

# UNDERSTANDING PRINCIPAL-AGENT ARRANGEMENTS

MCS Chapter 16 / GRAP 109

PRESENTED BY:

Office of the  
Accountant-General,  
National Treasury



**national treasury**

Department:  
National Treasury  
REPUBLIC OF SOUTH AFRICA



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# Contents

- Identifying agent-principal arrangements
- Other relevant matters to consider
- Unpacking examples

[applicable to both departments applying MCS and other entities applying GRAP]

*The information contained in these slides includes extracts from the relevant standard, and has added application guidance and/or explanations on the concepts already included in the relevant standard. This is not part of any standard, and relevant standard takes precedence.*

# Introduction

- Legislation often sets out the mandate and/or service delivery requirements of a **department/entity**
- Such requirements could also be set out in other instruments such as cabinet decisions, municipal council decisions, or even the strategic or performance plans of the **department/entity**
- In fulfilling these requirements, a **department/entity** may carry out the activities using its own resources or may require the assistance of an external party (or a combination thereof)
- Engaging with an external party is not an automatic principal-agent arrangement
- **NB:** The existence of **Chapter 16/GRAP 109** does not infer that all external parties are “agents” of a **department/entity**
- **Chapter 16/GRAP 109** is important as it aims to ensure that the rights and obligations are recognised/recorded by the appropriate reporting entity

# Introduction (cont..)

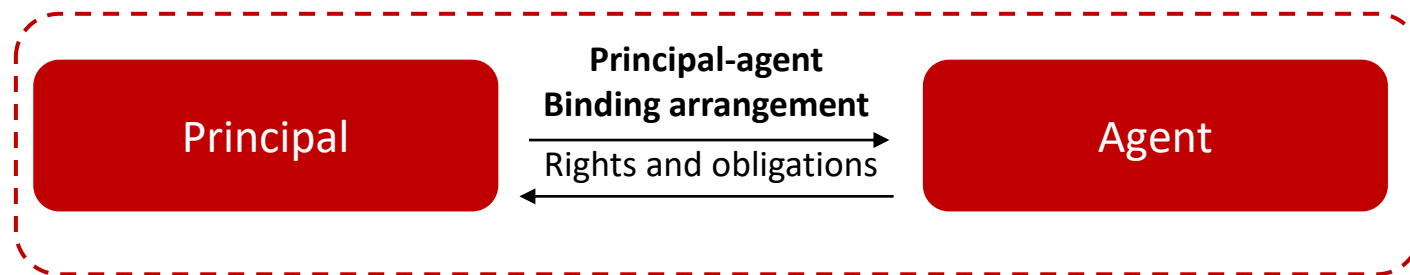
- The arrangement with the external party must be assessed to be a **principal-agent arrangement**
- Alternative arrangements could identify the external party as:
  - a service provider,
  - a controlled entity receiving a transfer payment (to fund its operations),
  - an operator (in a Service Concession Arrangement), or
  - an external party receiving a donation or subsidy from the **department/entity**.

[See Slide 12]

# When should **Chapter 16/GRAP 109** be considered for application?

When there is an arrangement between a **department/entity** and another party, **first** consider if it is a principal-agent arrangement

A **principal-agent arrangement** results from a binding arrangement in which one entity (an agent), undertakes transactions with third parties on behalf, and for the benefit of, another entity (the principal) [**16p.06/109.05**]



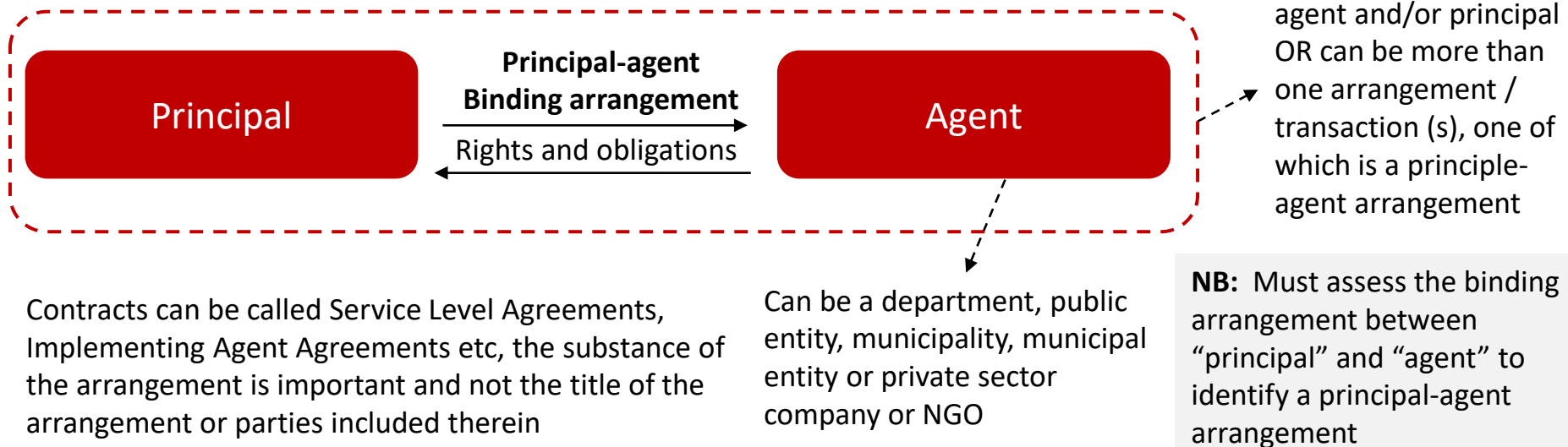
- It is unlikely that an entity will undertake activities on behalf of another entity in the absence of a binding arrangement, as the arrangement imposes rights and obligations on the parties to perform in a particular manner [**16p.12/109.11**]
- A principal-agent arrangement only exists as a result of a binding arrangement and in the absence of a binding arrangement no principal-agent arrangement exists [**16p.13/109.12**]

# 1 Identifying binding arrangements

A binding arrangement is any arrangement that confers enforceable rights and obligations on parties to the arrangement. These rights and obligations could arise from [16p.20/109.19]:

- Contracts
- Legal or similar means; and/or
- Common law, i.e. legal precedent set through court rulings

Whilst *third parties* may be referred to in the binding arrangement, they are not “signatories”, i.e. they cannot enforce the rights and obligations between the principal and the agent

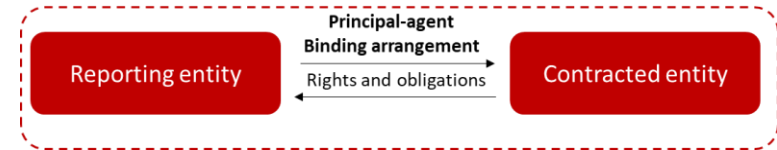


Contracts can be called Service Level Agreements, Implementing Agent Agreements etc, the substance of the arrangement is important and not the title of the arrangement or parties included therein

Can be a department, public entity, municipality, municipal entity or private sector company or NGO

**NB:** Must assess the binding arrangement between “principal” and “agent” to identify a principal-agent arrangement

# 1 Identifying binding arrangements (cont..)



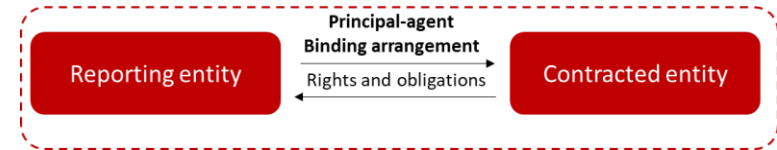
## Level of assessment: activity vs transaction(s)

- A binding arrangement may require an entity to undertake an activity(ies);
- Focusing on the activity(ies) to assess the existence of principal-agent arrangement may result in different interpretations and/or challenges in identifying transactions with third parties
- The assessment is thus carried out at a transaction level (or by grouping similar transactions together) → the transaction(s) undertaken in delivering the identified activity

[16.BC13]

See Scenario 5

# 1 Identifying binding arrangements (cont..)



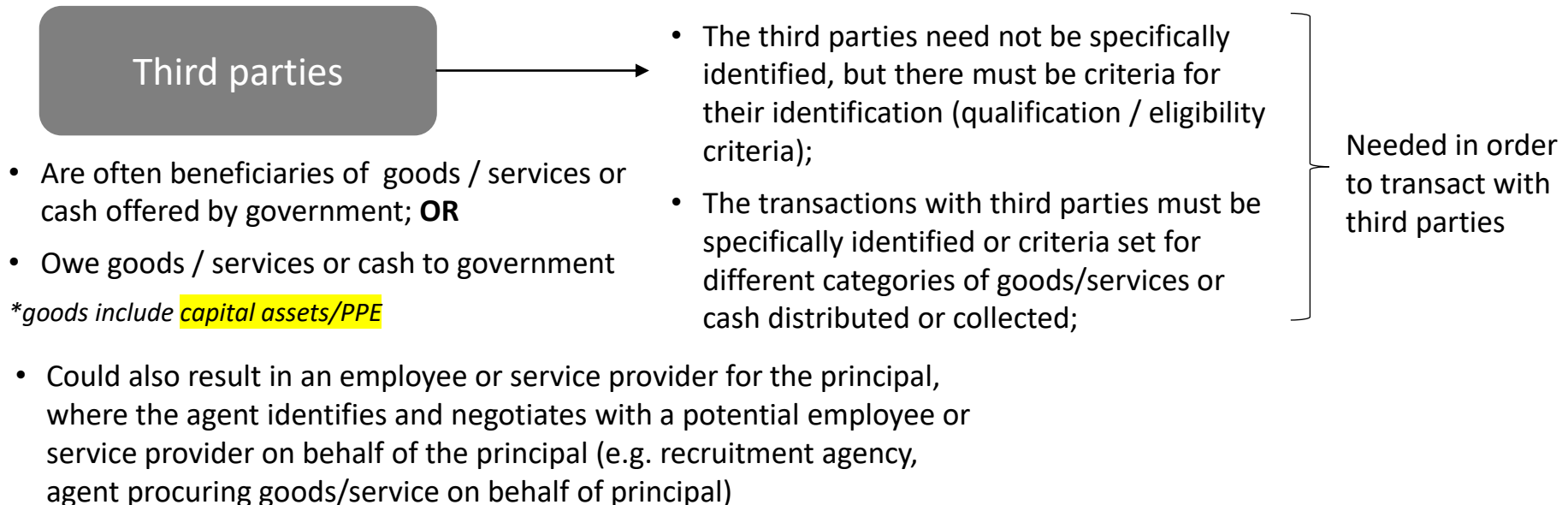
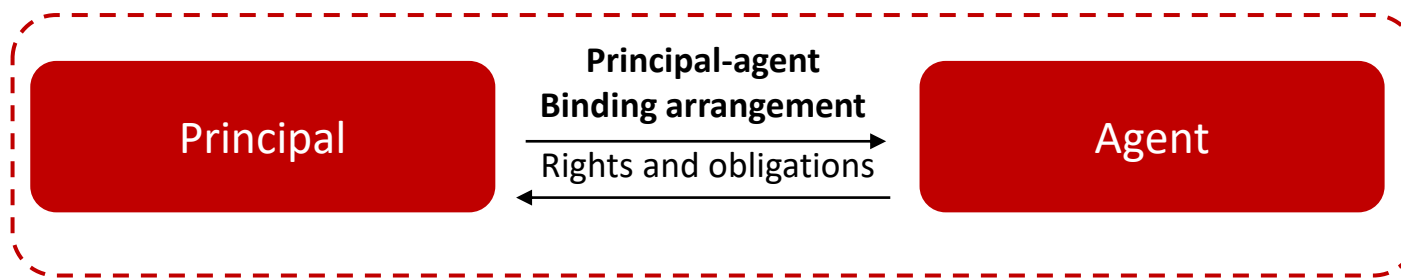
Sometimes principal-agent arrangements are established in legislation, this is when a **department/entity** is required by law to use the services of another department/entity to act on its behalf, for example:

- SASSA – for the distribution of social grants;
- SARS – for the collection of taxes and fees;
- Municipalities / SAPS – for the issuance and collection of traffic fines;
- SITA - for the purchase of IT equipment for a government department [mandatory service of SITA];
- NSF – collection of skills development levies;
- These principal-agent arrangements arise out of “legal or similar means”
- Sometimes arrangements arising out of legislation are supported by written contracts (or service level agreements), usually to clarify performance requirements and associated fees
- Both legislation and written arrangements are reviewed to assess the responsibilities of each party and the nature of the arrangement



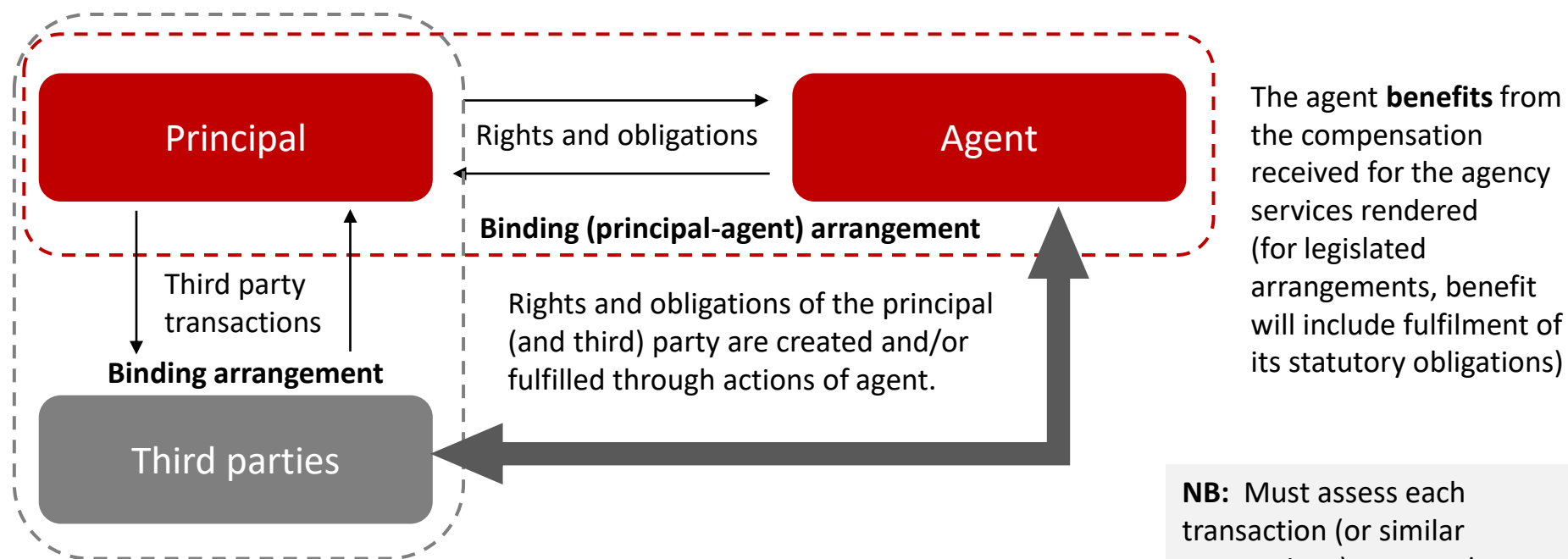
## 2 Does the binding arrangement require transactions with third parties?

Transactions with third parties includes the execution of a specific transaction with a third party(ies) [16p.11/109.10]



### 3 Do the transactions with third parties facilitated by one party, create or fulfil rights / obligations of or for the other party?

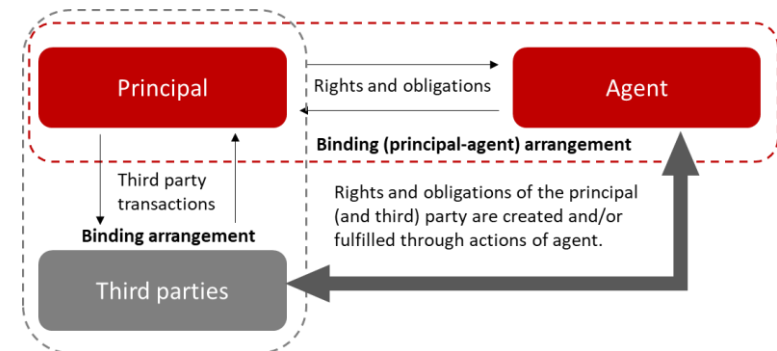
One party to the arrangement (the agent) represents the interests of the other party to the arrangement (the principal) when that entity (the principal) transacts with third parties [16p.14/109.13]



**NB:** Must assess each transaction (or similar transactions) separately

The principal **benefits** through the delivery of the goods/services or cash to third parties or the receipt of goods/services or cash from third parties

## 4 How to identify the principal and the agent?



- The principal primarily benefits from the transactions with the third party, as the reason for the arrangement is to fulfil the rights and obligations of the principal to or from the third parties
- The reporting entity is the agent when, all three of the following criteria are present **[16.26/109.25]**:
  - It does not have the power to determine the significant terms and conditions of the transaction *{need not be considered if the reporting entity has been granted specific powers in terms of legislation to direct the terms and conditions of particular transactions [16.27/109.26]}*;
  - It does not have the ability to use all, or substantially all, of the resources the result from the transaction for its own benefit
  - Is not exposed to variability in the results to the transaction.

# Summary of key differences between principals and agents

Principal	Agent
The principal controls the goods or services acquired or provided on the principal's behalf by the agent	The agent does not control any goods or services acquired or provided on behalf of the principal
The principal may determine and/or alter the nature or the value of the supplies made between the principal and third parties	The agent will not determine and/or alter the nature or value of the supplies made between the principal and third parties
The principal may determine and/or alter the criteria to identify third parties	The agent may not determine and/or alter the criteria to identify third parties
Transactions by the agent will have an impact on the extent of revenue or expenditure recognised by the principal	Transactions on behalf of the principal do not affect the agent's surplus/deficit, except to the extent of the commission or fee earned on such transactions

\*\*Only examples and is not all-inclusive

Is the arrangement a principal-agent arrangement?

Reporting entity  
is the Principal

YES

NO

Consider if the arrangement is also a Service Concession Arrangement [GRAP only] – GRAP 32

Consider if the arrangement is a Service Concession Arrangement [GRAP only] – GRAP 32

Consider if the arrangement is a Construction Contract [GRAP only] – GRAP 11

Consider if the arrangement is a Transfer of Functions – Chapter 19/GRAP 105, GRAP 106

Consider other relevant Chapters/Standards to account for assets, liabilities, revenue, expenditure

Reporting entity  
is the Agent

Disclosures in  
Chapter 16/GRAP 109

- Recognise assets – Chapter 11, GRAP 32, GRAP 17, GRAP 16, GRAP 13, GRAP 31, GRAP 103
- Recognise revenue - Chapter 7/GRAP 9, GRAP 23
- Recognise expenses – Chapter 8, GRAP 19
- Recognise any receivables/payables - Chapter 9, Chapter 10, Chapter 13/GRAP 104, GRAP 108, GRAP 32, GRAP 19, GRAP 13

- Recognise agency fee as revenue - Chapter 7/GRAP 9
- Recognise non-reimbursed expenses – Chapter 8, GRAP 19
- Recognise any receivables/payables - Chapter 9/GRAP 104, GRAP 108

# Other matters

# Concept of an “agent” as understood in common law

An agency is a **contract** whereby one person (the agent) is authorised and required by another person (the principal) to **contract or to negotiate a contract with a third person**, on the latter’s behalf.

The agent in representing the principal, creates, alters or discharges legal obligations of a contractual nature between the principal and the third party.

Same as the concept in **Chapter 16/GRAP 109** 

(however, using the term **contract** this definition is narrower than in the standards → see slide 6 on Identifying Binding Arrangements)

The agent therefore provides a service to the principal and normally charges a fee (generally referred to as “commission” or an “agency fee”) but does not acquire ownership of the goods and/or services supplied to or by the principal

# Concept of an “agent” as understood in common law (cont.)

In essence, the principal is ultimately responsible for the commercial risks associated with a transaction, and that the agent is trading for the principal's account. The agent is appointed by and takes instruction from the principal regarding the facilitation of transactions as per the principal's requirements and generally charges a fee or earns a commission for that service

This agent/principal relationship may be expressly construed from the wording of a written agreement or contract concluded between the parties

Where a written agreement or contract does not exist, the onus of proof is on the agent who seeks to bind the principal in a contract to demonstrate that an agency agreement exists between the agent and another person who is the principal for the purposes of the supply



# Extract from Supreme Court of Appeal Judgment (671/2020)

[11] The term 'agency' has a variety of meanings, depending on the context in which it is used. It may, for instance, be used to denote a contract of mandate. There a person (the principal) contracts with another (the agent) to perform some task, such as to find a buyer for the principal's property or to represent the principal in legal proceedings. A mandate is a contract by which the principal and the agent create rights and obligations only between them. It does not involve legal relationships with third parties [1 Lawsa 3 ed par 125].

[12] The expression is particularly used in respect of the phenomenon of representation. In such a case, a person (the agent) is authorised by another (the principal) to create, alter or discharge legal relationships between the principal and third parties. The essential characteristic of agency in the form of representation is that authority is conferred on the agent to bind the principal to third parties [J M Silke De Villiers and Macinstosh, *The Law of Agency in South Africa*, 3 ed (1981) at 38-39].

# Principal-Agent Arrangements and Service Concession Arrangements (SCA) [GRAP only]

A service concession arrangement is a contractual arrangement between a grantor and an operator in which:

- (a) The operator uses the service concession asset to provide a mandated function on behalf of the grantor for a specified period of time; and
- (b) The operator is compensated for its services over the period of the service concession arrangement.

**NB:** the wording “on behalf of” does not infer that a service concession arrangement is in all cases a principal-agent arrangement

**WHY?** The operator, using the service concession asset, must undertake transactions with third parties. There must be a specific transaction executed by the operator with third parties and the terms of the engagement are set by the grantor

Where a SCA is a principal-agent arrangement, **account** for transactions and balances in terms of **GRAP 32** and consider **additional disclosures from GRAP 109** (similar disclosures required in GRAP 32 and GRAP 109 should not be duplicated)

# Principal-Agent Arrangements and Service Concession Arrangements (SCA) (cont.)

## Scenario 1: Toll roads

An entity enters into a SCA with a private party for the construction of a toll road to be managed for a period of 10 years. The entity sets the fees that may be charged by the private party. The SCA further specifies that the private party (operator) may retain user charges up to a certain amount (p.a.), and amounts collected above this threshold are paid over to the entity (grantor). Where the amount collected is below the threshold the entity (grantor) will step in and compensate the private party (operator)

This arrangement is a principal-agent arrangement because there are transactions with third parties (by operator on behalf of the grantor), the user fees collected, under the set limit, is an “agent commission”. The entity (principal) is exposed to variability in the results of the transactions with third parties.

# Principal-Agent Arrangements and Service Concession Arrangements (SCA) (cont.)

## Scenario 2: Convention Centre

An entity enters into a SCA with a private party for the construction and operation of a convention centre. The private party is responsible for the identification, organisation and execution of events etc. and must ensure that the revenue generated from such events cover the operating costs of the convention centre.

The private party (operator) engages with third parties but for its own benefit and not on behalf of the entity (grantor), such arrangement is not a principal-agent arrangement.

# Assignment of Functions and unfunded mandates [Department and Municipality]

National and provincial governments are mandated to perform certain activities in the functional areas which are listed in Part A of Schedule 4 and Part A of Schedule 5 to the Constitution

Municipalities have the right to administer the local government activities listed in Part B of Schedule 4 and Part B of Schedule 5 to the Constitution

National and provincial governments may also assign certain of the activities mandated to them to a municipality (by agreement and subject to any conditions), if the matter would be most effectively administered locally, and if the municipality has the capacity to administer it:

- The municipality conducts the activity and not the provincial government and is thus responsible for the delivery of the services
- The arrangement that assigns activities to a municipality is not a principal-agent arrangement (consider *Transfer of Functions*)
- Care should be taken to assess the arrangement to ensure that the activities have been assigned (in substance) along with consideration of other legal requirements needed for such to occur

# Assignment of Functions and unfunded mandates (cont.)

National or provincial government may appoint a municipality as its agent to carry on certain activities to assist it in carrying out its mandate

- For example, the collection of motor vehicle license and registration fees on behalf of the provincial departments

National or provincial government may appoint a municipality as a service provider or contractor to carry on certain activities to assist it in carrying out its mandate

- For example, the upgrading of bulk water and sanitation infrastructure for the water services authority with funding received by way of an indirect grant

# Assignment of Functions and unfunded mandates (cont.)

In some instances provincial governments and municipalities have a shared constitutional responsibility to deliver goods and/or services to the general public.

In these instances, municipalities are expected to contribute financially to assist the provincial government to carry out its mandate (referred to as “unfunded mandates”)

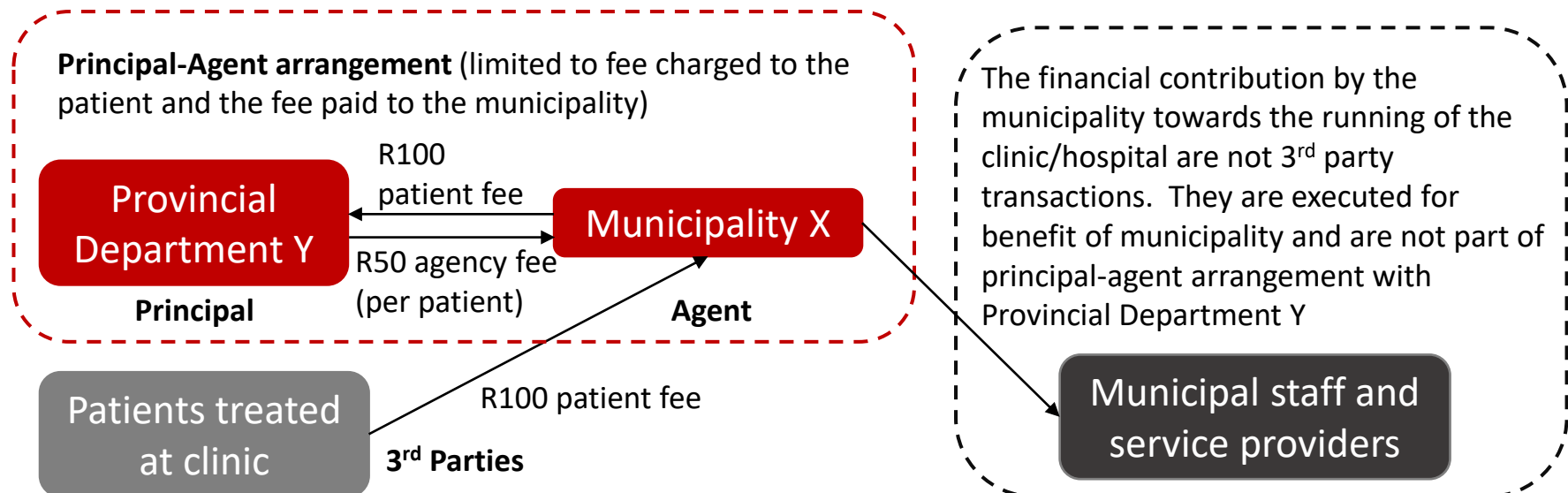
Examples of these “unfunded mandate” activities include the provision of Primary Health Care (PHC) services in provincial hospitals and municipal clinics, and the activities associated with the administration and maintenance of certain museums and libraries

**NB:** Arrangements other than formal assignment of activities to a municipality should be assessed to identify any principal-agent arrangements.

# Assignment of Functions and unfunded mandates (cont.)

## Scenario 3: Provision of Primary Health Care Services by municipality as an “unfunded mandate”

Province Y provides PHC services within Municipality X’s demarcated area and charges R100 per patient. Municipality X acts as the agent of Province Y in overseeing and managing the activity on behalf of Province Y under an SLA. Municipality X charges Province Y a fee of R50 per patient per month (including VAT). In addition Municipality X purchases medicines and pays R20 000 (inclusive of VAT) to the supplier as its financial contribution towards Province Y’s activities (“unfunded mandate”)





# Assignment of Functions and unfunded mandates (cont.)

## Scenario 4: Provision of Library Services

Province Y provides Library Services within Municipality X's demarcated area. Municipality X acts as the "agent" of Province Y in overseeing and managing the activity on behalf of Province Y under an SLA. Municipality X receives a conditional grant allocation from Province Y to assist with the funding of the costs associated with the running of the library. Any access fees and/or penalties charged are determined by and for the benefit of Municipality X. All operating costs are incurred by Municipality X as its financial contribution towards Province Y's activities ("unfunded mandate")

- The provision of library services has not been formally assigned to Municipality X
- In performing this service, Province Y's constitutional responsibility is fulfilled however Province Y is not involved in the management decisions, and terms of engagement with citizens accessing the library services
- Municipality X has accepted responsibility for the execution of the library services and engages with citizens in its own capacity (i.e. in its own name) with Province Y exercising oversight and providing some financial support
- Not a principal-agent arrangement

# Classification Circular 21 and Principal-Agent Arrangements [MCS only]

Does the classification of expenditure drive the decision on whether an arrangement is a principal-agent arrangement?

- **No**, the decision on how to classify expenditure is made after the decision on whether an arrangement is a principal-agent arrangement
- If expenditure should be classified as goods/services it does **not** mean that the arrangement is a principal-agent arrangement
- Example of **principal-agent arrangement with transfer expense**: Department of Social Development and payment of social grants by SASSA
- Example of **principal-agent arrangement with goods/service expense**: Department of Housing appoints a municipality to identify and construct social housing for beneficiaries (non-accredited municipality acting as a project manager)

# Additional Examples

NB: Fact patterns may vary according to arrangements in place

## Scenario 5: Maintenance and construction of proclaimed provincial roads

A Provincial Department of Transport enters into contract with a District Municipality in terms of which the District Municipality performs the roads maintenance and construction function on proclaimed roads on an agency basis for the Provincial Department of Transport

- A fixed amount for the execution of this activity is included in the contract, covering all the direct and indirect current / capital expenditure incurred
- An agency fee may be levied by the District Municipality but it is limited to a fixed percentage of the fixed amount specified in the contract. This fee must be approved and reviewed annually by the Provincial Department of Transport
- The contract states that “agency basis” means the relationship between the Provincial Department of Transport as the principal and the District Municipality as agent, whereby the latter performs the roads functions as directed by the principal through this agreement for the benefit of the principal

**NB-1: Even if a contract explicitly states that it is establishing a principal-agent arrangement or defines both parties as either the principal or the agent, it must nonetheless be assessed using the principles in Chapter 16 / GRAP 109.**

**This is line with the accounting concept → applying substance over form**

## Scenario 5: Maintenance and construction of proclaimed provincial roads (Cont.)

**NB-2: Although the activities undertaken by the District Municipality are for the benefit of the Provincial Department of Transport, there is no interaction with road users by the District Municipality. Therefore at an activity level, there are no transactions with 3<sup>rd</sup> parties.**

In executing the activity, the District Municipality is expected to:

- Employ **employees** for purpose of the roads function

The employees are appointed by the District Municipality and are, in terms of their employment contracts, employees of the District Municipality → The appointment of the officials are not considered to be 'transactions with third parties' and these transactions are **NOT** undertaken in a principal-agent arrangement;

- Purchase **materials and/or supplies or services** to be used for the maintenance and construction of proclaimed provincial roads

The contracts with the suppliers / service providers are between the District Municipality and the respective suppliers / service providers → The contracting with the suppliers / service providers are not considered to be 'transactions with third parties' and these transactions are **NOT** undertaken in a principal-agent arrangement;

## Scenario 5: Maintenance and construction of proclaimed provincial roads (Cont.)

### NB-3: What next?

#### District Municipality

***Rendering of Services*** (GRAP 9 on *Revenue From Exchange Transactions*) : revenue associated with the transaction is recognised with reference to the stage of completion of the transaction at the reporting date

***Compensation of Employees*** (GRAP 25 on *Employee Benefits*) : recognise liability and expense as and when the employee renders the service

***Goods / Services*** (GRAP 104 on *Financial Instruments* / GRAP 19 on *Provisions, Contingent Liabilities and Contingent Assets*) : recognise liability and expense when entity becomes a part to the contractual provisions or when the entity has a present obligation as a result of a past event

## Scenario 5: Maintenance and construction of proclaimed provincial roads (Cont.)

### NB-3: What next?

#### Provincial Department of Transport

**Prepayment** (Chapter 9 on *General Department Assets and Liabilities*) : recognise when the department pays the District Municipality as expense\*\* or asset

**Goods / Services** (Chapter 8 on *Expenses*) : recognise expense when prepayment is made\*\* or when service is rendered

*\*\*expensing of prepayments when made will no longer be permitted from 1 April 2023.*

## Scenario 6: Service Concession Arrangement facilitation

Department ABC appoints GTAC to assist the department with initiation and conclusion of a service concession arrangement

- In terms of this arrangement GTAC will prepare the requisite procurement documents, facilitate the procurement process and assist in the contract drafting and negotiation for Department ABC. The bid specifications are set and defined to address the needs and requirements of Department ABC

Transactions with  
third parties  
facilitated by GTAC

- The final service concession arrangement will be concluded between Department ABC and the successful party

For the benefit of  
Department ABC

The arrangement between Department ABC and GTAC is a principal-agent arrangement