Part (a) Calculate the impact that the implementation of the proposed activity-based cost allocation methodology would have on the FY2020 profit of each geographical segment				Marks
Cost per activity	**Total cost**	**Total activity**	**Rate**	
Innovation, research & development and technical manuals	43 245	1 441 500	0,03	1
Finance and administration	58 100	830 000	0,07	1
Payroll and human resources	48 950	445	110,00	1
Alternative				
Number of transactions	350 000	365 000	115 000	
% of total transactions	42,2%	44,0%	13,9%	1
Number of employees	180	165	100	
% of total employees	40,4%	37,1%	22,5%	1
External revenue	778 000	480 000	183 500	
% of external revenue	54,0%	33,3%	12,7%	1
Allocation to segments	**SITS SA**	**SITS China**	**SITS Brazil**	
Innovation, research & development and technical manuals	23 340	14 400	5 505	1
Finance and administration	24 500	25 550	8 050	1
Payroll and human resources	19 800	18 150	11 000	1
Managerial services	10 250	10 250	10 250	
Proposed allocation	77 890	68 350	34 805	
Current allocation	105 555	69 050	32 729	
Increase/(decrease) in profit	27 665	700	(2 076)	1C
Management services could be excluded in both the proposed and current allocation because the allocation base does not change and thus has no impact on profit.				1C
			Available	**8**
			Maximum	**7**
			Total for part (a)	**7**

Part (b)	**Evaluate the royalty fee transfer pricing model currently in place for management decision-making purposes**		**Marks**
1.	The method is very **simple and easy** to understand, and the consistency might appeal to managers – the system will not be difficult to administer, leading to cost savings.		1
2.	Recovering the costs of innovation, research and development and technical manual development through a revenue-based **royalty may be unfair**, because one division may be more responsible for R&D, which it then shares across other divisions; one of the divisions may also undertake a great deal of R&D that does not necessarily generate income. *Alternatively:* This **seems reasonable** as **these costs are required to generate revenue** and therefore the greater the segment's revenue, the more benefit it will receive from these services.		1 1
3.	Recovering finance and administration costs through a revenue-based royalty **is arbitrary**, as these costs are not revenue generation costs.		1
4.	The 12,25% rate appears to be **arbitrary.** (*or question* **how determined, or whether is market related**?) Was the management involved in negotiating the percentage of 12,25%?		1
5.	If the rate is not accurately set, there may be an **under- or over-recovery** of all the shared service division costs.		1
6.	There will be a **time lag** between R&D expenditure and its impact on revenue. Therefore the current allocation for this item does not seem to be appropriate as it is based on current year revenue.		1
7.	From a transfer pricing perspective, an arbitrary allocation may lead to incorrect **resource allocation** decisions for the company as a whole, or shifting staff to another division perceived to be more profitable.		1
8.	Currently there is an **over-recovery** of R26 million, calculated as follows:		
	Royalty earned by SSC (95 305 + 58 800 + 22 479)	176 584	1
	Costs incurred by SSC (43 245 + 58 100 + 48 950)	150 295	1
	Over-recovery of costs	26 289	1C
9.	Effectively a support centre is treated **as a profit centre –** this does not appear to be reasonable?		1
10.	However, this has limited impact as **no-one is evaluated on this profit:** it is not considered in measuring the performance of SITS SA and is eliminated on consolidation for measuring the performance of group management.		1
11.	P**rofit is shifted from low to high tax jurisdiction** for both SITS Brazil and SITS China which does not seem to be tax efficient.		1
12.	It will continue to be a challenge to prove that this over-recovery is reasonable for the **Chinese authorities to approve** its remission to SA.		1
13.	The current system does not incentivise the shared service center to **minimise costs**.		1
14.	The royalty fee of 12.5% comprises a **significant contribution** of revenue, especially considering the net profit percentages of the three divisions. This emphasises the fact that a reasonable and fair transfer price ought to be set.		1
15.	Including these costs in performance analysis **is appropriate** when considering the performance of **SITS as a whole** and not segment performance.		1
16.	The managers are assessed on a **basket of measures,** which also includes the net profit percentage. An unfair allocation of costs from a shared services division (as is the case here) would lead to unhappy management and unfair performance measurement.		1
17.	The current system, as it is based on revenue, may paradoxically lead to management **not wanting to increase revenue** in certain circumstances, as		1

the allocated cost will then increase as well (for instance if there was any uncertainty on collection of revenue).	
18. The company should use **standard costs (or budgeted)** for allocations to avoid inefficiencies being passed onto divisions if costs are exceeded. The service center must remain responsible for minimising costs. 19. They should rather use an allocation basis such as **activity based costing** to correctly allocate the costs based on their use using appropriate drivers. 20. The transfer price should be set correctly to ensure that the divisions goals are **congruen**t with those of the company as a whole, without compromising **autonomy**.	1 1 1
21. The impact on the movement of profits between the territories may result in **transfer pricing consequences with the** tax authorities, with resulting implications. Could be challenged under the general anti avoidance provisions under GAAR, to the extent not at market value.	1
Available	**24**
Maximum	**10**
Total for part (b)	**10**

Part (c) Evaluate each geographical segments' performance in relation to the key performance indicators presented in section 1. • Support your answer with appropriate calculations where necessary.	Marks
General	
1. Consider the ability of the division to **control the royalty and management fees** (shared service center costs). 2. If non controllable, should be **excluded** from the performance evaluation.	1 1
3. The fact that the **weightings** are different for the MDs and CFO makes **sense** as the MDs would have to do more work on the ground (e.g. relating to client satisfaction) and the CFO would have **greater responsibility** for budgets and cost control (net profit percentage). Alt – The CFO evaluation should include a measure of accuracy in accounts and reporting.	1 1
4. It is positive that **qualitative** elements are being considered.	1
5. The arbitrary allocation of **management fees distorts** the performance of the divisions 6. Management fees should be allocated to the division(s) that require the **most management attention**, rather than an arbitrary allocation, for a more accurate result.	1 1
7. The company should consider using a **balanced scorecard** approach to correctly drive performance management, 8. they should also consider using **economic measures** that are not impacted by accounting shortcomings.	1 1
9. The basis for the **allocation of royalty fees**, as a percentage of revenue, appears to have **changed** from previous year.	1
10. Overall performance based on the weighed KPIs indicates that SITS **China outperformed** the other two geographical segments, followed by SITS Brazil. This is consistent for the performance of both regional MDs and the regional contribution to the group CFO. The calculations are as follows:	1

	SA	***China***		***Brazil***	
CEO	**% x indicator**	**% x indicator**		**% x indicator**	
Net profit percentage	1.85	4.475		3.15	9.475

Return on average assets	5.525	8.575	3.7	17.8	
Client satisfaction score	13.75	18.75	17.5	50	
Direct staff utilisation percentage	23.75	20	25	68.75	
Total weighting	**44.875**	**51.8**	**49.35**	**146.025**	3
CFO	**% x indicator**	**% x indicator**	**% x indicator**		
Net profit percentage	2.59	6.265	4.41	13.265	
Return on average assets	7.735	12.005	5.18	24.92	
Client satisfaction score	8.25	11.25	10.5	30	
Direct staff utilisation percentage	14.25	12	15	41.25	
Total weighting	**32.825**	**41.52**	**35.09**	**109.435**	3A

Combined	CEO	CFO	
Net profit percentage	9.475	13.265	
Return on average assets	17.8	24.92	
Client satisfaction score	50	30	
Direct staff utilisation percentage	68.75	41.25	
Total weighting	146.025	109.435	2A

SITS SA Evaluation	
11. SITS SA had a **significant increase in revenue** from 2019 of 11.9%. And therefore outperformed the other two divisions in growth.	1
12. SITS SA was the only segment whose **net profit percentage increased significantly** showing an excellent performance, most likely due to **its reliance on the Go-Mobility programme** for its performance. Other segments should **get some credit.**	1 1
13. The SA direct **staff costs have decreased significantly**, 14. investigate as to why, either **less staff**, or they are being **paid less.**	1 1
14.1. The decline in staff costs means that with **less staff** at SITS SA, the **capacity utilisation** is necessarily higher.	1
14.2. There is a significant increase in **other fixed costs**. This is a **concern and needs to be investigated**. 14.3. Could be due to **load-shedding / staff union negotiations** (or other reason)? These are likely to affect South Africa more than, say, China. 14.4. This will also impact on the **risk of the division**, and their degree of operating leverage.	1 1 1
15. SITS SA's net profit percentage is still lower because of the **higher tax rate** in SITS SA Profitability would have been **significantly higher** if head office allocated costs (approximately R27 million for SITS SA which is an overallocation) had been based **on ABC principles (better allocated)**.	1 1 1
16. All three segments experienced a decline in their return on assets (ROA), indicating that **assets have been used less effectively to generate profits**. SA, however, had the **smallest decline**. 17. This is partly due to their **assets increasing by 21.5%,** therefore 18. Additional assets may be **building capacity**.	1 1 1

19. This is consistent as witnessed by the increase in its depreciation charge.	1
20. All other things being equal, one would have expected the **SITS SA ROA to have improved**, given its strong increase in profits.	1
21. When comparing the segments' ROA, the following factors need to be considered:	
21.1. For SA vs China - Comparability of **right-of-use** asset with owned premises 21.2. depends on the **length of the lease –** the longer the lease the more comparable it will be, as more lease payments would be capitalised as a right of use.	1 1
21.3. The **age of the assets, and resultant carrying value** should be considered. Any older assets have a lower carrying value resulting in a higher ROA which is a flaw of ROA. This can affect the **comparability** of the ROA percentages among the 3 geographical segments.	1 1
22. There is a need to question the medium- to **long-term impact of 100% staff utilisation:** 23. **for example** what about staff development to ensure staff stay abreast of changes in a fast-moving sector?	1 1
24. SITS SA **client satisfaction** is not only the lowest of the three, but is also **decreasing**, therefore poorest performer.	1
24.1. Projects may have been **rushed and not completed properly**, leading to a decline in customer satisfaction.	1
24.2. An over-reliance on foreign staff. SITS SA clients could have struggled to understand the workers due to **language and cultural barriers, or less care by foreigners**.	1
SITS CHINA Evaluation	
25. The CHINA division is **stable, or stagnant**, and the staff has grown in line with revenue.	1
26. Despite the slight decline in SITS China's staff utilisation, the Go-Mobility programme **had a positive impact on SITS China's net profit percentage** 27. as the extra revenue earned **negated** the lower profit percentage.	1 1
28. If the opportunity loss for Brazil below is taken into account, the net profit percentage in **China is still higher** than that of Brazil.	1
29. China experienced the largest decline in their return on assets (ROA), indicating that **assets have been used less effectively to generate profits**. 30. The assets have declined, therefore the **profit decline is the biggest** driver of this decrease.	1 1
31. The decrease in **SITS China's staff utilisation is surprising** given the increase in Chinese staff used by SITS SA and the increase in external revenue. 32. Thus staff were **more effective in generating revenue** when they were busy.	1 1
33. The increase in SITS China's client satisfaction score is significant and puts them as **lead on client service**. 34. which is important for securing **future work** with existing clients	1 1
SITS BRAZIL Evaluation	
35. Brazil has performed particularly **badly on profits**, significant decline of 34.4%. May be due to transferring **labour to SITS SA** at a lower margin, therefore reducing their profit.	1 1
36. SITS Brazil had **an opportunity cost** for not being able to take advantage of the **30% increase** in demand in that country. The lost profit is calculated as follows:	1

Loss of external revenue (183 500 / (1 – 22,1%) x 30%)	70 667	1
Go-mobility revenue	61 500	1
Lost revenue	9 167	
After tax of 15%	7 792	1

37. However, would SITS Brazil have had **capacity for the 30% increase in demand** for IT services?	1
38. If the opportunity cost is excluded, SITS Brazil's net profit percentage would have been **15,23% (or net profit would have increased by 11,4%**).	1
39. The **royalty charged** to Brazil is **significantly less** than the previous year, and has **dropped more than revenue**, this should be investigated.	1
40. It is surprising that Brazil **staff costs increased** so significantly, by 12.8%, while revenue decreased by 6%, 41. this warrants investigation into **unproductive employees** or too expensive staff. 42. Brazil staff costs went up by 12.8%, and utilisation by 17.6%, this has **not however yielded a full increase** in profits as the staff were seconded on the Gomobility programme.	1 1 1
43. SITS Brazil appears to have **managed its other fixed costs well** given the large decrease, increasing profit.	1
44. Although the increase in SITS Brazil's **direct staff costs was high**, it enabled the **increase in Go-Mobility revenue** and increased SITS SA's profitability.	1
45. The question is whether SITS Brazil ensured that **group profitability was maximised** 46. by making sure that staff resources were allocated to generating the **highest revenue, given that all costs are fixed**.	1 1
47. Brazil experienced a decline in their return on assets (ROA). Their **assets have declined significantly** by 34.4%, therefore the profitability decline is even more significant considering the base decreased as well.	1 1
47.1. **Asset structure – flexible working** arrangements result in a lower net asset base. 47.2. This **inflates** SITS Brazil's **ROA performance** relative to the other segments that use owned or right-of-use assets.	1
48. The **need for SITS Brazil to sacrifice revenue growth** due to it already having committed staff to the Go-Mobility programme needs to be questioned, in view of the fact that **SITS SA was not at 100% utilisation**.	1
49. This could be as a result of the **inflexibility** of the Go-Mobility programme that requires a minimum of **three months**.	1
50. SITS Brazil's **increase in staff utilisation** is a result of the increase in staff used by SITS SA and the increase in demand for IT services in SITS Brazil.	1
51. SITS Brazil is the most consistent **best performer on client service**. 52. The decrease in SITS Brazil's client satisfaction score could result in **clients leaving** and therefore further decreases in revenue.	1 1
53. This could have been due to **stretched staff resources** (as indicated by the 100% staff utilisation) resulting in staff not spending sufficient time on ensuring that clients were satisfied (quality of service).	1
Available	**75**
Maximum	**20**
Communication skills – presentation; logical argument	***2***
Total for part (c)	**22**

Part (d) Discuss the income tax and VAT consequences for SITS SA arising from the Go-Mobility programme (see section 3, note 1)	**Marks**
Value-added tax	
SITS Brazil and SITS China are non-residents for both VAT and Income Tax purposes as each of the companies is managed in the country of origin making the place of effective management outside South Africa (s 1 'resident' definition VAT Act & Income Tax Act).	1

A **subsidiary is a separate legal entity** and just because the holding company (SITS SA) is registered for VAT doesn't mean the subsidiaries (SITS Brazil and China) are registered and could not charge South African VAT.	1
1. The Go-Mobility charge from SITS SA is for supplies made by SITS Brazil and SITS China, who are non-residents carrying on enterprises outside South Africa, there is **no indication** that SITS Brazil or SITS China would have charged **South African VAT**.	1
2. The Go-Mobility charge is in respect of an **imported service** which may give rise to VAT charged under s7(1)(c) of the VAT Act.	1
3. However, tax charged is only payable to the extent to which the imported services are utilised or consumed in South Africa for purposes **other than making taxable supplies** (s1 'imported services' definition/ s14(5) of the VAT Act). According to the scenario **none of SITS SA listed offerings include zero rated services** (listed in s11) or **exempt services** (listed in 12).	1
4. SITS SA **will not be required to charge VAT** on these imported services because the Go-Mobility services are fully used to make taxable supplies.	1
Income tax	
No VAT consequences arise on the Go-Mobility programme so VAT does not have to be taken into account for Income Tax purposes (s23C of the Income Tax Act).	1
5. The charges paid by SITS SA constitute expenditure actually incurred in the course of carrying on a trade, in the production of income and not of a capital nature, and would be **deductible under the general deduction formula** provided all requirements are met (s11(a) read together with s23).	1
6. The Go-Mobility charges incurred would have to be translated from the foreign currencies to rand using the **spot rate on the date of the transaction** in terms of s25D(1).	1
7. The mark-up that is at 7,5% while the market related rate is at 35% can result in a deduction of the Go-Mobility charges by SITS SA that may be subject to the **transfer pricing provisions (s31)** if there is an affected transaction that results in a tax benefit being derived by any party to the transaction.	1
8. In this context there is an affected transaction if:	
4.1 the cost recovery arises from an **agreement** between the SITS entities;	1
4.2 the Go-Mobility agreement was entered into between **a resident (SITS SA)** and **non-residents (SITS Brazil and SITS China);**	1
4.3 the parties to the agreements **are connected persons** as SITS SA **holds all the shares** in each of SITS Brazil and SITS China; and	1
4.4 the charge at cost plus 7,5% is a term in the contract that differs from what would **apply in an arm's length transaction** between unconnected persons. The market-related rate would be cost plus 35%.	1
9. However, the existing arrangement **does not result in a tax benefit** for SITS SA because SITS SA is claiming a **lower deduction** (cost plus 7,5%) instead of market rate (cost plus 35%). This is a higher deduction than it is currently claiming.	2
10. **Conclusion:** As a result, **s31 will not apply** because none of the parties to the arrangement derives a tax benefit from it.	1
Available	**17**
Maximum	**10**
Communication skills – logical argument	***1***
Total for part (d)	**11**