

## QUESTION 1

50 marks

All amounts exclude value-added tax (VAT) unless stated otherwise.  
Ignore the double tax agreements between South Africa and Brazil or China.

### 1 Background

The Superior Information Technology Services ('SITS') group consists of a number of unlisted companies operating in the information technology (IT) services industry. The group's service offerings include the following:

- Information and system security services;
- Outsourcing and network provider services;
- Business process automation; and
- Application and systems integration.

You may assume that these services are not regarded as electronic services for VAT purposes.

The SITS business operations are structured across three geographical segments, namely South Africa ('SITS SA'), China ('SITS China') and Brazil ('SITS Brazil'). Each segment operates through a company that is a separate legal entity incorporated in that country. Both China and Brazil have corporate tax rates of 15%. The group's headquarters are in Johannesburg, South Africa. SITS China and SITS Brazil are wholly-owned subsidiaries of SITS SA. SITS SA is a registered VAT vendor. All entities comply with International Financial Reporting Standards (IFRSs).

Each segment is managed by a regional managing director and the group is managed by a group chief executive officer (CEO) and a group chief financial officer (CFO). The performance of the group CEO and CFO is measured on the performance of the group based on its consolidated results. The performance of the regional managing directors (MDs) is measured with reference to the performance of their respective segments only. The following performance measures and weightings are used:

Performance measure	Weighting: group CEO and regional MDs	Weighting: group CFO
Net profit percentage	25%	35%
Return on average assets	25%	35%
Client satisfaction score	25%	15%
Direct staff utilisation percentage	25%	15%
Total weighting for performance measurement	100%	100%

### 2 Shared services centre

The company has a centralised shared services centre, situated at its headquarters and operated through SITS SA. The centre is responsible for innovation, research and development, technical manuals development, finance, administration, payroll, human resources and the management of the group. The shared services centre's costs are not allocated to the segments using conventional cost allocation methods but are rather 'sold' to the segments through a royalty fee charge. The royalty fee is calculated as 12,25% of the segment's external revenue. In addition to the royalty fee, a management fee that covers the cost of the CEO, CFO and non-executive directors is split equally between the three segments. The shared services centre earns its revenue through the royalty and management fees.

SITS China owes SITS SA R35 million in royalty and management fees. The Chinese Revenue Authority (CRA) has not allowed SITS China to pay this amount to SITS SA. In terms of Chinese legislation, approval needs to be obtained from the CRA before monies can be remitted to foreign shareholders. Over the past few years, the CRA has not given approval for all royalty and management fees charged by SITS SA to be transferred.

### 3 Financial results and operational performance

The segment report below for the three geographical segments has been prepared for the financial year ended 31 December 2020 (FY2020). Results of SITS SA exclude the revenue and expenses of the shared services centre but include the inter-segment expenses (royalty and management fees) charged by the shared services centre to the SITS SA segment.

Superior Information Technology Services							
Segment performance report for the year ended 31 December 2020							
	Notes	SITS SA		SITS China		SITS Brazil	
		2020	Δ from 2019	2020	Δ from 2019	2020	Δ from 2019
		R'000	%	R'000	%	R'000	%
<b>Revenue</b>		<b>778 000</b>	<b>11,9</b>	<b>507 250</b>	<b>3,2</b>	<b>245 000</b>	<b>(6,1)</b>
External	1	778 000	11,9	480 000	2,8	183 500	(22,1)
Inter-segment	1	–	–	27 250	10,1	61 500	141,2
<b>Operating expenses</b>		<b>698 155</b>		<b>400 325</b>		<b>208 629</b>	
Inter-segment charges		194 305	34,2	69 050	3,7	32 729	(14,3)
Royalty fees		95 305	11,9	58 800	2,8	22 479	(22,1)
Management fees		10 250	9,6	10 250	9,6	10 250	9,6
Go-Mobility charges	1	88 750	76,6	–	–	–	–
Direct staff costs	2	209 000	(16,4)	149 000	2,2	90 500	12,8
Depreciation	3	2 550	4,1	1 575	1,6	250	2,0
Other fixed costs		292 300	20,2	180 700	6,0	85 150	(5,8)
<b>Profit before tax</b>		<b>79 845</b>	<b>45,5</b>	<b>106 925</b>	<b>(0,4)</b>	<b>36 371</b>	<b>(30,0)</b>
Tax expense		22 357	36,5	16 039	(0,4)	5 456	(30,0)
<b>Profit</b>		<b>57 488</b>	<b>49,4</b>	<b>90 886</b>	<b>(0,4)</b>	<b>30 915</b>	<b>(30,0)</b>
<b>Net operating assets</b>	3	<b>285 750</b>	<b>21,5</b>	<b>260 200</b>	<b>(3,7)</b>	<b>165 750</b>	<b>(34,4)</b>
		<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>
Net profit		7,4	33,5	17,9	(3,5)	12,6	(5,2)
Return on average assets		22,1	(9,0)	34,3	(26,8)	14,8	(15,7)
Client satisfaction score		55,0	(26,7)	75,0	25,0	70,0	(10,3)
Direct staff utilisation		95,0	5,6	80,0	(3,6)	100,0	17,6

Δ Refers to the change from FY2019 amounts.

## Notes

- 1 The geographical segments share staff through a programme known as Go-Mobility. Under this programme, staff members are shared between segments for periods of at least three months. Staff are transferred at their cost of employment applicable at the transfer date plus a 7,5% mark-up. Given the nature of the services SITS provides, staff can offer their services anywhere in the world, thus sharing of staff through the Go-Mobility programme can be done remotely, while staff continue to be physically present at their normal places of work. The market-related charge-out rate for the Go-Mobility services to external clients is cost plus 35%.

The demand for IT services in Brazil increased by 30% during FY2020. However, because SITS Brazil had already committed staff to SITS SA as part of the Go-Mobility programme, SITS Brazil was not able to take full advantage of the increased demand.

The internal revenue of SITS China and SITS Brazil refers to income received from SITS SA as a result of the Go-Mobility programme. Due to the shortage of personnel with the required IT skills in South Africa, SITS SA increasingly relies on the Go-Mobility programme to provide the staffing resources it requires.

- 2 Direct staff costs are those relating to the staff responsible for delivering the IT services. These staff members are full-time employees. Remaining staff costs are included in other costs.

SITS Brazil has flexible working arrangements, allowing staff to work either from home or from co-working spaces. Co-working spaces are membership-based workspaces where diverse groups of remote workers and other independent professionals work in a shared communal setting. Staff members are paid a monthly allowance, included in direct staff costs, for working from home or to cover their co-working space membership fees.

- 3 Depreciation relates to the depreciation of properties, office equipment and IT hardware and software that are included in net operating assets. SITS SA owns the headquarters building. SITS China leases its premises because of restrictions on foreign ownership of property in China. SITS China's depreciation charge includes the depreciation on the underlying right of use asset recognised in accordance with IFRS 16 *Leases*. Given SITS Brazil's flexible working arrangements, SITS Brazil does not own or lease any premises.

#### 4 Revised cost allocation methodology

SITS is evaluating a new activity-based cost allocation method to replace the current application of royalty and management fees. In terms of the proposed methodology, there would be the following cost pools and cost drivers:

Cost pool	Cost driver
Innovation, research and development, and development of technical manuals	Rand amount of external revenue generated by the segmented division
Finance and administration function	Number of transactions
Payroll and human resources function	Number of employees
Managerial services	None: split equally between the divisions

The following information relating to the costs incurred by the shared services centre has been gathered based on the results achieved in FY2020:

Cost pool	R'000
Innovation, research and development, and development of technical manuals	43 245
Finance and administration function	58 100
Payroll and human resources function	48 950
Managerial services	30 750

Cost driver	SITS SA	SITS China	SITS Brazil
Number of transactions	350 000	365 000	115 000
Number of employees	180	165	100

**INITIAL TEST OF COMPETENCE, SEPTEMBER 2021**

**PROFESSIONAL PAPER 1**

<b>PAPER 1 QUESTION 1 – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(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.	7	7
(b)	Evaluate the royalty fee transfer pricing model currently in place for management decision-making purposes.	10	10
(c)	Evaluate each geographical segment's performance in relation to the key performance indicators presented in section 1.	20	
	<ul style="list-style-type: none"> <li>Support your answer with appropriate calculations where necessary.</li> </ul> <p><i>Communication skills – presentation; logical argument</i></p>	2	22
(d)	Discuss the income tax and VAT consequences for SITS SA arising from the Go-Mobility programme (see section 3, note 1).	10	
	<i>Communication skills – logical argument</i>	1	11
<b>Total for question 1</b>			<b>50</b>