*-value less than 0.05.

On the other hand, Spearman's correlation analysis shows the relationship between the contingent liabilities (CL) and the variables: litigation claims (LC) and interdepartmental payables (IP) is found to be strong, with a significant *p*-value less than 0.05. The findings show that lawsuits and litigations are steadily increasing in government departments, with many challenges in litigation management and unconfirmed balances, which are likely to affect the balance sheet. As a result, risk management processes should be used to empower the legal departments in national government departments to defend claims against the departments and to manage litigations and disputes. On the other hand, the positive relationship indicates a likely increase in interdepartmental payables (IP) in millions of Rand within the government sector. The reason is that there are amounts in the financial statements resulting from uncertainty regarding the recoverability of the unconfirmed balance of millions of Rand, and the impact that might have on the level of the retained earnings on the balance sheet is unknown. Hence, the paper recommends the following policy improvement: At year-end, the department must confirm and agree on any interdepartmental balances that exist or are unconfirmed. As a result, the departments must agree on the confirmed and unconfirmed balances for disclosure in the financial statements.

The findings support the contentions of Jain et al. (2020) (among other researchers) that litigation claims could have been factored into the contingent liabilities (as government guarantees), and as Mitchell et al. (1995) observed, these guarantees could remain on the liability side of the consolidated public sector balance sheet for an extended period. In addition, Gapen et al. (2004) examined the application of the contingent claims approach to identifying corporate sector vulnerabilities and reported that public sector assets continue to decline because of contingent liabilities. Albeit at different levels of significance, the findings support the contention that litigation claims and interdepartmental payables contribute uncertainty to the financial health of government departments.

Summary statistics – Non-parametric (median, interquartile range *IQR*).

Median = $p50$
$IQR = (p25 - p75)$

Table 2, Table 3, and Table 4 represent how far apart the lowest and the highest measurements are in each department. The tables further describe the middle 50% of values when ordered from lowest to highest, while the sampling range = max-min for the entire sample data. These values are quartiles $p50$, $p25$, and $p75$. Therefore, the *IQR* shows the difference between $p75$ and $p50$. The literature review on contingent liability shows that litigation claims and interdepartmental payables are related, and the relationship between these variables is strictly positive. The *IQR* represents the variability in the central 50% of the data. The position of $p25$ (or the median) within the

Table 2. ***Summary for Variables : Y_ContingentLiabilities_C by Categories of Department2 (Department)***

Department 2	N	p 50	p 25	p 75	min	max
Correctional Ser	12	6864.5	2410	22024.5	1338	96703
Education	12	27534	17311.5	38978	12991	75352
Health	12	13581.5	1917.5	20258	936	38641
SAPS	12	14449.5	8850	22782.5	5234	35274
Total	**48**	**14202.5**	**7236.5**	**27575**	**936**	**96703**

Table 3. ***Summary for Variables : X1_Litigation Claims_LC by Categories of Department2 (Department)***

Department 2	N	p 50	p 25	p 75	min	max
Correctional Ser	12	25379.5	13042	48136	315	98431
Education	12	17067	3400	28132	356	45884
Health	12	3504	859.5	11058.5	0	18267
SAPS	12	9319.5	6649.5	19495.5	5152	35243
Total	**48**	**13058.5**	**4320.5**	**25379.5**	**0**	**98431**

Table 4. ***Summary for Variables : X2_InterdepartmentalPayables_IP by Categories of Department2 (Department)***

Department 2	N	p 50	p 25	p 75	min	max
Correctional Ser	12	17736.5	243	31929.5	102	69474
Education	12	3782	83.5	17192	0	70891
Health	12	59.5	0	21507	0	86000
SAPS	12	3893	2741	7174.5	1152	8124
Total	**48**	**4048**	**156.5**	**17192**	**0**	**86000**

tables assesses the symmetry of the data in the middle 50% of the data set. At the same time, a comparison of the two sides helps understand the symmetry outside the table.

Managerial and Theoretical Implications

The study's findings imply that a balance sheet may be negatively affected if government departments do not effectively manage financial risks arising from contingent liabilities. The important policy implication of this study is the need for government departments to exercise caution in contingent liabilities. This is because the government faces various litigation claims, lawsuits, and unconfirmed interdepartmental claims. Thus, the paper suggests that the risk management units should identify and profile all the unsettled claims. This study also highlights the need for public policy improvement to monitor the amounts due to the reporting government department to ensure that charges for services rendered by the reporting unit for another government are identified. Furthermore, the public sector accountants may use these findings to improve awareness, empower themselves on the effects of contingencies in the financial statements, and build up staff capacities through training and departments supporting each other through experiences dealing with contingencies. Therefore, the positive accounting theory supports explanations of accounting practices in the public sector and will motivate public accountants to apply appropriate accounting policies.

Conclusion

The study set out to examine the annual reports of four national government departments in South Africa. The study's objective is to evaluate factors affecting contingent liabilities in the public sector, using financial statements from four service delivery-focused government departments. The data were collected from audited annual integrated reports and financial statements for four national government departments over 12 years (between 2007/8 and 2018/19). The quantitative approach was deemed suitable; hence, Spearman's correlation analysis is used because the research design is positivist and measures the relationship between the two variables. Thus, on the whole, the results of statistical analysis show that the *p*-value is less than 5%, which leads us to conclude that within the four national government departments, the relationship exists between the contingent liabilities (CL) and the variables: litigation claims (LC) and interdepartmental payables (IP). This implies that the relationship exists and that litigation claims (LC) and interdepartmental payables (IP) are likely against the departments, and that the departments may even suffer transactional claims by the other government departments for an unconfirmed balance.

The contingent liabilities presented in these government departments show that the government loses billions of rands each year, most of which cannot be justified. It is abundantly clear that government departments fail to take necessary steps to prevent litigation and claims, resulting in unnecessary expenditure. Although the risks of contingent liability increased and the litigation claims continue to threaten government budgets, this paper recommends that the government should consolidate all contingent liabilities and establish one portfolio within the risk management function of each department to prevent such uncertainties. Since the paper adds a slightly modest to non-existing literature, it brings in an aspect that is somewhat unnoticed within the South African context, especially in public sector accounting research. The practical implication is that, given the growing trend of financial losses as a result of contingent liabilities, the public sector governance and users of financial statements can now learn about how the government fails to comply with their commitments to prevent the probable amount of claims against the state by going through disclosed financial statements in the annual reports. This disclosure tends to appraise the nature of liabilities and financial losses suffered by the department. This finding should motivate the public already interested in the integrated annual reporting of the government to make financial sense. On the other hand, this study also attempts to address the knowledge gap and literature shortage in the public sector accounting field in South Africa.

Limitations of the Study and Scope for Further Research

The study uses secondary data obtained from the financial statements of four national government departments, which include Education, Correctional Services, South African Police Services, and Health. The period surveyed is the 12 financial years between 2007/8 and 2018/19. The findings offer an agenda for further research to expand the observation period covered by this paper on both sides – pre-and post-2007/8 and 2018/19 to see how contingent liabilities pose risks to departmental budgets.

Authors' Contribution

Dr. K. N. Motubatse conceived the idea, developed a quantitative design to undertake the empirical study, and further performed statistical analysis of the study. The major contribution of this study is to fill the gap in the extant public sector accounting literature by examining factors affecting contingent liabilities in the public sector. Dr. K. R. Chauke participated in the sequence alignment and draft of the manuscript. Both authors read and approved the final manuscript.

Conflict of Interest

The authors certify that they have no affiliations with or involvement in any organization or entity with any financial interest or non-financial interest in the subject matter or materials discussed in this manuscript.

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Disclaimer

The views and opinions expressed in this article are those of the authors.

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