Southern African Business Review
Volume 7 Number 2
December 2003

Contents

Research articles

The *Southern African Business Review* is a publication of the Faculty of Economic and Management Sciences, University of South Africa.

A Note from the Editor

Accreditation of the *Southern African Business Review* and new editors

We have been informed by the Department of Education that the *Southern African Business Review* (SABR) will be included on the list of accredited journals from the beginning of 2004.

As editor, I wish to thank all the authors who have published articles in the *SABR* in the past. Your contributions have made it possible to establish the journal as an accredited publication for the southern African region in the generic field of economic and management sciences.

With your continued support, the *SABR* will continue to grow in stature as the premier journal in this field, and we look forward to receiving further contributions from you in future.

My second stint as editor of the *SABR* has come to an end. As from 2004, the journal will be under two new editors, Professor André Ligthelm, Research Director of the Bureau for Market Research and Professor Elmare Sadler, from the Department of Applied Accountancy, both at the University of South Africa. Erna Koekemoer takes over as Assistant to the Editors, and Robyn Arnold will continue as Advisory Editor. I wish them and their editorial team all the best with this responsibility, and may they gain as much as I did in performing the editorial functions.

As outgoing editor, I would like to thank Marlé Geldenhuys (Assistant to the Editor) and Robyn Arnold (Advisory Editor) for the ways in which they have supported the journal over several years.

With best wishes for the new year,

Marius van Wyk
Editor: *Southern African Business Review*
December 2003

Tourism marketing value of the World Summit on Sustainable Development

*J.H. Martins**

South Africa hosted the World Summit on Sustainable Development (WSSD) in 2002. This event is regarded as the single biggest conference to have been held anywhere in the world, and is the largest international conference to have been held in South Africa to date. The aim of this paper is to discuss the tourism marketing value of the WSSD and its parallel events to South Africa. The value is discussed in terms of the impression of South Africa as a tourist destination that delegates gained during their stay in the country. Delegates were required to indicate how satisfied they were with various aspects during their stay for the WSSD, as well as their opinion of South Africa as a tourist destination.

Introduction

The international community came together for the first time to focus on environmental issues in 1972 at the United Nations Conference on the Human Environment, held in Stockholm, Sweden (United Nations 1972). One of the main outcomes of this conference was the creation of the United Nations Environment Programme (UNEP), tasked with protecting the global environment. Following the Stockholm Conference, the impact of environmental degradation on human socio-economic development received increased attention. In 1983, the United Nations set up the World Commission on Environment and Development (WCED). The work and findings of the Commission were published in 1987 in a report entitled *Our Common Future* (WCED 1987). The report made it clear that critical and globally threatening environmental problems were emerging. The WCED came up with the concept of sustainable development, which recognises that environmental protection and socio-economic development can be mutually supportive and need to be looked at in an integrated manner.

The Summit immediately prior to the WSSD was held in Rio de Janeiro, Brazil, and was also known as the 1992 Earth Summit. At the time, it was the largest international gathering ever held, bringing together 108 heads of state to endorse Agenda 21, the action plan for a sustainable future. The conference was attended by 50 000 delegates, representing 179 countries.

International experience suggests that events of the nature of an international summit are funded from various sources, and through various financial instruments. In the main, funds (in the form of public funding) provided by the host country have tended to account for a significant share of the total budget. Given that the WSSD would be funded through public funds, it became critical how these funds would be spent. It was against this background that the South African government had to decide whether to bid to hold the WSSD in South Africa. A decision had to be taken on whether the WSSD would create more net benefits to the South African economy than other exclusive options for the use of the resources in question.

International experience with respect to events of this nature and scale is very limited, if not non-existent. It has emerged that no tourism and economic impact assessment study was conducted of the 1992 Earth Summit in Rio de Janeiro.

A study conducted by Grant Thornton Kessel Feinstein (2001) predicted that the WSSD would inject about R1599.7 million into the South African economy and would create approximately 16 400 jobs during the Summit. It was expected that the WSSD would be attended by more than 65 000 people, including 135 heads of state. Furthermore, the relevant study suggested that, from a tourism perspective, the WSSD would increase South Africa's exposure as a tourist destination through the arrival of about 5000 international media personnel. It is against this background that the South African government decided to proceed with its bid to host the WSSD.

South Africa hosted the WSSD between 26 August and 4 September 2002 in the City of Johannesburg

* Professor J.H. Martins is director of the Bureau of Market Research, University of South Africa.
E-mail: martijh@unisa.ac.za.

(United Nations 2000). This event is regarded as the single biggest conference to have been held anywhere in the world, and is the largest international conference to have been held in South Africa to date. It should also be borne in mind that the activities were not restricted to a single event. Almost 500 (494) parallel events were held concurrently in other parts of South Africa. Whereas the WSSD was covered and managed by the United Nations, these smaller events were covered and managed by organisations or groups independent of the United Nations.

Problem statement

The question remained: 'What was the marketing value of the investment made?' To estimate this, the Department of Environmental Affairs and Tourism commissioned Urban-Econ and a consortium consisting of Iklwa Structured Financial Products and the Bureau of Market Research at the University of South Africa to undertake an independent marketing and economic impact assessment of the WSSD and side events with respect to the South African economy.

The aim of this paper is to discuss the marketing value to tourism of the WSSD and its side events. This impact will be discussed in terms of unquantifiable findings, such as the creation of possible future prospects for tourism. Before discussing the survey methodology and the research results, the next section is devoted to a brief theoretical discussion, which underpins the study.

'Tourism' and 'tourist'

The Tourism Society's definition of 'tourism' is quoted as follows in Bennet (2000: 6): "Tourism is deemed to include any activity concerned with the temporary short-term movement of people to destinations outside the places they normally live and work, and their activities during the stay at these destinations." A tourist can be defined in terms of a statistical and conceptual attribute. Standard international statistical definitions were formulated to monitor the size and characteristics of tourism markets. Bennett (2000: 4) describes the two types of definition, as discussed in the following sections.

Statistical definitions

For statistical purposes, the following categories of tourists are distinguished:

- A distinction is drawn between international visitors, international tourists and international excursionists. International *visitors* are defined as people who visit a country other than their usual place of residence, for no longer than one year, and whose main purpose in visiting is not the pursuit of an occupation remunerated from within the country visited. International visitors can be subdivided into international tourists and international excursionists:
  - International *tourists* are international visitors staying for at least 24 hours, but for no more than one year, in the country visited. The purpose of such a visit can be classified under one of the following headings:
    - Pleasure, recreation, holiday, sport
    - Business, visiting friends and relatives, missionary work, meetings, conferences, health, studies, religion.
  - International *excursionists* are international visitors staying for less than 24 hours in the country visited.
- A similar distinction is drawn between domestic visitors, tourists and excursionists. Domestic *visitors* are residents of a country (regardless of nationality) who travel to a place within the same country for no longer than one year and whose main purpose in visiting is not the pursuit of an occupation remunerated from within the place visited. This category of visitors is subdivided into domestic tourists and domestic excursionists:
  - Domestic *tourists* are defined as domestic visitors staying for at least 24 hours, but not more than one year, in the place visited.
  - Domestic *excursionists* are described as domestic visitors staying for less than 24 hours in the place visited.

Conceptual definition

The word 'tourist' is derived from the word 'tour', which can be described as 'a journey during which one returns to the starting point, a circular trip ... during which various places are visited and for which an itinerary is usually planned'. In attempting to define a tourist, four dimensions are relevant:

- The journey, which involves a stay of at least one night away from the usual place of residence.
- Activity, which involves discretionary use of time and monetary resources. This includes both holiday tourists and business travellers.

- Consumption, namely the fact that tourists are net consumers of economic resources within regions visited.
- Tours, which refer to the fact that the trips tourists make are of a circular nature, always leading back to the point of origin.

With the above dimensions in mind, Leiper (in Bennett 2000) defines a tourist as "a person making a discretionary, temporary tour which involves at least one overnight stay away from the normal place of residence, excepting tours made for the purpose of earning remuneration from points en route".

Most of the delegates attending the WSSD and side events were not tourists in the true sense of the word. However, they experienced tourist facilities during their stay in South Africa and, as such, obtained a first-hand impression. The next section explains the importance of this experience.

Motivation to travel

The decision to take a holiday and to travel stems from individual needs and desires, which in turn determine motivation. The motivation is followed by an evaluation of alternative holiday destinations, a booking (decision), the holiday itself and eventual satisfaction. When considering alternative destinations, prospective tourists rely heavily on their impressions of a particular destination. If the impression of a destination coincides with the tourist's preferences and expectations, the destination will be given a favourable rating. An individual's perceptions of holiday destinations are conditioned by the information available at the time of decision-making. At any given time, each person is aware of only part of the total holiday opportunity.

According to Witt & Moutinho (1995), classifying the traveller's decision process from a micro-perspective requires a more discriminating approach:

- Novel and/or inexperienced tourists are likely to engage a process known as 'extensive problem-solving'. In order to arrive at a travel decision, the tourist runs through a sequence of perceptual and learning steps. When such people become aware of new travel options, they actively search for information, develop choice criteria, establish overall attitudes towards the range of alternatives, determine a preference for a particular tour operator, and so forth.
- A decision process, known as 'limited problem solving', helps travellers to avoid conflict and reach a conclusion in their endeavour. A satisfactory amount of product knowledge and firmly established choice criteria help to reduce the information-seeking period and thus the decision time.
- Consumer information processing drops to a minimum level in 'routinised response behaviour'. Preferences are stable, and the main question is whether the favourite alternative is still available. Loyalty *vis-à-vis* a tour operator, an agency, a resort or a hotel is quite common in such travel behaviour.
- Conversely, 'impulse buying', the fourth type of consumer decision process, is a rare phenomenon in travel and tourism. For most consumers, holiday and travel decisions are highly important, with a great deal of ego involvement. They are not usually dealt with spontaneously in a rapid booking action.

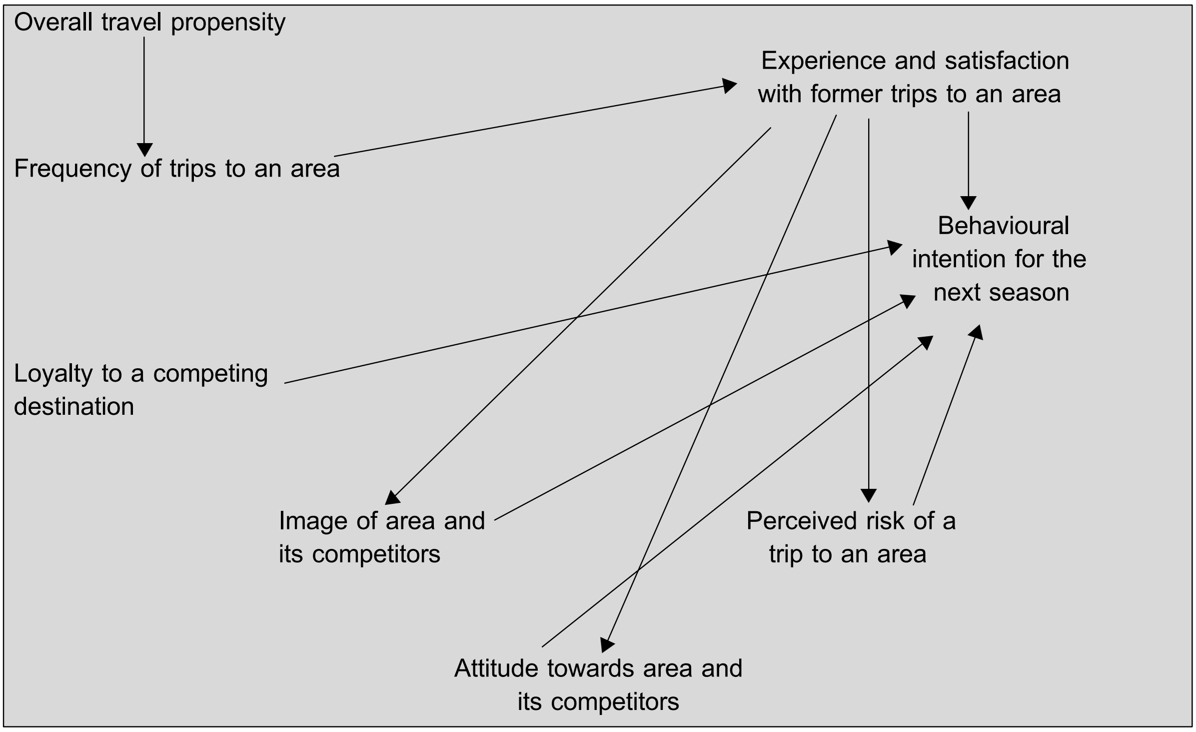
Witt & Moutinho (1995: 275) portray a structured model of travel behaviour, as shown in Figure 1.

The purpose of the survey conducted during the WSSD was, among other things, to establish the image of South Africa as perceived by delegates.

Tourism research

Tourism has already developed theoretical concepts peculiar to tourism itself. Various quantitative and qualitative research methods have been developed. Jennings (2001) describes, *inter alia*, two of the survey techniques used in the WSSD study, namely on-site and en-route surveys. The following codes of ethics must be adhered to (Jennings 2001: 98):

- Voluntary participation by the individual
- Informed consent given by the participant after being provided with either oral or written information about the research
- The right of the individual to refuse to answer any questions or perform any actions
- The right of the individual to withdraw from the research at any time
- The right of the participant not to be deceived regarding any aspect of the research (purpose, sponsor or use of the findings)
- The right of the participant not to be harmed during any stage of the research, as well as after the research has concluded
- The right of the individual to have any personal information or data treated as either confidential or anonymous, as befits the circumstances of the research



Source: Adapted from Witt & Moutinho (1995)

Figure 1: A structural model of travel behaviour

- The right of research participants to access the research findings.

This paper will provide an opportunity for respondents interviewed at the WSSD to access the research findings.

Uniqueness of tourism marketing

According to Bennett (2000: 195), tourism marketing differs somewhat from traditional product marketing in the following ways:

- Tourism products manifest the typical characteristics of services, namely intangibility, inseparability, heterogeneity and perishability.
- The tourism product is, in fact, an amalgam of several services and products offered by different organisations, for example the transportation, accommodation, food and beverage, attraction and activity components.
- Because tourism products and services are removed from potential customers, specialised intermediaries (such as travel agents) are often needed to bridge the gap.
- Tourism demand is highly elastic and seasonal.
- The tourism product is marketed at two levels. The national, regional or local tourist organisation will typically be engaged in a marketing campaign to persuade the potential tourist to visit the country, region or city it covers. The aim of this marketing effort is to create an identifiable image and persuade visitors to visit the area. Under this umbrella marketing campaign, the various individual providers of tourism products and services (such as airlines, hotel groups and tour operators) can market their own components of the total tourism product.

Forecast of international tourism

Latham (1994) maintains that forecasting in any form of business activity, though often necessary, is hazardous, with numerous pitfalls. Even short-term forecasts can be wildly inaccurate as a result of sudden changes in trends or other unforeseen circumstances.

The methods used to make forecasts in tourism are wide-ranging, though essentially they are either time-series based or econometric in nature. Those based on time series make use of data from the past to produce projections of the future. The econometric forecasting of demand involves establishing a mathematical relationship between demand and a number of other key variables (such as origin, population size, personal disposable income, cost of living for tourists, cost of travel). Forecasts of these variables are then fed into an equation to derive a forecast of demand.

The survey results, discussed in the second part of this paper, provide no quantitative forecast. However, an indication of tourism expectation is given, based on the survey results.

International tourism highlights

The information in this section was derived from the World Tourism Organisation (2002). Tourism enjoyed exceptional years in 2000 and 2001. In 2000, international tourism grew by 45 million arrivals, reaching levels rarely seen before.

In 2001, international arrivals declined by 0.6%, the first year of negative growth for international tourism since 1982. However, the results for 2001 would have been in line with the trend observed over the past decade had it not been for the magnitude of the increase in tourist arrivals in 2000, which was far larger than the figures for the preceding years. Table 1 shows international tourist arrivals for 2000 and 2001, by main area.

As already mentioned, worldwide tourist arrivals experienced a 0.6% decrease, which is somewhat less than the feared decrease after the incident of 11 September. The Americas suffered the most, followed by South Asia and the Middle East.

Africa

Africa experienced a 4.6% increase in international arrivals in 2001. South Africa remains the most important destination, despite suffering a 1.5% decrease in arrivals. The countries that enjoyed the biggest growth in 2001 were Namibia, Tanzania and Nigeria, but this was due mainly to their low baseline international arrival figures.

The Americas

All of the Americas, excluding Central America, suffered declines in international arrivals in 2001. It was a very poor year for tourism in the Americas, especially for the United States (10.7% decrease). The entire region experienced an average decline of 6.0%.

East Asia and the Pacific

In contrast with the Americas, East Asia and the Pacific continued with strong growth, as seen in 2001, averaging 5.5%. China, together with Hong Kong and Macau, is becoming the unrivalled leader of Asian tourism, followed by Malaysia, Thailand and other countries, while Australia experienced a 2.6% decrease from 2000, when it hosted the Olympic Games.

Europe

Europe failed to repeat the record results posted in the Jubilee Year of 2000. In relative terms, the decrease of 0.7% does not appear that bad; however Northern Europe, especially the United Kingdom, suffered an average decline of 5.9%.

Middle East

On average, international arrivals were down 2.5% from the previous year. The greatest success was experienced in Lebanon, Jordan and Iraq (although on very low baseline figures), while Egypt suffered a decline of 14.8%.

South Asia

South Asia felt the impact of the increased tension between India and Pakistan and the war in Afghanistan. Arrivals were down 4.5%, with Nepal, Pakistan and Sri Lanka suffering the biggest declines. India managed to keep its decline below the average, while Iran did well with growth of 4.5%.

Table 1: International tourist arrivals

	Number (millions)		Growth rate (%)	Market share (%)	
	2000	2001*	2001*/2000	2000	2001*
World	**696.8**	**692.6**	**-0.6**	**100**	**100**
Africa	27.2	28.4	4.3	3.9	4.1
Americas	128.5	120.8	-6.0	18.4	17.4
East Asia and the Pacific	109.2	115.2	5.5	15.7	16.6
Europe	402.5	399.7	-0.7	57.8	57.7
Middle East	23.2	22.7	-2.5	3.3	3.3
South Asia	6.1	5.8	-4.5	0.9	0.8

* Data as collected by the World Tourism Organization, September 2002

Source: World Tourism Organization (2002)©

International tourism in South Africa

This section is based on information released by Statistics South Africa (2003), which uses the term 'travellers' to denote both tourists and other categories of travellers, such as persons visiting the country for business purposes, meetings, conferences and studies.

Total foreign travellers visiting South Africa (December 2002)

The total number of foreign travellers who visited South Africa from mainland Africa, overseas and unspecified countries, arriving through all ports of entry during December 2002, was 657 734, which represents an increase of 13.0% on the December 2001 figure of 582 249.

Overseas travellers visiting South Africa (December 2002)

During December 2002, 194 348 overseas travellers visited South Africa. The December 2002 figure represents an increase of 28.9% on the December 2001 figure of 150 791. The figures show that for December 2002, there were 166 227 air arrivals from overseas, which accounted for 85.5% of all overseas arrivals. Of the 194 348 overseas travellers visiting South Africa during December 2002, 179 516 (92.4%) stated that they were on holiday in South Africa, while 6799 (3.5%) indicated that they were on a business trip. Overseas travellers in transit in South Africa amounted to 4492 (2.3%), while 2545 (1.3%) were in the country for purposes of work (including contract work) and 913 (0.5%) for purposes of study.

During December 2002, the number of travellers from the United Kingdom visiting South Africa amounted to 56 718 (29.2%), making it the leading country of origin of overseas travellers. This was followed by travellers from Germany, who amounted to 24 570 (12.6%). The other main countries of origin of overseas travellers were: the USA, 17 730 (9.1%); the Netherlands, 11 737 (6.0%); France, 8 618 (4.4%); Australia, 7287 (3.7%); Italy, 4659 (2.4%) and Canada, 4240 (2.2%).

Travellers from mainland Africa visiting South Africa (December 2002)

Of the 447 922 travellers from mainland Africa visiting South Africa during December 2002, the overwhelming majority of 407 868 (91.1%) stated that they were on holiday in South Africa, while 23 324 (5.2%) indicated that they were on a business trip. Transit visitors amounted to 7518 (1.7%), while 4 788 (1.1%) were in the country for purposes of study and 4223 (0.9%) for purposes of work (including contract work).

During December 2002, the top eight countries of origin in mainland Africa for travellers arriving in South Africa were: Lesotho, 112 133 (25.0%); Botswana, 87 547 (19.5%); Swaziland, 79 725 (17.8%); Zimbabwe, 54 869 (12.2%); Mozambique, 51 896 (11.6%); Namibia, 28 929 (6.5%); Zambia, 11 915 (2.7%) and Malawi, 8 041 (1.8%).

Total foreign travellers visiting South Africa (1980–2002)

Table 2 provides a summary of the arrivals of foreign travellers in South Africa since 1980.

Table 2: Arrivals of foreign travellers

Year	Number of travellers	Change	
		Number	%
1980	702 794		
1990	1 029 094	326 300	46.4
2000	6 026 086	4 996 992	485.6
2001	5 908 024	(118 062)	–2.0
2002	6 549 916	641 892	10.9

The number of travellers in 2001 was 2% lower than in 2000. The main reason for this may be the attack of 11 September 2001, which brought about a mass aversion to flying. This is borne out by declining profit margins among international airlines. However, taking the entire period into account, there was an immense increase in the number of travellers, from 702 794 in 1980 to 6 549 916 in 2002. This increase of 5 847 122 represents a percentage increase of 832% over the 22-year period, or 10.7% per year.

Data collection for the WSSD study

In order to achieve the aims of this study, it was necessary to undertake extensive primary data collection in the form of a survey among WSSD delegates. Face-to-face interviews were conducted with delegates at the Ubuntu Village (craft market) or in transit from the Village to the Convention Centre. They were selected by means of a judgemental quota sampling method. Researchers used pre-structured questionnaires during interviewing, and questions related to aspects such as the group represented by the delegate, a breakdown of expenditure, length of stay, satisfaction with services and country of origin. A total of 422 delegates were interviewed. Table 3 shows the number of interviews by type of delegate. The respondents came from 72 different countries.

Table 3: Number of interviews by type of delegate

Type of delegate	Interviews
Government delegates	**45**
Non-government (civil society)	**369**
• Women	28
• Youth	33
• Labour	13
• NGO (unspecified)	88
• Indigenous	20
• Civic	43
• Business	29
• Local government	26
• Environment	63
• Agriculture	9
• Church/religion	17
Media	**8**
Total	**422**

The number of delegates to the WSSD was given as 31 127 foreigners from 205 different countries and 49 508 South Africans. A total of 24 760 people registered for the Civil Society Forum at NASREC, the other major international event, of whom approximately 8645 were local delegates and 16 115 were foreigners. However, some of these delegates also registered as delegates at the WSSD. The additional civil society delegates for the NASREC events are estimated at 6895 South Africans and 10 815 foreigners. In addition, it is estimated that 25 000 delegates visited the Water Dome, 12 000 visited the *Business Week* events and approximately 307 570 visited Ubuntu Village, a logistical hub and exhibition space erected for the duration of the WSSD.

Survey results

Satisfaction rating by delegates

Respondents were asked to indicate, on a five-point scale, how satisfied they were with ten different aspects of their experience during the WSSD. Provision was also made for responses of 'don't know' or 'not applicable', since it was possible that a respondent might not have had experience of an aspect before the date of the interview. Table 4 presents the results of the ratings given by respondents.

The positive ratings ('good' and 'excellent' combined) range from a low of 30.4% ('pre- and during Summit leisure activities') to a high of 84.6% ('hospitality and friendliness'). The low rating for 'pre- and during Summit leisure activities' may be attributed to the high percentage of respondents (46.0%) that had not had the opportunity to experience these activities. Aspects with a combined positive rating of just less than 50% include 'organisation of the WSSD' (44.3%), 'information on the WSSD' (41.5%) and 'transport in South Africa' (43.4%).

The negative ratings ('very poor' and 'poor' combined) range from a mere 1.7% ('hospitality and friendliness') to a relatively low 26.1% ('information on the WSSD'), with 'transport in South Africa' (23.9%) and 'organisation of the WSSD' (15.4%) also perceived as 'very poor' or 'poor' by a limited number of respondents.

Table 4: Rating by respondents

Aspect	Rating					
	Very poor	Poor	Satis-factory	Good	Excellent	Don't know/not applicable
Organisation of WSSD	2.4	13.0	35.1	36.7	7.6	5.2
Information on WSSD	3.6	22.5	28.9	33.4	8.1	3.6
Personal service	0.7	6.2	18.7	46.4	23.7	4.2
Transport in South Africa	8.3	15.6	21.1	32.9	10.9	11.2
Value for money	3.1	7.8	22.3	39.3	15.4	12.1
Safety and security	6.4	8.3	24.2	40.5	15.6	5.0
Communication systems	2.8	11.4	29.1	38.4	10.7	7.6
Accommodation quality	1.4	5.0	25.1	41.5	17.8	9.2
Pre- and during Summit leisure activities	1.2	5.7	16.8	24.2	6.2	46.0
Hospitality and friendliness	0.5	1.2	9.7	31.3	53.3	4.0

Positive ratings (good/excellent) and negative ratings (very poor/poor) are illustrated in Figures 2 to 7.

Overall, it would seem that respondents were generally satisfied with the organisation, infrastructure and public relations at the Summit.

Tourism potential

Delegates were asked whether they would return to South Africa on holiday and whether they would recommend the country to friends, relatives and colleagues at home.

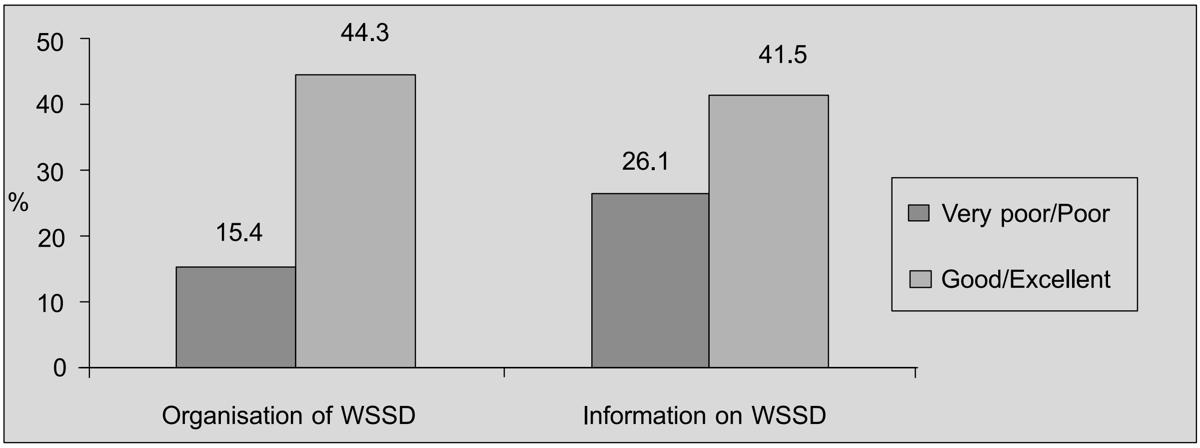


Figure 2: Rating of functions of the United Nations

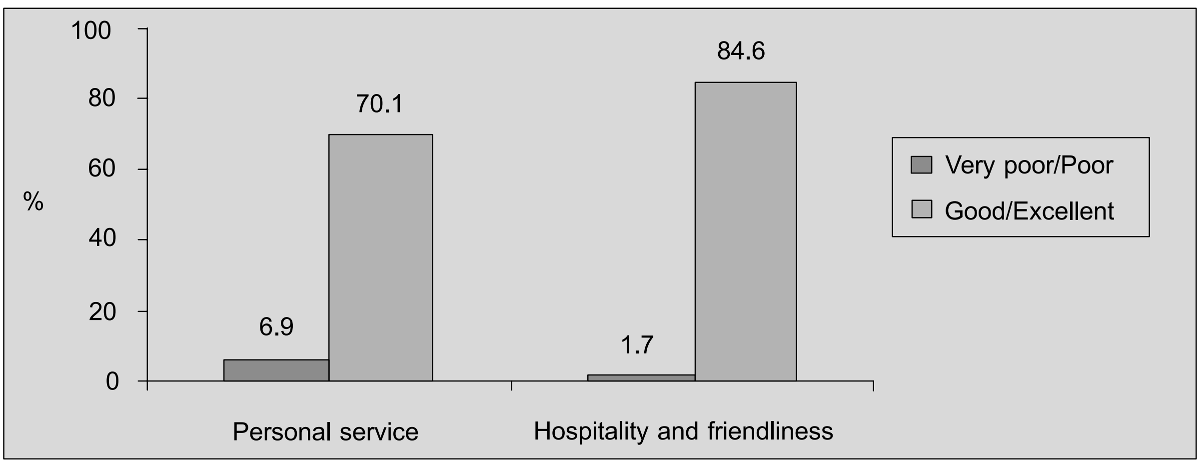


Figure 3: Rating of public relations

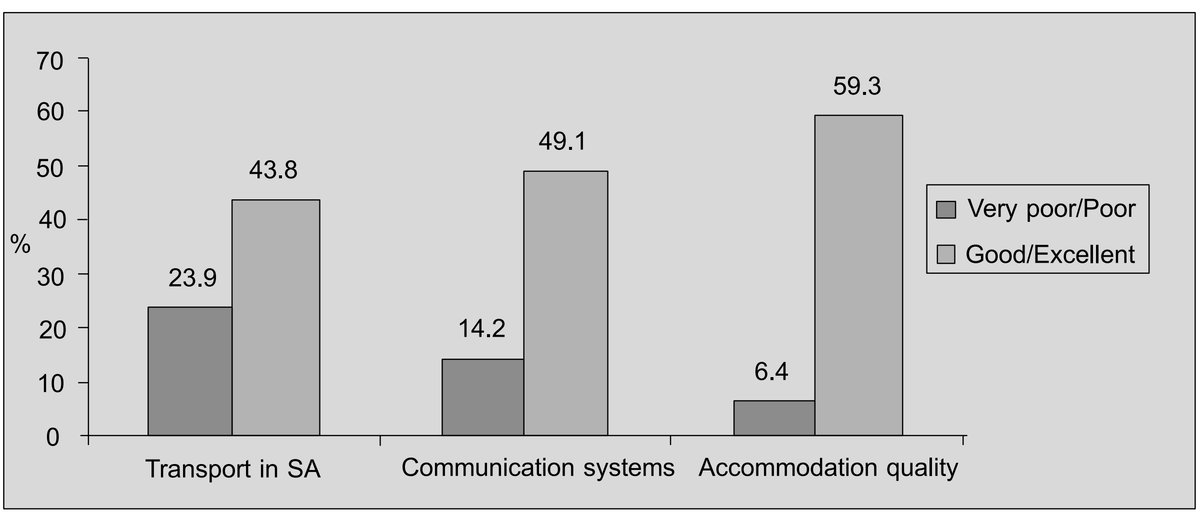


Figure 4: Rating of infrastructure

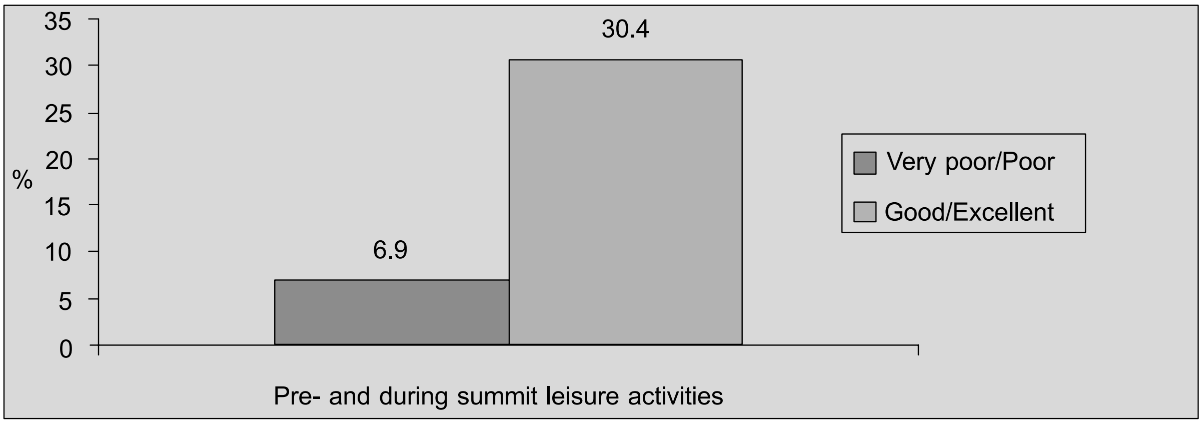


Figure 5: Rating of leisure activities

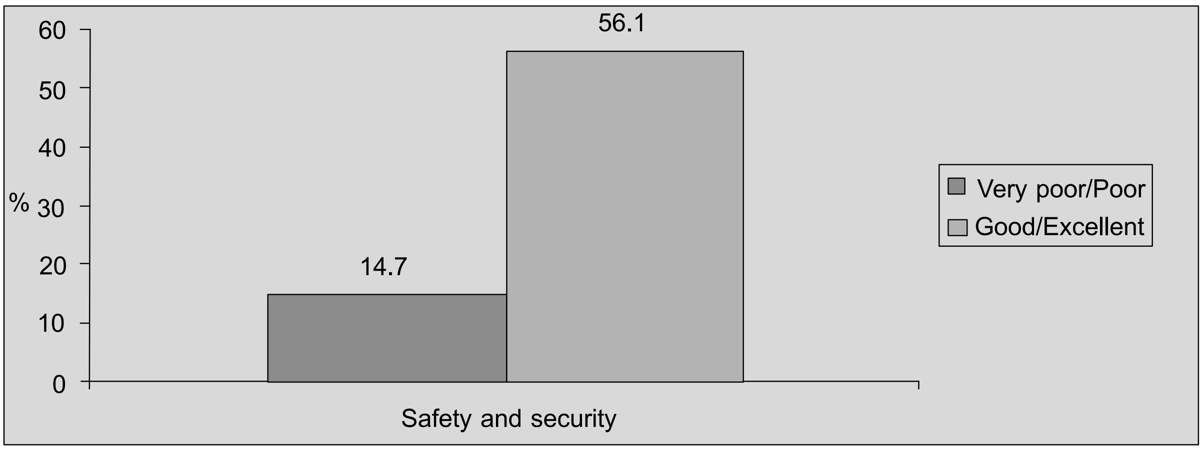


Figure 6: Rating of safety and security

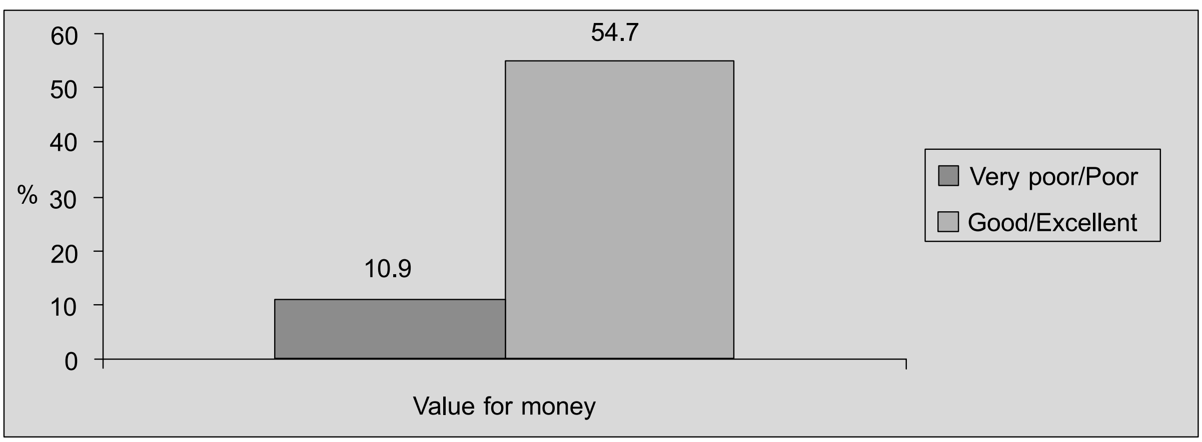


Figure 7: Rating of value for money

Return visits

Most respondents (73.5%) indicated that they would like to come back to South Africa on holiday, while almost a quarter (24.2%) either did not respond or were uncertain whether they would return to South Africa. Only 2.4% indicated that they would not return.

Recommendations to friends, relatives and colleagues at home

The structural model of travel behaviour (Figure 1) shows that a positive impression of an area, as well as satisfaction with former trips to the area, tend to create a positive attitude towards that area. This is borne out by the results in Figure 8, which show that the majority of respondents (75.4%) indicated

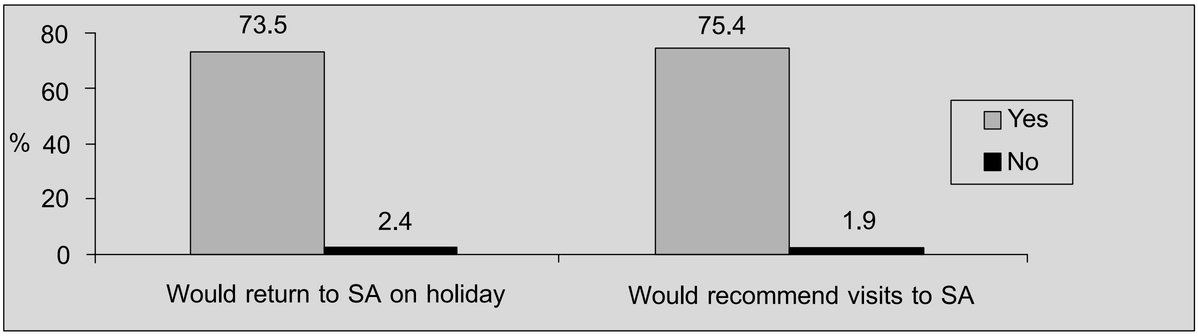


Figure 8: Positive and negative attitudes towards tourism

that they would recommend South Africa to their friends, relatives and colleagues at home as a holiday destination. A low 1.9% responded in the negative and would advise people not to visit the country. The remainder (22.7%) were either undecided or did not respond to the question. The positive and negative responses are illustrated in Figure 8.

Conclusion

The survey results clearly show that the WSSD generally contributed to a positive image of South Africa among delegates and thus had good marketing value. The vast majority of foreign delegates indicated that they would recommend South African as a tourist destination, and almost three-quarters indicated that they themselves would visit South Africa again for holiday purposes. These positive sentiments may already have contributed to the growth of 13.0% in travellers from the rest of Africa and overseas to South Africa between December 2001 and December 2002. Viewed separately, the increase in overseas travellers of 28.9% from December 2001 to December 2002 is even more dramatic, especially if this is viewed against the background of what is happening in many other countries.

References

Bennet, J.A. 2000. *Managing Tourism Services: A South African Approach* (2nd edition). Pretoria: Van Schaik.

Grant Thornton Kessel Feinstein 2001. *Framework for Economic Guidelines for Sustainable Tourism Development.* (October).

Jennings, G. 2001. *Tourism Research.* Australia: Wiley, Milton.

Latham, J. 1994. 'Forecasts of international tourism', In C.P. Cooper & A. Lockwood (eds), *Progress in Tourism Recreation and Hospitality Management.* Chichester: Wiley.

Statistics South Africa. 2003. *Tourism and Migration* (News release P0351, 6 March). Pretoria: Stats SA.

United Nations. 1972. *Report of the United Nations Conference on the Human Environment.* Stockholm.

United Nations. 2000. *United Nations to hold 2002 World Summit on Sustainable Development in Johannesburg, South Africa.* (Press Release ENV/DEV/557PI/1318, 21 December.)

Witt, S.F. & Moutinho, L. (eds) 1995. *Tourism Marketing and Management Handbook.* London: Prentice Hall.

WCED (World Commission on Environment and Development), Brundtland Commission. 1987. *Our Common Future.* Oxford: Oxford University Press.

World Tourism Organization. 2002. *Tourism Highlights, 2002.* Available from: <www.world-tourism.org>.

Customer management: fad or substance?

*T.G. Kotzé, M. Prinsloo & P.J. du Plessis**

Customer management, customer relationship management (CRM) and relationship marketing are currently receiving substantial attention in academia and industry. It may well be asked whether these concepts should be regarded as mere fads or as substantial contributions to management thought and practice. As a starting point for this debate, an extensive literature review was undertaken. A distinction is made between the different categories and responsibilities of customer management, CRM and relationship marketing, and a new grouping is suggested. It is surmised that CRM and customer management are positioned towards the fad end of the continuum, and that relationship marketing has proven itself as an orientation founded on substance.

Introduction

Progress generally occurs through a process of trial and error, and is brought about by people who are spurred on by discontent with the status quo and a desire to adapt the world to their own needs. In a turbulent and highly competitive business environment, business leaders have to tread with caution when it comes to adopting new, unproven managerial approaches or techniques. Trailblazers often run the risk of making expensive mistakes.

It has been argued that the 'mass marketing' of managerial ideas fosters superficiality, as it encourages managers to accept and utilise new management approaches and techniques without an in-depth grasp of their underlying foundation, and without the commitment required to sustain them (Clarke & Clegg 2000: 49).

While research has not found a correlation between the adoption of new management fads and resulting financial performance, organisations that are closely associated with popular management ideas attract greater public admiration and are regarded as being more innovative. These companies are also regarded as having better managers (Gibson & Tesone 2001: 132).

CRM and related developments (such as customer management and relationship marketing) are currently receiving substantial attention in academia and industry. It may well be asked whether CRM, customer management and relationship marketing should be regarded as 'mere fads' or as substantial contributions to management thought and practice.

The objectives of this article are to stimulate debate around the following questions:

- What is the difference between a management fad and a proven management practice?
- Which fads have managers followed during the past decade? Which of these fads have had a substantive impact on management thought and practice?
- What is the relationship between customer management, CRM and relationship marketing?
- Where should customer management, CRM and relationship marketing be placed on the fad–substance continuum?

Clarification of concepts: fads, fashions and paradigms

Many books by management experts, consultants, academics, chief executive officers and other management trendsetters claim to have found 'the answer' to the intricate problems that business managers face today. Cynics often sarcastically refer to the perspectives presented in such books as 'just another fad or fashion', while the term 'a paradigm shift' has become quite common in the blurb on the back covers of such management best sellers. These concepts – fads, fashions and paradigms – require further definition.

Management fads and fashions

Carson, Lanier, Carson & Guidry (2000: 1143) point out that there is a lack of agreement on what

* The authors are in the Department of Marketing and Communication Management, University of Pretoria. T.G. Kotzé is a lecturer, Ms M. Prinsloo is a senior lecturer and Professor P.J. du Plessis is Head: Marketing Management. E-mail: flip.duplessis@up.ac.za

constitutes a management fad or fashion. These two terms are often used interchangeably in the literature.

Gibson & Tesone (2001: 122–123) define management fads as "widely accepted, innovative interventions into the organization's practices designed to improve some aspect of performance". They also point out that fads either evolve into new management practices or are abandoned as failures.

This suggests that fads can be regarded as widely accepted, though unproven, management innovations. From this definition, it is also clear (contrary to general opinion) that the term can have a positive, or at least a neutral, connotation.

Carson et al. (2000: 1143–1144) provide a much more lengthy and structured definition of management fashions. In their view, management fashions refer to interventions that are:

- Subject to social contagion because they are novel and are perceived to be progressive, or preferable to earlier fashions
- Perceived to be innovative, rational and functional
- Aimed at encouraging better organisational performance, either materially or symbolically, through image enhancement
- Motivated by a desire to remedy some existing operational deficiency or to capitalise on opportunities for improvement
- Considered to be of transitory value because, despite a 'post latency' period of acceptance, no systematic and comprehensive research legitimising their prolonged utility or generalisability has emerged.

It can be argued that the terms 'management fad' and 'management fashion', as defined here, essentially refer to the same thing. If there is a difference, it probably relates to the lifespan of the 'intervention' being considered. To prevent confusion, the term 'management fad' will therefore be used in this article.

Research on management fads has revealed that they progress through a bell-shaped life cycle consisting of five stages, namely:

- Discovery: The fad is just beginning to come to the public's attention.
- Wild acceptance: The fad becomes very popular.
- Digestion: Critics begin to suggest that the fad is not the panacea it might once have seemed to be.
- Disillusionment: There is more widespread recognition that there are problems associated with the fad.
- Hard core: Only staunch supporters remain loyal to the fad.

(Gibson & Tesone 2001: 124)

While management fads are frequently referred to with disdain, it is important to recognise that many current management practices started out as fads. Gibson & Tesone (2001: 123) argue that management fads – even those that have entered the declining stages of the fad life cycle – often have a significant and lasting impact on management practice. They linger in the workplace either as the roots of a new management fad or under the guise of different jargon and terminology.

Some authors suggest that failures involving management fads often make companies more determined to embrace change and prove that they have overcome past errors. In consequence, these failures can paradoxically stimulate the adoption of new fads (Gibson & Tesone 2001: 124; Carson et al. 2000: 1146). According to Gibson & Tesone (2001: 131), this adoption of new fads may not necessarily be problematic: they argue that understanding management fads and translating them into practice within the organisation is a mark of the manager who stays current in both theory and practice.

Carson et al. (2000: 1144) analysed 16 management fads, which are listed in Table 1.

Their analysis suggests the following:

- Compared with earlier fads, contemporary management fads are more difficult to implement, are more broad based and require more substantial implementation efforts from top management.
- Because of these three factors, contemporary management fads have a much shorter lifespan than earlier fads. Carson et al. (2000: 1147) ascribe this to the fact that contemporary managers, who are "already predisposed to impatience" because of environmental pressures, are likely to abandon fads before they have reached their logical conclusions.
- Contemporary management fads tend to be more production-oriented and less people-oriented than those of earlier eras.

Table 1: Management fads since the 1950s

1950s	1960s	1970s	1980s	1990s
Management by objectives (MBO)	Sensitivity training and T-groups	Quality-of-work life programmes	Corporate culture	Employee empowerment
Programme evaluation and review technique (PERT)		Quality circles	Total quality management (TQM)	Horizontal corporations
Employee assistance programmes (EAPs)			ISO 9000	Vision
			Benchmarking	Re-engineering
				Agile strategies
				Core competencies

Source: Carson et al. (2000: 1144)

- There has recently been more interest in difficult, radical management fads. This suggests that managers have been willing to try, but less willing to persevere in their commitment to, fads that offer more distant payoffs.

In 1993, the international consulting firm, Bain & Company, launched a multi-year research project to investigate issues related to the use of 'management tools' by companies across the world (Bain & Company 2001).

The 2001 survey, which involved 451 senior executives from a broad range of international firms, focused on 25 of the most popular management tools. To qualify for inclusion, a tool had to be:

- Relevant to senior management
- Topical (as evidenced by coverage in the business press)
- Measurable.

(Bain & Company 2001)

Table 2 lists the 25 management tools included in the 2001 survey and indicates the percentage of firms using each tool. The mean usage percentage was 41%.

It can be deduced from Table 2 that:

- 60% or more of companies used the top five tools, namely:
  - Strategic planning
  - Mission and vision statements
  - Benchmarking
  - Outsourcing
  - Customer satisfaction measurement.
- The least utilised tools were:
  - Corporate venturing
  - Real options analysis
  - Market disruption.

The results of the 2001 survey also revealed the following (Bain & Company 2001):

- 73% of respondents agreed that it is important to stay at the cutting edge of tools and techniques (8% disagreed).
- 90% believed that management tools require top-down support in order to succeed (3% disagreed).
- 77% believed that most management tools promise more than they deliver (8% disagreed).
- 74% agreed that once they find a tool that works, they use it over and over again (10% disagreed).
- The most widely used tools remained the same as in 1999, namely:
  - Strategic planning (76%)
  - Mission and vision statements (70%)
  - Benchmarking (69%).
- 'New economy' tools, such as corporate venturing, market disruption analysis and CRM, had some of the highest defection rates and lowest satisfaction scores.

Different management tools have been designed for different purposes. Table 3 depicts tools that have repeatedly achieved satisfaction scores that are significantly above average for a specific dimension of corporate performance.

Table 2: Percentage of firms using the management tools included in the Bain & Company survey (2001)

Management tool	Percentage of companies using the tool
Strategic planning [a]	76
Mission and vision statements [a]	70
Benchmarking [a]	69
Outsourcing	63
Customer satisfaction measurement [a]	60
Growth strategies [a]	55
Strategic alliances [a]	53
Pay-for-performance [a]	52
Customer segmentation [a]	51
Core competencies [a]	48
Total quality management	41
Cycle time reduction	39
Re-engineering	38
Balanced scorecard [a]	36
Customer relationship management [ab]	35
Scenario planning [a]	33
Shareholder value analysis [a]	32
Supply chain integration [a]	32
Knowledge management [a]	32
Activity-based management [a]	31
One-to-one marketing [a]	28
Merger integration teams [a]	26
Corporate venturing [ab]	14
Real options analysis [a]	9
Market disruption analysis [a]	8

Mean = 41%

a Denotes a tool that is significantly above/below the mean.
b Denotes tools included in the survey for the first time in 2000.

Source: Bain & Company (2001)

Table 3: The best tools for the job

	Financial results	Customer equity	Performance capabilities	Competitive positioning	Organisational integration
Cycle time reduction	●	○	○		
Pay-for-performance	○				
Strategic planning	●		●	●	●
Customer relationship management		●			
Customer satisfaction measurement		●		○	
Customer segmentation		○		●	
One-to-one marketing		●			
Total quality management		●			○
Core competencies			○		
Growth strategies				○	
Strategic alliances				●	
Balanced scorecard					○
Mission and vision statements					●

● Consistently the best tool for the job.
○ Often the best tool for the job.

Source: Bain & Company (2001)

From Table 3, it can be deduced that all these management tools have achieved high satisfaction scores over a period of time. Some of the tools, such as pay-for-performance, CRM, one-to-one marketing, core competencies, growth strategies, strategic alliances, the balanced scorecard and mission and vision statements, were each related to only one aspect of organisational performance, namely, financial results, customer equity, performance capabilities, competitive positioning, and organisational integration. The other management tools related to multi-organisational performance outputs. Customer equity had the highest number of tools contributing to satisfaction scores, followed closely by competitive positioning and organisational integration.

The previous discussion of research results by Carson et al. (2000: 1143), as well as by Bain & Company (2001), suggests that management fads, while often short-lived, may not be as insubstantial and inconsequential as is often suggested. Past fads, however transitory in practice, often have a significant impact on current management practices (Gibson & Tesone 2001: 129).

The nature of paradigms and paradigm shifts

As was mentioned earlier, management writers often use the term 'paradigm shift' when referring to a new management fad. According to Clarke & Clegg (2000: 46), the concept of 'paradigm' is derived from the Greek word 'paradeigma'. In the classic sense, it refers to a model, framework, pattern or example. These authors describe a paradigm as "a systematic set of ideas, values, methods and problem fields, as well as standard solutions, *that explain the world and inform action*" [own emphasis].

The term paradigm and the idea of paradigm shifts were popularised by Thomas Kuhn, a science historian. For Kuhn, science was characterised by the dominance of succeeding paradigms, or 'models of thinking', which he defined as "a constellation of concepts, values, perceptions and practices shared by a community which forms a particular vision of reality that is the way a community organizes itself" (Clarke & Clegg 2000: 46).

Management paradigms are far more numerous than those in the natural sciences. Clarke & Clegg (2000: 47) argue that, at any particular time, there are a number of competing management paradigms in circulation. These paradigms "allow us to see certain things ... but they also make it difficult to see certain other things that do not 'belong' within the paradigm". These authors point out that every paradigm eventually encounters new problems it cannot solve. Such insoluble problems provide the catalyst for triggering a paradigm change or shift.

Management thinkers are currently wrestling with the problem "of how organizations can continually adapt, change, innovate, create, and network in order to survive and succeed in market environments that are quickly becoming more unpredictable, with technologies that are becoming more pervasive and integrative, with organizations that have become pliable and porous, and with people who are questioning, assertive and independent" (Clarke & Clegg 2000: 51).

But how do paradigms differ from management fads? Clarke & Clegg (2000: 49) argue that paradigm shifts relate to "*substantial* shifts in the knowledge and practice of management, but [that] the concept is frequently applied wrongly to the most trivial matters" [own emphasis].

This definition, although very vague, suggests that it is only possible to judge whether the introduction of a new management idea can be regarded as a paradigm shift by considering factors such as:

- The level of sustained enthusiasm the idea attracts over a prolonged period of time
- Whether the idea has led to 'substantial' changes in business thought and organisational practices
- Whether a broad base of managers, management thinkers and scholars regard the idea as a fundamental shift in the way the theory and practice of management are viewed.

(Clarke & Clegg 2000: 51)

In a sense, the distinction between a fad and a paradigm, or paradigm shift, is therefore in the eye of the beholder.

Relationship between customer management, customer relationship management and relationship marketing

One has to assess whether customer management is 'just another management fad' or whether it should be regarded as a substantial improvement in management thought representing a fundamental paradigm shift.

When considering this statement, one encounters some conceptual confusion. For example, what exactly is the difference (and relationship) between customer management, CRM and relationship marketing?

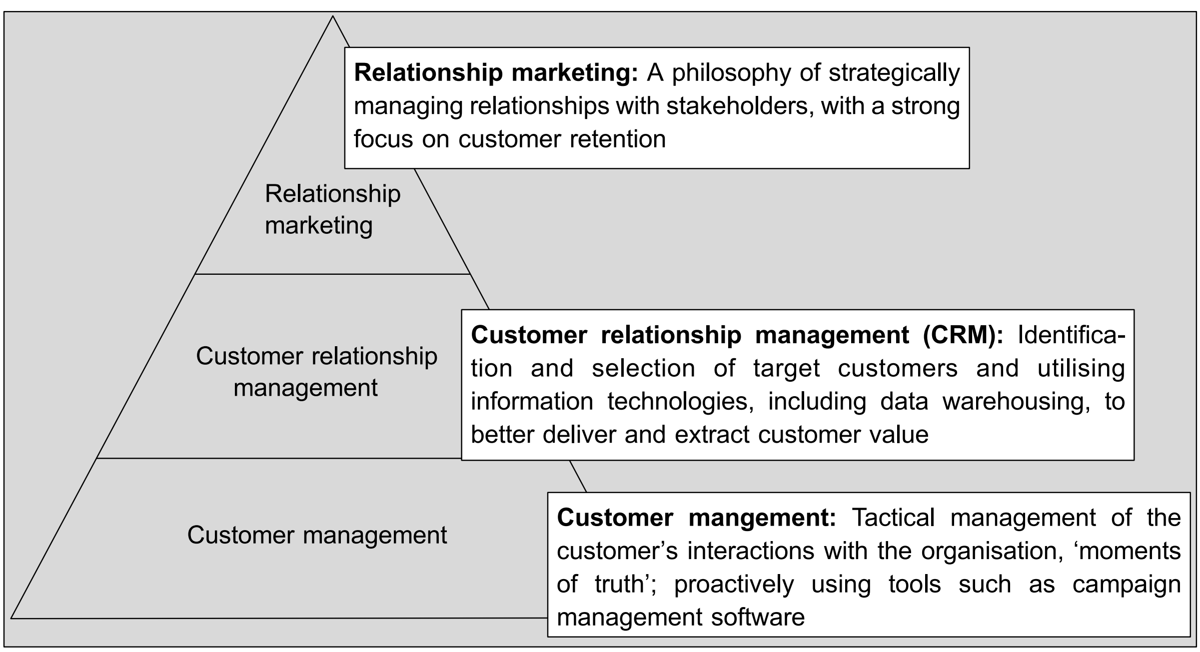
The conceptual 'vagueness' surrounding customer management, CRM and relationship marketing is acknowledged and addressed by various authors, including the following two groups of collaborators:

- Ryals & Payne (2001: 12) point out that these terms are used increasingly, but that no clear definitions have emerged to explain the differences between them. On the basis of research conducted among 11 financial services organisations in the United Kingdom, the conceptual distinctions outlined in Figure 1 are proposed. Figure 1 suggests that customer management and CRM are extensions from the basis on which relationship marketing was built.
- The second set of authors to address the varying and confusing definitions around these concepts are Starkey, Williams & Stone (2002: 378), who support the idea that the terms seem to have been born out of relationship marketing and state that ''the term customer relationship management (CRM) is becoming standard terminology replacing what is widely perceived to be a misleadingly narrow term, Relationship Marketing (RM)''.

In many ways, it seems as if relationship marketing has evolved towards CRM and customer management. This may have resulted, firstly, from 'getting to know' large volumes of customers well enough to establish a relationship with each, and secondly, from management's frustration in changing product-centred companies into customer-responsive organisations to enable them to support their initial service promise.

This evolution started in the 1990s with the emergence of relationship marketing, which focused on developing and maintaining relationships with individual customers. It relied on a two-way dialogue between a company and a customer to develop a deep relationship. Unfortunately, establishing and maintaining this two-way dialogue proved to be labour-intensive and thus had to be limited to a small subset of customers (Goodhue, Wixon & Watson 2002: 80).

CRM extended the reach of relationship marketing by utilising information technology (IT) to automate the labour-intensive aspects, thereby making it feasible across a wide range of different customers. Several authors accentuate the important facilitative role of IT in the operationalisation of relationship marketing (Berry 1995: 238, Grönroos 1996: 11; Ryals & Payne 2001: 3; Winer 2001: 91). The current emphasis on CRM is driven by the changing demands of the business environment, the availability of large amounts of data, and advances in IT. In particular, IT is a critical CRM enabler. Since



Source: Adapted from Ryals & Payne (2001: 13)

Figure 1: The relationship between relationship marketing, customer relationship management and customer management

many CRM strategies resulted in the implementation of software without impacting on the behaviour of employees or on actual service delivery, the concept of customer management was introduced (Starkey et al. 2002: 379). Customer management serves to channel and coordinate the efforts of relationship marketing and CRM by integrating the service promise into the processes of the larger organisation (Goodhue et al. 2002: 80). Customer management, in essence, attempts to internalise customer needs and ensure that they are reflected in the behaviour of the organisation, since relationship management, as a core business process that extends throughout the organisation and enhances the relationship marketing effort, has received insufficient attention in many organisations (Sheth & Parvatiyar 2002).

Supporting this evolutionary idea, Starkey et al. (2002: 379) propose the following definition of customer management: ‘‘Customer management is about: Finding the right customers (those with an acceptable current and future net value); Getting to know them (as individuals or groups); Growing their value (if appropriate); and Retaining their business in the most efficient and effective way. It is achieved by companies enabling their people, processes, policies, suppliers and customer-facing technologies to manage *all customer interactions proactively* during each stage of the *customer lifecycle* in a way that enhanced each customer's experience of dealing with the company.''

The way in which CRM and customer management take relationship marketing promises into the operations of the larger organisation is fundamental to the success of these initiatives (*Strategic Direction* 2002: 20). The European Centre of Customer Strategies (ECCS) emphatically states that the lack of impact on the larger organisation is a major role-player in the failure of many of these initiatives (*European Business Review* 2002: 1). It is therefore a prerequisite that these concepts be implemented in many parts of the organisation, not only in the Marketing Department, as is the case with relationship marketing, since they require a fundamental change in company culture.

On the basis of the preceding arguments, it may be surmised that customer management encapsulates CRM and relationship marketing activities, where relationship marketing initiatives are enabled by CRM initiatives in larger organisations, or supported by CRM in smaller organisations.

If one accepts these conceptual distinctions, the question whether customer management represents a fad or a paradigm shift can actually be viewed at two levels. One could critically examine the status of CRM and customer management as practical manifestations of a relationship marketing orientation, or one could critically question the status of relationship marketing as a philosophy or marketing orientation. The next two sections will consider both these perspectives.

Customer relationship management

CRM is a manifestation of a relationship marketing orientation (see Figure 1) that has recently generated substantial interest among marketing practitioners. The current enthusiasm for CRM has led Winer (2001: 89) to label it as the new ‘mantra' for marketing.

Unfortunately, as with most business ‘buzzwords', CRM means different things to different people. A review of the literature shows that the term CRM has in many ways been used to cover almost any activity that involves customers. In this regard, Galbreath & Rogers (1999: 163) point out that: ‘‘CRM as a discipline is broad, encompassing many components, and is still being defined''. These authors define CRM as ‘‘the activities a business performs to identify, qualify, acquire, develop and retain increasingly loyal and profitable customers by delivering the right product or service, to the right customer, through the right channel, at the right time and the right cost. CRM integrates sales, marketing, service, enterprise resource planning, and supply-chain management functions through business process automation, technology solutions, and information resources to maximize each customer contact. CRM facilitates relationships among enterprises, their customers, business partners, suppliers, and employees'' (Galbreath & Rogers 1999: 163).

According to Galbreath & Rogers (1999: 165), CRM fosters an environment where the automation of customer-facing processes and the integration of isolated customer databases allow a firm to take a 360-degree view of its customers, and to provide them with customisation, personal attention and focused after-sales support.

The Gartner Group defines CRM as follows (Starkey et al. 2002: 379): ‘‘RM is a management discipline – a philosophy even – that requires businesses to recognise and nurture their relationships with customers. With CRM, an individual customer's needs and preferences are available to anyone in the business working at the customer interface, regardless of the channel. Each customer is treated as an individual in a relationship that feels like one-to-one.''

Ryals & Payne (2001: 6) explain that CRM focuses on issues that entail the implementation of relationship marketing using IT. In their view, CRM ''seeks to provide a strategic bridge between IT and marketing strategies aimed at building long-term relationships and profitability'' (Ryals & Payne 2001: 3). These authors point out that CRM is founded on four tenets:

- Customers should be managed as important assets.
- Customer profitability varies. Therefore, not all customers are equally desirable.
- Customers vary in their needs, preferences, buying behaviour and price sensitivity.
- By understanding customer drivers and customer profitability, companies can tailor their offerings in order to maximise the overall value of their customer portfolio.

However, to achieve the aforementioned goals, a company needs detailed information on its individual customers. CRM ultimately focuses on effectively turning data and information into intelligent business knowledge in order to more efficiently manage customer relationships (Galbreath & Rogers 1999: 162). In addition, CRM systems attempt to integrate disparate technologies, databases and business processes in order to streamline the firm's interaction with its customers (Bose 2002: 89).

CRM applications can be of value to the marketer in a number of ways. These applications, for example, enable marketers to do the following:

- Segment their customer base according to the current and projected profitability of individual customers.
- Identify the customers that contribute most to the company's bottom line.
- Identify customers that are at risk of defecting to competitors.
- Develop a profile of prospects most likely to respond to a marketing offer based on the profiles of consumers that responded to a similar offer in the past.
- 'Mine' large data sets to identify the combination of products that market segments regularly purchase together. This information can then be used to develop tie-in offers or special promotions.
- Monitor the progress of sales quotations, transactions and service recovery efforts in order to ensure customer satisfaction.
- Ensure 'seamless' interaction and communication with a customer regardless of the specific contact method the customer chooses (for example, phone, fax, e-mail, written correspondence, website, interaction with a service agent or salesperson).
- Provide customer contact personnel with detailed customer profiles to assist them in delivering high quality customer service and allow them to effectively cross-sell and up-sell the firm's products or services.
- Add value to customers through the 'mass customisation' of products and service experiences.
- Tailor communications to customers based on each individual's unique needs, interests and past interactions with the firm.
- Offer services at arm's length through automated service agents as well as through the Internet.

The question is whether CRM is the panacea it is often made out to be. In other words, is it a fad or a substantial improvement in management thinking and practice? Again, this is not an easy question to answer.

A recent report by Accenture (2002: 3–4) paints a gloomy picture of the development of CRM to date. The report begins with the following statement:

> Customer Relationship Management swept through the business landscape in the early '90s, promising to help sellers *please most of the people most of the time*. Riding the coattails of customer satisfaction would come increased organisational efficiency and, better still, increased revenues. That hasn't happened. Rather than transforming the customer experience, sellers have inadvertently created a fragmented marketplace in which sales, service and marketing are at best inconsistent and at worst frustrating.

Another reason for the market failure is that many software vendors and major management consultancies have tried to give the impression that CRM is mainly a question of implementing a particular technological solution. Technology is certainly one of the key enabling and supporting factors in CRM, but in itself it does not constitute CRM (Starkey et al. 2002: 380).

The results of Bain & Company's latest 'tools and techniques' survey (2001) also cast something of a shadow over CRM as currently used by firms. While the study reports that CRM is used by 35% of companies, 18% of respondents reported that they have stopped using CRM after using it at least once in the previous five years.

Part of the current disillusionment with CRM may be due to unrealistic expectations among managers about the potential short-term yields of CRM, as well as an underestimation of the changes needed to successfully establish CRM systems and the necessary supporting culture within an organisation (Galbreath & Rogers 1999: 165–170).

The authors of the Accenture report (2002: 3–4) believe, however, that the last decade's investment in CRM has not been wasted. They argue that companies have not reached the end of the CRM road, as CRM applications are entering their 'third wave' (see Table 4).

The report asserts that few companies have optimised CRM to create lasting customer relationships and build superior value. As a result, those companies are not realising the full return on their CRM investments. This type of statement supports the notion that there is an evolutionary movement towards truly customer-centred organisations with a wider focus than mere marketing efforts.

Georgiadis & Lane (2001: 1) argue that CRM initiatives that create substantial value require four integrated elements:

- A strategy for managing customer relationships that is tied to business economics targeting customers and channel leverage
- Compelling, well-executed programmes that can drive customer value levers (capabilities)
- Technology to support key activities, both data management and customer experience
- An organisation that underpins the ability to deliver and sustains the first three elements over time.

A multifaceted framework for CRM adoption is provided by Ryals & Payne (2001) and is depicted in Figure 2. The dynamic nature of relationship marketing (incorporating CRM and customer management) becomes clear from this framework.

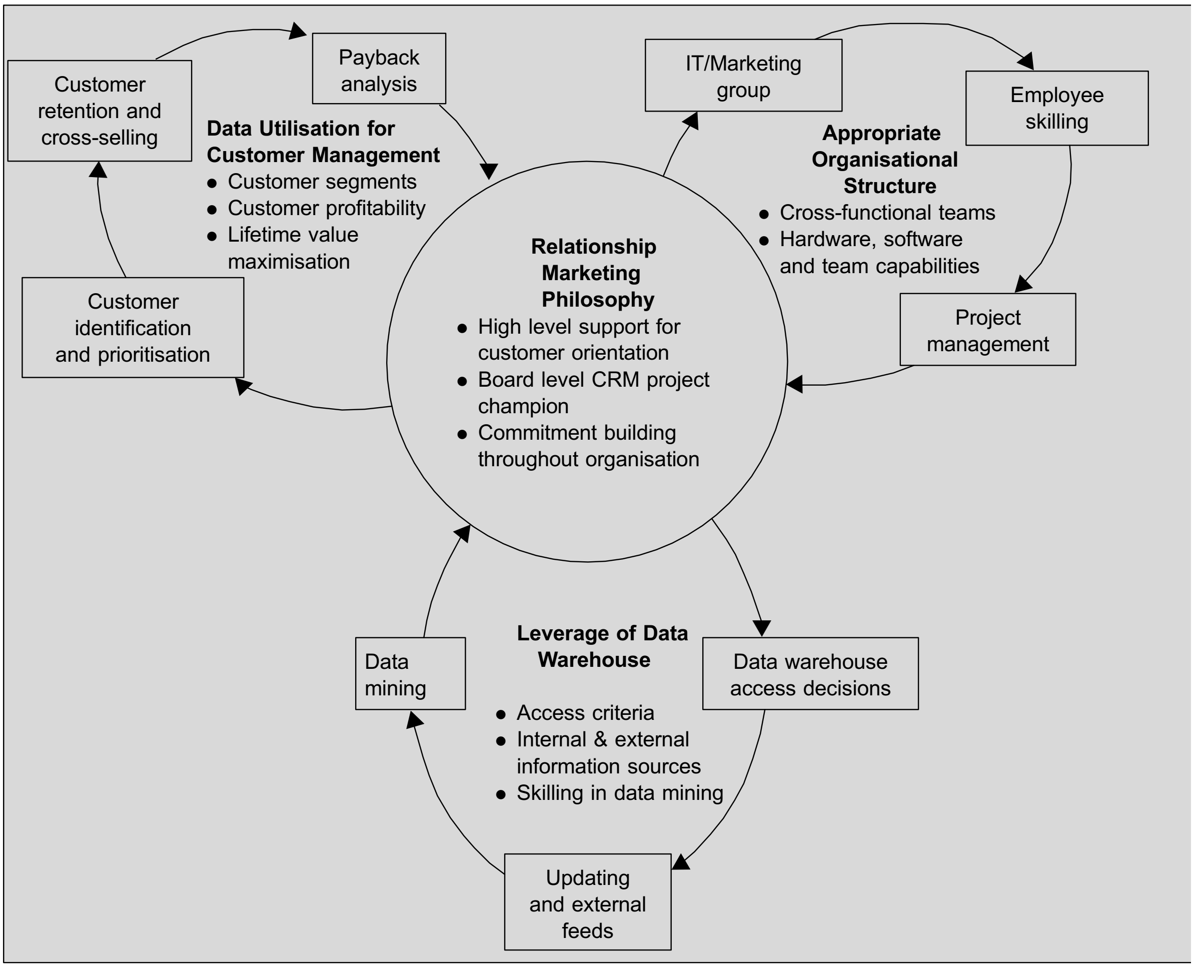
Bose (2002: 96–97) quite rightly points out that predicting the future of CRM is a bit like picking which country will win the next Soccer World Cup: while there is some past history to consider, there are no sure bets. According to Bose (2002: 97), the biggest threat to CRM is managements' focus on short-term profits rather than on a long-term vision. He also points out that: ''CRM is an expensive, time-consuming and complex proposition. Even in the best case, CRM requires a certain 'leap of faith' by a firm, as technology is still not available to completely develop the full power of a customer-centric approach'' (Bose 2002: 97).

It seems as if CRM is currently past the ''wild acceptance'' phase of the fad life cycle, with some companies already moving past the ''digestion'' phase into ''disillusionment''. This is supported by Bain & Company's report (2001), which reflects the

Table 4: Evolution of CRM

	Stage One **Call centre/Sales force effectiveness**	**Stage Two** **Multi-channel integration**	**Stage Three** **Conversational marketing**
CRM goals	Improving channel efficiency Increasing customer satisfaction	Improving customer interactions Increasing customer retention	Predicting customer behaviour Building brand and lifetime customer value
CRM strategy	Provide more efficient means of customer interaction	Provide customers with multiple points of contact: gather insights	Integrate communications and brand across channels
Resulting customer experience	Customers enjoyed more convenient transactions, but channels were not integrated	Customers had more options to interact with the company, but the experiences were fragmented across contact points	Customers are given a seamless integrated experience across all channels
Marketing focus	Customer acquisition Product sales	Customer retention Cross-selling	Customer conversation Brand equity

Source: Accenture [S.a.]



Source: Ryals & Payne (2001: 3–27)

Figure 2: A framework for CRM adoption

number of defections from these customer strategies and the fact that they have received some of the lowest satisfaction ratings. A review of the literature suggests that many companies battle to successfully implement their CRM initiatives. Experts suggest that this may largely be due to the fact that many managers underestimate the changes necessary to successfully implement CRM solutions. This bodes ill for the future of CRM because, as Carson et al. (2000: 1147) have argued, contemporary managers are likely to abandon a new fad before it reaches its logical conclusion. Even if the enthusiasm for CRM proves to be short-lived, however, it will undoubtedly – like many other previous fads – have a profound impact on management practice.

Relationship marketing: a universal paradigm or management fad?

> Is relationship marketing merely another 'big new idea' which has risen on an opportunistic wave, only to follow previous big ideas such as Total Quality Management and Management by Objectives into obscurity when critics realised that there was really nothing new? Or does the development of relationship marketing reflect fundamental shifts in the business environment, which will continue to provide a place for the concept?
>
> Palmer (2002: 80)

The quotation summarises the core question to be addressed. However, the origins and nature of relationship marketing need to be highlighted. Leonard Berry apparently coined the term 'relationship marketing' and first used it in a paper on services marketing published in 1983 (Berry 2002: 59; Grönroos 1999: 328). However, Möller & Halinen (2000: 31) postulate that marketing relationships are as old as the phenomenon of trade itself. They argue that the current debate over relationship marketing has its roots in four research traditions, which, together, "have contributed most to the shift from viewing marketing exchange as a transactional phenomenon to viewing it as on-going relationships". These four 'roots' of relationship marketing are given as services marketing, business marketing interaction and networks, marketing channels, and database/direct marketing. This viewpoint is extensively discussed by Möller & Halinen (2000: 29-54), Brodie, Coviello, Brookes & Little (1997: 383–385) and Aijo (1996: 8–18).

The concept of relationship marketing as an overall philosophy or orientation is shared by a number of authors:

- Ryals & Payne (2001: 13), for example, specifically define relationship marketing as "a philosophy and marketing orientation emphasizing customer retention".
- Berry (2002: 73) also views relationship marketing as "a philosophy or orientation, about customers, marketing and value-creation, not just a set of techniques, tools, and tactics. Relationship marketing is holistic, a sum of integrated parts that drive a firm's marketing competencies."
- Finally, Palmer (2002: 82) argues that relationship marketing is "probably best understood as an umbrella concept which stresses the need to see exchanges from a long-term perspective rather than short-term".

The following two definitions attempt to provide insight into more comprehensive, or operational, definitions of relationship marketing:

- Grönroos (1999: 328) points out that there is no agreement in the literature on a definition of relationship marketing. His definition, which is often cited, states that marketing, from a relationship marketing perspective, can be defined as "the process of identifying and establishing, maintaining and enhancing, and when necessary also terminating relationships with customers and other stakeholders, at a profit, so that the objectives of all parties involved are met; and this is done by a mutual exchange and fulfilment of promises".
- Gummesson (2002: 39) offers another definition, suggesting that relationship marketing is "marketing based on relationships, networks and interaction, recognising that marketing is embedded in the total management of the networks of the selling organisation, the market and society. It is directed to long-term win–win relationships with individual customers, and value is jointly created between the parties involved. It transcends the boundaries between specialist functions and disciplines".

To further highlight these definitions, a number of authors, including Gruen (1997: 32–38), Grönroos (1999: 327–335), Ryals & Payne (2001: 13), Gummesson (2002: 37–57) and Rigby, Reichheld & Schefter (2002: 105) discuss the basic tenets of relationship marketing, which include:

- A focus on customers as individuals
- Collaboration and joint value creation
- Long-term relationships
- Customer selectivity
- Win–win relationships
- Service and relationship values versus bureaucratic-legal values
- Every employee becomes a part-time marketer.

Clearly, many an author has defined and described the concept of relationship marketing, but according to De Wulf, Odekerken-Schröder & Iacobucci (2001: 35), few efforts have been made to define what relationship marketing tactics are and how valuable customers perceive them to be. When discussing the tactics or physical manifestations of a relationship marketing orientation, authors often refer to the three levels of relationship marketing first mentioned by Berry (1995: 240), which are summarised in Table 5.

A review of the literature suggests that there are a number of activities, programmes and tactics that are generally associated with the operationalisation of a relationship marketing orientation. These are summarised in Table 6. It should be noted that the distinctions between many of these activities, programmes and tactics are blurred in practice.

Taking all the definitions, descriptions and activities into account, one realises that the concept of relationship marketing has attracted considerable attention since the early 1990s. A keyword search[1] of leading academic full-text databases has, for example, identified nearly 1400 references to peer-reviewed articles on relationship marketing. Thousands of articles on relationship marketing have also appeared in the popular management and marketing press.

Several authors have suggested that relationship marketing represents a new 'paradigm' in marketing

1 Articles were identified by searching for the phrase 'relationship marketing' in a key word search facility. The searches were limited to peer-reviewed publications.

Table 5: Three levels of relationship marketing

Level	Primary bond	Degree of customisation	Potential for sustainable competitive advantage	Example
One	Financial	Low	Low	Frequent buyer programmes
Two	Social	Medium	Medium	Individualised communication with customers through multiple means, referring to customers by name during transactions, providing continuity of service through the same representative, augmenting the core service with educational and entertainment activities such as seminars or parties, creating ‘communities’ around a product or brand such as the Harley-Davidson Owners Group
Three	Structural	Medium to high	High	Offering target customers value-added benefits that are difficult or expensive for the customers to provide themselves or that are not readily available elsewhere. Customised solutions to an individual customer’s problems are built into the service delivery process, thereby creating a bond between the customer and supplier

Source: Adapted from Berry (1995: 240)

Table 6: Activities, programmes and tactics associated with the operationalisation of a relationship marketing orientation

Type of activity, programme or tactic	Author(s)
Initiatives aimed at improving the quality of customer service and creating a customer-orientated service system	Boedeker (1997: 250) Winer (2001: 99) Grönroos (1996: 11)
Relationship pricing strategies and/or gift incentives for regular customers	Berry (1995: 240) De Wulf et al. (2001: 35)
Preferential treatment for regular or high volume customers through initiatives such as frequent-buyer/loyalty programmes	Boedeker (1997: 250) De Wulf et al. (2001: 35) Winer (2001: 99)
Gathering transactional, quantitative and qualitative information about customers and creating a customer database	Boedeker (1997: 250) Grönroos (1996: 11)
Direct, bi-directional communication between the company and individual customers (e.g. through direct mail or e-mail)	Boedeker (1997: 250) De Wulf et al. (2001: 35)
Communication that is proactive rather than reactive, yet happens on the customer’s terms (e.g. the customer is given the option to ‘opt-out’ by, for example, unsubscribing to an electronic newsletter)	Boedeker (1997: 250)
Internal marketing to emphasise that everyone in the organisation is a potential ‘part-time’ marketer	Boedeker (1997: 250) Grönroos (1996: 12)
Customisation of goods and services according to the requirements of individual customers	Winer (2001: 100)
Creating ‘communities’ around a specific product or brand	Berry (1995: 240) Winer (2001: 100)

– see Grönroos (1994: 347–360), Sheth & Parvatiyar (1995: 387–418), Aijo (1996: 8–18) and Grönroos (1999: 327–335). At the same time, this ‘new’ approach has generated heated debate, and some authors question whether it is really new (Petrof 1997: 26–31); others question its applicability to all markets and customer relationships (Palmer 1996: 18–25 and O’Malley & Tynan 2000: 797–815); some criticise one or more of its underlying assumptions (Saren & Tzokas 1998: 187–196); others criticise the way in which relationship marketing is implemented in practice (Fournier, Dobscha & Mick 1998: 42–50); and some argue that there is a lack of detailed empirical evidence to guide marketing practitioners in choosing which strategies and policies to use in order to enhance customer relationships (Saren & Tzokas 1998: 187).

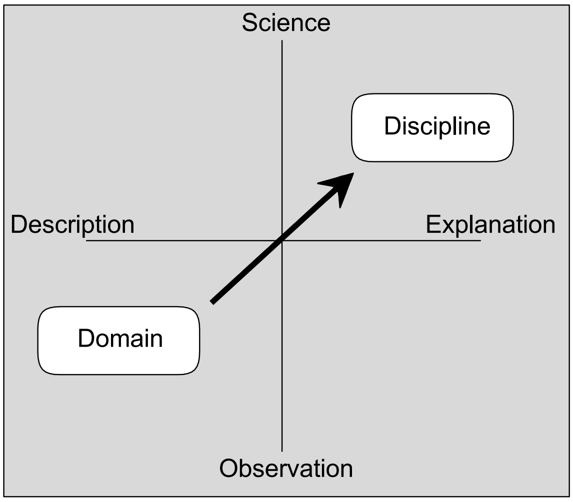
Returning to the question of whether relationship marketing represents a fad or a paradigm shift, many authors suggest that if one considers the volumes written on relationship marketing and on related topics such as customer satisfaction, one-to-one marketing, mass customisation, customer loyalty, customer retention, lifetime value analysis, CRM and defection management, it becomes clear that the 1990s indeed saw the emergence of a strong focus – in academic and practitioner circles – on buyer–seller, firm–customer, and inter-firm relationships. This strong relationship focus has also been fuelled by research on market-orientation (Jaworski, Kohli & Sahay 2000: 45–54), as well as on relationship-based competitive advantage (Day 1994: 37–52; Morgan & Hunt 1999: 281–290).

This prevailing emphasis on relationships has led Sheth & Parvatiyar (2002: 3–4) to conclude that: "Relationship marketing, *at least at the practice level*, is recognized as a major paradigm shift in marketing comparable to what the marketing concept in the 1960s (with its focus on customer needs and wants) and more recently the quality concept (with its focus on customer satisfaction) did in transforming business practices and philosophy" [emphasis added].

Sheth & Parvatiyar (2002: 4) point out, however, that relationship marketing has not yet developed into a paradigm that guides disciplined academic enquiry. In this regard, they distinguish between a discipline and a domain (see Figure 3).

These authors argue that in order for a domain to become a discipline, it needs to go beyond description and into explanation of the phenomenon by providing hypotheses and theory; and at the same time, it needs to go beyond observation and become a science by utilising methodological rigour. Relationship marketing, in their view, has not yet fulfilled these conditions. They add that they wish that this would happen, because marketing would benefit enormously from it. However, Sheth & Parvatiyar (2002: 14) believe that relationship marketing has the potential to become a well-respected, free-standing and distinct discipline in marketing.

Empirical research conducted by Brodie et al. (1997: 383–406) suggests that while one cannot



Source: Sheth & Parvatiyar (2002: 5)

Figure 3: Domain versus discipline

conclude that the transactional marketing perspective is being replaced by a relationship marketing approach in a 'paradigm shift', there is considerable evidence of a shift in managerial thinking and practice towards increased customer orientation, as well as towards efforts directed at improving customer understanding and the development of synergistic relationships and partnerships. A replication of this empirical research is needed in other countries and markets to evaluate the nature and extent of the shift suggested.

Palmer (2002: 79–92) also considers the question of whether relationship marketing should be regarded as a new marketing paradigm. He points out that there are two schools of thought as far as this issue is concerned:

- The first believes that the underlying principles of relationship marketing are indistinguishable from the fundamental principles of marketing. Viewed as a philosophy, relationship marketing shares with traditional definitions of marketing a concern for satisfying customers effectively and profitably. According to this point of view, *relationship marketing will mature until it becomes essentially a basic principle of marketing, and the distinguishing title of 'relationship' will become less relevant* (Palmer 2002: 80).
- The second school of thought, which lends support to the previously outlined theory on the evolutionary nature of relationship marketing (also strongly supported by Palmer), is that relationship marketing emerged in the 1990s in response to changes that were occurring in the technological, social, economic and political/legal environment. Palmer (2002: 80) argues

> that *as environmental change continues, relationship marketing will evolve by fragmenting into numerous specialist interest subjects*. "Academics and practitioners will need to keep hold of a 'big idea', which will gradually mutate. Part of this mutation may be represented by subtle changes in language which have appeared in published material and training courses, for example 'customer relationship management', 'database marketing', 'direct marketing' and 'customer loyalty'."

Palmer (2002: 91–92) concludes his arguments on the future of relationship marketing with the following thoughts:

> Relationship marketing as it has developed during the past two decades is firmly based on change in the business environment of organizations. It is too simplistic to say that it is nothing new or simply a big idea spun out of long standing practice. There are many factors in the business environment which explain why the concept became a dominant idea of the 1990s. Many of the changes which gave rise to Relationship Marketing will still have effect over the next couple of decades, so the concept will still be with us.
>
> It has been widely accepted that relationship marketing at the philosophical level differs very little from general definitions of marketing, and this is likely to continue to be the case. However, in its evolution, new strands of specialisation are likely to emerge. The emergent technology has spawned new areas of study in the form of database marketing, for example. Inevitably, some semantic drift will occur as big new ideas are promoted to highlight specific areas. The concept of data mining, for example, may not be entirely new to statisticians, but as a subset of relationship marketing is likely to be received by an eager audience seeking to get more out of its databases. *Relationship marketing is not new and it is not a passing fad.* There are sound reasons to explain its emergence and that it will need to adapt to change in the environment if it is to remain an important paradigm [own emphasis].

It is argued that relationship marketing – at least at a philosophical level – is not just a short-lived fad. While a relationship marketing approach may not be feasible or desirable in all circumstances, the debate around relationship marketing has already had a profound effect on how market relationships are viewed and the priority attention they receive, especially in services, retail and business-to-business marketing.

Closing arguments

Bose (2002: 90) argues that we are now in the beginning stages of a new customer-centric business orientation (see Figure 4). In his view, a customer-centric firm is capable of treating every customer individually and uniquely, depending on the customer's preferences. This is largely made possible because of developments in the field of IT.

While other authors will argue about the 'birth date' of this new customer-centric business approach, it is generally accepted that the 1990s will be remembered as the decade of 'relationships'. The philosophy of relationship marketing has certainly contributed to the renewed focus on firm-stakeholder relationships.

CRM, as a physical manifestation of a relationship marketing orientation, has had a much shorter lifespan than its philosophical base. However, judging by the number of dedicated websites on the topic and the number of articles appearing on CRM in the popular business press, the management of customer relations and associated software applications is generating enormous interest in business circles. While cynics, supported by many a case study on CRM failure, regard CRM as merely another 'flavour of the month' business solution touted by software vendors and opportunistic consultants, the fact remains that a multi-billion dollar global industry has developed around issues relating to customer relationships and the management thereof. Another argument simply asks: Can focusing on customers be wrong in essence, or is the scepticism caused by disillusionment about implementation, rather than any con-

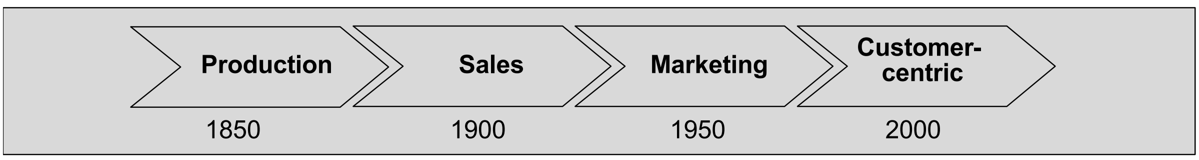


Figure 4: Business orientations of the last 150 years

ceptual flaw? It is surmised that the concept has potential value, and that the way in which it is implemented will determine its success.

Can relationship marketing be regarded as 'the new paradigm of marketing' that will displace the so-called 'marketing mix paradigm'? While relationship marketing offers a much-needed emphasis on buyer–seller relationships, customer retention, customer lifetime value and customer loyalty, it must be recognised that building closer relationships with customers remains very difficult. In some situations, it may be unnecessary, undesirable (from both the firm's and the customer's point of view) or even impossible (see Palmer 1996: 18–25). Relationship marketing should rather be seen as one possible strategic alternative that is appropriate for specific industries, markets and customers (see Li & Nicholls 2000: 449–464).

This view, however, should not detract from the positive influence of the debate over relationship marketing, in that it has focused attention on the importance of firm–stakeholder relationships in general, and firm–customer relationships in particular. Relationship marketing has specifically pointed out the need for a balance between customer acquisition and customer retention activities.

Where should customer management, CRM and relationship marketing be placed on the fad–substance continuum? In our opinion, relationship marketing has proved itself as an orientation founded on substance. While it may not be a new universal paradigm, as some proponents claim, it has already had a profound influence on the importance that organisations attach to relationships with stakeholders, including relationships with customers.

On the basis of the information provided in this paper and the evolutionary nature of the concepts, it is proposed that the different categories and responsibilities of customer management, CRM and relationship marketing can be grouped in the categories illustrated in Table 7.

Table 7 depicts some ideas with regard to the reciprocity between the stated concepts, as well as the evolution from relationship marketing to CRM and customer management.

The major driving force behind relationship marketing initiatives is an emphasis on the benefits that strong customer relationships hold for organisations. The realisation of these initiatives (as listed in the last column of Table 7) has been hindered by various factors, however, including the sheer size of the organisation's target market, knowledge with regard to which relationships are worthwhile to the organisation, and campaign management problems due to the ongoing nature of the these initiatives.

The CRM era brought some answers to the challenges born out of the relationship marketing

Table 7: Distinction between customer management, customer relationship management and relationship marketing

Customer management	Customer relationship management (CRM)	Relationship marketing
• Customer satisfaction management • Loyalty based management • Lifetime value of customers • Customer value creation • Customer portfolio analysis • Corporate culture management • Organisational process alignment based on customer loyalty drivers	• Customer retention • Customer segmentation • Customer loyalty measurement • Database management • Defection management • Measurement of customer lifetime value • Campaign effective measurement	• One-to-one marketing • Mass customisation • Frequent buyer programme • Customised solutions • Customer oriented service solutions • Customer interaction • Develop customer contact points • Creating 'communities' around products and brands (e.g. Harley-Davidson Owners Group) • Relationship pricing strategies • Internal marketing – employee relationship management (ERM) and the concept of the 'part-time' marketer

era. In that way, CRM became an enabler of relationship marketing initiatives. To take this further, in terms of successful relationship marketing initiatives, one may consider Albert Einstein's theory that problems cannot be solved by remaining in the conceptual framework in which they were created. This theory seems applicable to this scenario, since the enablement of relationship marketing initiatives through CRM tools has led to disillusionment in the marketplace. The latest literature indicates that these initiatives are not effective unless the philosophy impacts on the larger organisation, changing the way in which it operates.

From this point of view, the success of relationship marketing and CRM becomes part of the customer management paradigm, creating a different conceptual framework in which to solve the problems created in the areas of CRM and relationship marketing.

Customer management enables the organisation to support the promises of the relationship marketing campaigns by changing organisational processes to support the customer interface. This attempts to overcome a barrier already explained by Senge, Kleiner, Roberts, Ross & Smith (1994: 15–47) in their work, *The Fifth Discipline Fieldbook,* in which they state that when placed in the same system, people, however different, tend to produce similar results. Customer management will attempt to prevent this from happening by guiding organisations through appropriate change to support their customer strategies – doing different things (relationship-based activities) in different ways (through a customer management paradigm) and not by doing different things (relationship-based activities) in the same way (traditional business model).

It is therefore contended that CRM and customer management are currently positioned towards the fad end of the continuum. These initiatives have not yet proved their worth. While IT (in the form of CRM, enterprise resource planning and knowledge management applications) does have an important facilitative and supportive function in the development and management of firm–customer relations, a mere piece of expensive computer software in itself is not enough. The management of the entire relationship philosophy is required to select the appropriate interventions, design the market efforts with which to communicate them and gear the organisation to be able to deliver on its service promises.

As stated at the beginning of this paper, although management fads are frequently referred to with disdain, it is important to recognise that many current management practices began as fads. Gibson & Tesone (2001: 123) argue that management fads – even those that have entered the declining stages of the fad life cycle – often have a significant and lasting impact on management practice. They linger in the workplace either as the roots of a new management fad or in the guise of different jargon and terminology. The authors propose that the customer concepts and terms debated in this article will in future be called many other things and yet remain part of the same quest – organisations realising that the closer they live to their customers, the more secure their future will become.

References

Accenture. [S.a]. *Revitalizing Customer Relationship Management: a Look into the Future.* Available from: <www.accenture.com/xd/xd.asp?it=enWeb&xd=services\crm\crm_thought.xml> [Accessed: 12.6.2002].

Aijo, T.S. 1996. 'The theoretical and philosophical underpinnings of relationship marketing', *European Journal of Marketing,* 30(2): 8–18.

Bain & Company. 2001. 'Management tools survey results: global presentation'. Available from: <www.bain.com/bainweb/pdf/articles/3559.pdf> [Accessed: 6.2.2003].

Berry, L.L. 1995. 'Relationship marketing of services: growing interest, emerging perspectives', *Journal of the Academy of Marketing Science,* 23(4): 236–245.

Berry, L.L. 2002. 'Relationship marketing of services: perspectives from 1983 and 2000', *Journal of Relationship Marketing,* 1(1): 59–77.

Boedeker, M. 1997. 'Relationship marketing and regular customer cards: daily product retailing in Finland', *Marketing Intelligence & Planning,* 15(6): 249–257.

Bose, R. 2002. 'Customer relationship management: key components for IT success', *Industrial Management & Data Systems,* 102(2): 89–97.

Brodie, R.J., Coviello, N.E., Brookes, R.W. & Little, V. 1997. 'Towards a paradigm shift in marketing? An examination of marketing practices', *Journal of Marketing Management,* 13: 383–406.

Carson, P.P., Lanier, P.A., Carson, K.D. & Guidry, B.N. 2000. 'Clearing a path through the management fashion jungle: some preliminary trailblazing', *Academy of Management Journal,* 43(6): 1143–1158.

Clarke, T. & Clegg, S. 2000. 'Management paradigms for the new millennium', *International Journal of Management Reviews,* 2(1): 45–64.

Day, G.S. 1994. 'The capabilities of market-driven organizations', *Journal of Marketing,* 58, (October): 37–52.

De Wulf, K., Odekerken-Schröder, G. & Iacobucci, D. 2001. 'Investments in customer relationships: a cross-country and cross-industry exploration', *Journal of Marketing,* October: 33–50.

Einstein, A. 1988. *Ideas and Opinions*. Reprint. Bonanza Books.

European Business Review. 2002. 'ECCS survey highlights continuing CRM investment plans and problems', 14(1): 1.

Fournier, S., Dobscha, S. & Mick, D.G. 1998. 'Preventing the premature death of relationship marketing', *Harvard Business Review,* January–February: 42–51.

Galbreath, J. & Rogers, T. 1999. 'Customer relationship leadership: a leadership and motivation model for the twenty-first century business', *The TQM Magazine* 11(3): 161–171.

Georgiadis, M. & Lane, K. 2001. *Customer Marketing Organization – The Key to Turbo-charging Customer Marketing Performance*. McKinsey. Available from: <www.marketing.mckinsey.com> [Accessed: 18.2.2002].

Gibson, J.W. & Tesone, D.V. 2001. 'Management fads: emergence, evolution, and implications for managers', *Academy of Management Executive,* 15(4): 122–133.

Goodhue, D.L., Wixon, B.H. & Watson, H.J. 2002. 'Realizing business benefits through CRM: hitting the right target in the right way', *MIS Quarterly Executive,* 1(2), June: 79–94.

Grönroos, C. 1994. 'Quo vadis, marketing? Toward a relationship marketing paradigm', *Journal of Marketing Management,* 10: 347–360.

Grönroos, C. 1996. 'Relationship marketing: strategic and tactical implications', *Management Decision,* 34(3): 5–14.

Grönroos, C. 1999. 'Relationship marketing: challenges for the organization', *Journal of Business Research,* 46: 327–335.

Gruen, T.W. 1997. 'Relationship marketing: the route to marketing efficiency and effectiveness', *Business Horizons*, November–December: 32–38.

Gummesson, E. 2002. 'Relationship marketing in the new economy', *Journal of Relationship Marketing,* 1(1): 37–57.

Jaworski, B., Kohli, A.K. & Sahay, A. 2000. 'Market-driven versus driving markets', *Journal of the Academy of Marketing Science,* 28(1): 45–54.

Li, F. & Nicholls, J.A.F. 2000. 'Transactional or relationship marketing: determinants of strategic choices', *Journal of Marketing Management,* 16: 449–464.

Möller, K. & Halinen, A. 2000. 'Relationship marketing theory: its roots and directions', *Journal of Marketing Management,* 16: 29–54.

Morgan, R.M. & Hunt, S. 1999. 'Relationship-based competitive advantage: the role of relationship marketing in marketing strategy', *Journal of Business Research,* 46: 281–290.

O'Malley, L. & Tynan, C. 2000. 'Relationship marketing in consumer markets: rhetoric or reality?', *European Journal of Marketing,* 34(7): 797–815.

Palmer, A. 2002. 'The evolution of an idea: an environmental explanation of relationship marketing', *Journal of Relationship Marketing,* 1(1): 79–94.

Palmer, A.J. 1996. 'Relationship marketing: a universal paradigm or management fad?', *The Learning Organization,* 3(3): 18–25.

Petrof, J.V. 1997. 'Relationship marketing: the wheel reinvented?', *Business Horizons*, November–December: 26–31.

Rigby, D.K., Reichheld, F.F. & Schefter, P. 2002. 'Avoiding the four perils of CRM', *Harvard Business Review,* 80: (20), February: 101–109.

Ryals, L. & Payne, A. 2001. 'Customer relationship management in financial services: towards information-enabled relationship marketing', *Journal of Strategic Marketing,* 9: 3–27.

Saren, M.J. & Tzokas, N.X. 1998. 'Some dangerous axioms of relationship marketing', *Journal of Strategic Marketing,* 6: 187–196.

Senge, P.M., Kleiner, A., Roberts, C., Ross, R. & Smith, B. 1994. *The Fifth Discipline Fieldbook.* New York: Doubleday/Currency: 15–47.

Sheth, J.N. & Parvatiyar, A. 1995. 'The evolution of relationship marketing', *International Business Review,* 4(4): 397–418.

Sheth, J.N. & Parvatiyar, A. 2002. 'Evolving relationship marketing into a discipline', *Journal of Relationship Marketing,* 1(1): 3–16.

Starkey, M.W., Williams, D. & Stone, M. 2002. 'The state of customer management performance in Malaysia', *Marketing Intelligence and Planning,* 20(6): 378–385.

Strategic Direction. 2002. 'CRM: easy to do wrong, hard to do right', 18(3): 19–22.

Winer, R.S. 2001. 'A framework for customer relationship management', *California Management Review* 43(4): 89.

Environmental performance evaluation in non-financial terms

Cecilia J. Beukes[*]

Count what is countable, measure what is measurable and what is not measurable, make measurable.
Galileo, in Stainer & Heap (1996: 11)

Management accounting systems can provide the information bases required for non-financial environmental performance evaluation. These bases have the key functions of identifying non-financial indicators and assigning values to such indicators, followed by reporting and comparison with previous situations and the situation of ideal equilibrium. Traditional financial accounting information needs to be expanded not only to include more fragmented environmental financial information, but also non-financial indicators for the evaluation of environmental performance. The incorporation of non-financial environmental performance evaluation into existing accounting systems could be effected, although it would be a real challenge to all concerned.

Introduction

Organisations interested in finding out how they are doing in terms of environmental operations need to allow environmental performance measurement and evaluation to become inherent in their culture and be included in the initial stages of strategic planning.

Performance measurement is "the process of quantifying the efficiency and effectiveness of action" (Neely, Mills, Platts, Gregory & Richards 1996: 424). Quality measurement serves as an analytical instrument to determine when, where and how money has been, and has to be, spent. The measurement process is the "assignment of numbers to objects in such a way that the relation among objects can be determined from the relation among numbers" (Ijiri 1967: 22). In addition to financial calculations and reports, performance evaluation programmes also include dynamic procedures that encourage improvement in quality environmental schemes, decrease waste volumes, and thus reduce operating costs and increase profits. The functions of evaluation reports (Tatikonda & Tatikonda 1996: 7) are to provide information and to motivate, communicate, coordinate, prioritise and evaluate performance. In the evaluation process, financial and non-financial performance indicators are established and interpreted in order to follow the progress of activities towards the set objectives. Potential further improvements are identified, and the cycle of evaluation continues, beginning with the monitoring of the effectiveness of operations (Smith 1995: 146). Environmental performance evaluation forms an integral part of the comprehensive management accounting strategy. The information bases required for these evaluations can be provided by management accounting systems that measure environmental performance and determine the rewards for such performance.

Objective

The major objective of the study is to investigate the need for environmental performance evaluation, particularly for non-financial indicators, in order to provide stakeholders with reliable, consistent and accurate information for comparing companies in the same industrial sector at least, and to enable them to make strategic decisions. This major objective is interrelated with other objectives, such as finding a link between non-financial indicators and environmental performance evaluation, and indicating the potential to incorporate and develop environmental performance evaluation systems that utilise and disclose environmental performance, including in non-financial terms.

It is hoped that this study will create an increased awareness among managers of finding ways to accurately and comprehensively measure non-

* Professor Cecilia J. Beukes is in the Department of Accounting, University of South Africa.
E-mail: beukecj@unisa.ac.za

financial environmental performance together with the generally accepted traditional financial evaluation approach.

Problem investigated

Popular environmental rating schemes seem to rely heavily on public reaction to pollution and ecological disasters, rather than on accurate and measurable figures (Ilinitch, Soderstrom & Thomas 1998: 397). This reliance on public opinion is confirmed by studies indicating that non-financial indicators become more important once more stringent environmental regulations are imposed (Hughes 2000: 225).

The evaluation of environmental performance becomes necessary for the following reasons (Eckel, Fisher & Russel 1992: 16; Bennett & James 1998: 20; Howes 1999: 33):

- Business activities have an impact on the ecology, on society and on the economy.
- Companies are increasingly being held responsible for environmental remediation costs, as may be deduced from regulations and penalties.
- Environmental management often results in improvements to the ‘bottom line’ as a result of cost reductions and increases in goodwill.
- Costs of capital increase for companies with poor environmental performance because stakeholders demand higher risk premiums.
- Pressure group campaigns damage the reputation of polluting companies, resulting in additional costs to rectify the situation.
- The allocation of scarce corporate resources to environmental policies requires evidence in the form of adequately measured information.
- Lower levels of management are increasingly becoming empowered and need more and better environmental information for decision-making and monitoring.
- The quality of environmental management is increasingly regarded as an indicator of the overall quality of management.

These reasons emphasise the fact that there are hidden revenues and benefits, as well as undiscovered profits and gains, behind the traditional disclosed figures, and that traditional management systems lack the ability to link long-term strategies to their short-term activities (Kaplan & Norton 1996: 75). These non-accounting advantages need to be measured and taken into account for decision-making purposes. Disadvantages and inefficiencies, however, once rationalised through accounting and rules, need to be separated and measured on other scales. Together with the need to unveil this unknown past information, there is a need to add goals of forward thinking and to measure the achievement of these set goals. This need contributes to the complexity of strategic management, which can, to a large extent, be attributed to the future with which it deals, and which is uncertain (Bull 1999: 24). Evaluation systems based only on predetermined characteristics in the form of checklists need to be critically evaluated and updated. There is a need for non-financial environmental performance metrics in order to provide stakeholders with more reliable, consistent and accurate information.

Research strategy

In this article, information is presented on issues related to the evaluation of environmental performance in non-financial terms. Relevant literature and situations are analysed, with an emphasis on finding ways to develop strategies for the evaluation of environmental performance.

Financial values

Environmental costs are inadequately allocated, because environmental costs are included in categories such as wages, supplies and sundry expenses (Ansari, Bell, Klammer & Lawrence 1997a: MMEC-6), and are not collected, classified, assessed and disclosed properly. This includes the fact that interested and affected groups are not taken into account when these expenditures are not separated for the purposes of providing information for management decisions.

Financial analysis of environmental activities indicates the current position at the end of the financial year, as well as comparisons with previous years. Financial planning, strategies and budgets are compared with this current information in order to facilitate decision-making by means of feedback mechanisms. Supporting financial information is needed for decision-making and activities (Parker, Ferris & Otley 1989: 84), and gives an indication of how financial returns will change.

The financial values to be included in performance evaluations follow existing, traditional approaches to the measurement and reporting of activities in monetary terms. Developing trends seek to identify and classify quality costs, such as prevention costs, appraisal costs and failure costs (Tatikonda &

Tatikonda 1996: 2). Prevention costs are incurred in minimising, re-using and recycling waste products, while appraisal costs are associated with assessments of the quality attained. Internal failure costs are incurred in correcting failed efforts to remediate environmental damage, and external failure costs are incurred in mitigating damage to the external environment. The focus is to highlight the environmental costs hidden in the accountancy system. The aim of cost calculations is to indicate that pollution production is costly because of the wastage of purchased input waste and the hidden costs related to the workforce (Jasch 2000: 1). The apparent cost of the treatment of waste and unwanted emissions is allocated to the centres producing pollution. The measurement and reporting of environmental cost can therefore be divided into the following aspects (Ansari et al. 1997a: MMEC-5):

- Determine the total amount of environmental costs incurred.
- Classify environmental costs into the categories of prevention, appraisal, control and failure.
- Report the environmental costs to managers.

The principle should be further developed, in that, by using more fragmented cost categories, quality information could be provided for improved decision-making. Companies that make their environmental impacts and approach to sustainable environmental management more transparent through improved financial information and disclosure will have an advantage in the process of meeting the expectations of their stakeholders. This development of utilising fragmented environmental cost categories could simultaneously be integrated with the process of finding and analysing non-financial indicators for decision-making purposes. Although relevant financial information is required, non-financial environmental performance indicators should be considered next to form a more complete picture of the total quality evaluation of environmental performance.

Non-financial values

Evaluation in financial terms only was not previously questioned because traditional views allowed environmental costs to be hidden, disguised and not adequately allocated. The lack of relevant, reliable and timely financial information is among the reasons for the limited means for evaluating environmental performance in terms of the non-financial value of quality. Environmental pollution is not normally a measured variable, as it cannot be readily translated into profitability and efficiency (Evans 1996: 48). Traditional financial accounting approaches do not provide all the elements that generate success and underwrite the progress of business. They are often too late and send distorted messages (Juchau 2000: 48). There is therefore a need to assess the impact of investments in environmental technology and procedures in non-financial terms that cannot immediately be translated into numbers, or are not easily identifiable.

The management functions of performance measurement and reporting, and the comparison with a balanced situation, form part of the overall evaluation function. After identifying the various non-financial components to be evaluated, the management team has to decide how each individual component should be evaluated.

Whereas non-financial measurements in the past took the form more of ad hoc assessments than systematic monitoring (Vaivio 1999: 414), vast resources of non-financial data are now available and could be identified and integrated into information for management decision-making purposes. Engineering technology in the manufacturing, mining and service sectors already has advanced information available on computer systems, which needs only to be unlocked by the accountant and management accountant. A team approach should be followed across several accounting and related sub-disciplines (Grinnell & Hunt 2000: 34). In order to obtain available data, non-financial evaluations would include toxicology, the health and safety of occupational and local residents (Shimell 1991: 16) and the environmental image of the organisation. Environmental damage could be assessed in terms of the levels of water and air pollution, solid and hazardous waste substances, soil degradation and the loss of biodiversity (Todaro 1994: 331). Environmental performance could be measured, for example, for water pollution readings relative to the permissible standards set by authorities. Similarly, the existence and potential of environmental liabilities (Cormier & Magnan 1997: 235) should be calculated and disclosed.

Non-quantitative factors could be indicated on a scale with a total equal to 10 or 100 points indicating flexibility, simplicity of operations, timeliness and organisation image (Carter 1992: 61). Other variables in this category would include safety, ethical attitude of decision-makers, morale, environmental awareness and skills (Smith 1995: 181). A spider diagram (Quest Quality 1997: 32) could be applied to illustrate these situations.

Non-financial indicators could be determined according to the nature and size of organisations, and would vary according to the needs of each individual situation. These indicators could be defined for each of the categories of input, performance, products and services, markets, employees and customers (Smith 1995: 180), for example:

- Time factors, such as time to repeat work, on backlog tasks and repairs and overtime, and time for the natural environment to recover after damage has been inflicted
- The number of failures, such as instances of clean water mixing with polluted run-off water from waste dumps
- Considerations such as rewards and awards received by the organisation and employees for their contribution to environmental activities
- Inputs and results pertaining to educational programmes, as well as research and development, that promote environmental awareness and sustainable management
- Safety and health factors relating to employees, customers, surrounding communities and products.

Percentages could be calculated, such as the percentage of unplanned environmental tasks in relation to planned tasks, preventive maintenance to total maintenance, and research and development on environmental schemes to total budgeted research and development allowances in both time and monetary terms (Beukes 1999: 23). Indices could be compiled for environmental education attainment, rehabilitation success, community involvement and satisfaction regarding environmental management, employee contributions, leadership and the utilisation of benchmarking opportunities. Non-financial indicators of environmental performance, such as quality, time and flexibility measures, could be distinguished.

In environmental strategies in particular, longer corporate time horizons are needed (Kleiner 1991: 38–47), since future quality of life should not be sacrificed for present economic gain. Non-financial indicators could be utilised, both for management decision-making and environmental performance measurement purposes.

Non-financial indicators are attached to individual components, such as the number of complaints from customers and the quantities of waste produced in terms of kilograms or litres, in order to measure environmental performance. Indicators can also be expressed in terms of time and ratios, and on scales of zero to ten, and illustrated in graphs in a meaningful way. These current indicators could then be compared with those of previous periods, with budgeted information, and with projections of future strategies.

The International Standards Organisation (ISO) provides a framework for the measurement of environmental performance through ISO14000 standards, which address the following categories (Rezaee 2000: 58):

- Environmental management systems
- Environmental auditing
- Environmental labelling
- Environmental performance measurement
- Life-cycle assessment
- Environmental aspects in product standards.

The implementation of ISO14000 and the process of obtaining an ISO14000 certificate provide a means of preventing future mandatory regulations and sanctions. An effective ISO14000 system can improve compliance with environmental laws, regulations and standards, reduce environmental liabilities, prevent damage from pollution and waste and improve public image.

For the successful utilisation of non-financial indicators, the human factor forms the basis regarding data accuracy, manipulation opportunities (Smith 1990: 26) and the ability to be continually innovative (Hiromoto 1988: 26). Because of the subjectivity factor, it is necessary to consult external experts and obtain more than one opinion, preferably from the same people each time, in order to obtain reliable performance measurements and make meaningful comparisons. The information about these evaluations, earmarked for the interested groups, should be in a format that can be easily analysed in order to enhance the usefulness and quality of the information (Gouws & Lucouw 1999: 119). The effectiveness of the utilisation of non-financial indicators would therefore depend largely on the historical background, culture and management style (Eccles 1991: 137) of the organisation and its people.

By putting more emphasis on the important role of non-financial performance evaluations, the quality and usefulness of environmental accounting information could be increased for all interested groups. Improved measurement criteria would have an escalating effect, from improved profits to more accurate macroeconomic figures. Cost-effectiveness would be improved, output could increase, resources would be better utilised, and the financial burden on authorities and the taxpayer could be lessened. Strategies could then be adopted that would ensure excellent products and service. The management of non-financial activities would build market credibility, improve the organisation's message to the market and re-establish customer belief.

Non-financial indicators are not adequately utilised for reporting purposes, because of uncertainty regarding their application possibilities and the limited recognition of their function (Cormier & Magnan 1997: 236). Environmental concerns (such as species extinction, habitat damage, and pollution and resource depletion) are not calculated and disclosed in a way that could be described as "accounting for the environment" (Gray 2000: 22). Environmental reporting still has a long way to go, because relatively few organisations are doing any form of non-financial reporting (Adams 1999: 18). In South Africa, however, social reporting, of which environmental reporting is an element, appears to have the same development pattern as in the United Kingdom, but with a time difference of six to eight years (De Villiers 1999: 9). In the meantime, developments in information technology keep providing improved measurement systems for the generation, analysis and storage of information in order to facilitate decision-making on more levels.

The relevance of environmental management systems to the stated goals should be taken into account when environmental information is reported and compared with an ideal situation. Elements to be considered are the transparency of information, the role that environmental measurables play in distorting traditional costing systems, the improvement of efficiency through the utilisation of this information, and the assessment of the efficiency of current environmental management projects (Girardi 2000: 32). A manageable number of key non-financial performance indicators could provide more efficient and less costly information.

The established non-financial indicators should be compared on a regular basis in order to provide quality information as part of the feedback mechanism to ensure constant improvement in the deployment of policies. Positive feedback would encourage management initiatives towards the evolution of improved non-financial indicators, techniques and approaches. These continuous improvement cycles should form part of long-term projections that will only show results after decades.

The compilation of the optimum set of non-financial indicators to evaluate environmental performance should be linked to the goals of the organisation, with an equilibrium situation as the ultimate goal, in order to be efficient. The number of reported and disclosed non-financial indicators that would be regarded as sufficient for the evaluation of environmental performance would depend on the mission and objectives of the organisation.

Environmental performance measurement and reporting systems that are being developed seem to be unnecessarily complex and might lead to confusion and cynicism (Ilinitch et al. 1998: 404). The development of evaluation systems that are clearly defined, reliable, standardised, valid and readily available to all potential users would, over time, allow a better understanding of the evaluation process. Not only would time and expenses be saved, but accountants could provide information to stakeholders in a format that would be easily understood, and improvements in environmental performance could be tackled over time.

The application of non-financial values in the evaluation of environmental activities involves the identification of non-financial indicators from available data, the assignment of values to these indicators, reporting these measurements, and comparison with existing results and with an ideal equilibrium situation. Instead of the initial limited diagnostic purpose of new policies, non-financial indicators have a more active role to play in the management process (Vaivio 1999: 430). Proper preparation and openness to the evaluation process provide the opportunity to generate new and improved ways to measure non-financial environmental performance evaluations. It is important for accountants, in particular, to develop an understanding of sound management practices related to ecological issues and the critical link to business success (Grinnell & Hunt 2000: 34). Expanding the accountant's domain to include non-financial indicators for the evaluation of environmental activities could contribute greatly to the meaningfulness of environmental performance measurement and management.

Results

Following an investigation and analysis of the relevant literature and situations, the following results were obtained. Recommendations are made on including the evaluation of non-financial environmental performance in management accounting systems.

This study found that non-financial environmental performance evaluation need not rely only on public reaction to ecological disasters, but could also be measured in terms of, for example, percentages and indices. By unveiling gains and inefficiencies, these data could be adequately measured, and stakeholders could be provided with more reliable, consistent and accurate information. This would enable management to make comparisons in the same industrial sector and improve strategic decision-making.

It was found that the principle of more fragmented environmental costing categories should be further developed and linked to non-financial indicators in order to provide quality information for improved decision-making. This awareness of and tendency to quality information provides an opportunity to explore non-financial environmental performance indicators in order to formulate more accurate and comprehensive policies. Non-financial indicators for performance measurement could be developed and utilised in concert with generally accepted traditional financial evaluations, as well as with environmental performance evaluation systems. It was found that non-financial indicators could be identified and values assigned to them, followed by reporting and comparisons in the process of evaluating the environmental performance of an organisation. Awareness is evolving that non-financial environmental evaluations could be conducted more accurately and more comprehensively. Resources of non-financial data need only be unlocked by the accountant and management accountant. It was found that non-financial performance evaluations would have an escalating effect in improving profits, providing more accurate information, building market credibility and improving the organisation's image among customers.

Conclusions

Financial and non-financial performance measures are complementary and together form a system of multidimensional performance measurement (Vaivio 1999: 409). Effective environmental performance measurement and performance systems should include a mix of financial and non-financial indicators (Juchau 2000: 50). Non-financial environmental performance assessments might initially rely on existing financial evaluation policies, based on the principle of more fragmented cost categories of quality costing. These evaluations function differently, however, and might not necessarily conform to the historical requirements of general accounting practice in terms of objectivity and calculations in monetary values only. Traditional values, beliefs and mindsets, which guided the behaviour of decision-makers in the past (Ansari et al. 1997b: SMA-12*)*, should be allowed to evolve to the next phase where all environmental measurable components are included in the accounting system. The accountant and management accountant should link both financial and non-financial measures in improved and more meaningful ways, taking into account the characteristics of each individual organisation, which depends on its needs, policies and leadership properties.

The nature and size of an organisation, as well as its particular circumstances, would influence the choice and combination of non-financial indicators to be selected. Available data could be investigated in order to identify and define non-financial environmental indicators. These indicators would, for example, include levels of water, air and soil pollution, loss of species and habitats, safety, ethical attitudes and skills. These identified indicators could be categorised for input, performance, products, services, markets, employees, customers and the external community.

Frameworks for the measurement of non-financial environmental performance could be developed with ISO14000 as the basis. The human factor should be taken into account when non-financial indicators are utilised in the evaluation process. Reported non-financial environmental activities form the basis for comparison with other organisations, previous periods, and the set goals and budgets. These reports allow feedback and, consequently, cycles of continuous improvement. The utilisation of non-financial evaluation instruments should be regarded as an ongoing and evolving process for obtaining future rewards.

Further research on non-financial environmental performance indicators is needed to provide additional insight into the response of management in terms of the type, format and amount of information to be disclosed. Future work includes designing performance measurement systems that capture the full diversity of environmental evaluation. Management accountants and researchers should consider how organisational members can participate in the selection of these measures and how to set appropriate standards. A better understanding of the available non-financial environmental information is needed in order to utilise it for managerial functions ranging from the formulation of the mission statement to feedback for continuous improvement after final results have been determined. The social, environmental and economic factors driving the flow of information should be adequately captured.

Non-financial information is becoming increasingly important in managerial decisions, and its incorporation into existing management accounting systems provides a challenge for the critical thinking skills of management accountants. It is, however, not an easy task to develop non-financial indicators and assessment schemes for long-term strategies that are flexible in terms of accounting, control and performance evaluation. This challenge to accountants and management accountants to develop, utilise and disclose environmental performance in non-financial terms could lead to a renaissance of innovations and evolution in the new century. If attempts are made to take up these challenges, the objectives of this research will have been achieved.

References

Adams, R. 1999. 'Performance indicators for sustainable development', *Accounting and Business*, April: 16–19.

Ansari, S., Bell, J., Klammer, T. & Lawrence, C. 1997a. 'Measuring and managing environmental costs (MMEC)', In *Management Accounting: a Strategic Focus.* California: Irwin.

Ansari, S., Bell, J., Klammer, T. & Lawrence, C. 1997b. 'Strategy and management accounting (SMA)', In *Management Accounting: a Strategic Focus.* California: Irwin.

Bennett, M. & James, P. 1998. 'The green bottom line: management accounting for environmental improvement and business benefit', *Management Accounting*, 76(10): 20–25.

Beukes, C.J. 1999. 'Non-financial indicators in management accounting', *Accountancy and Finance Update: Africa's Journal for Financial Professionals*, 4(2): 22–24.

Bull, R. 1999. 'The foundations of strategic management', *Management Accounting*, 77(8): 24–26.

Carter, W.K. 1992. 'To invest in new technology or not? New tools for making the decision', *Journal of Accountancy*, May: 58–64.

Cormier, D. & Magnan, M. 1997. 'Investors' assessment of implicit environmental liabilities: an empirical investigation', *Journal of Accounting and Public Policy*, 16(2): 215–241.

De Villiers, C. 1999. 'The disclosure of social information in annual reports: increasingly popular in South Africa', *Accountancy & Finance Update: Africa's Journal for Financial Professionals*, 4(1): 8–9.

Eccles, R.G. 1991. 'The performance measurement manifesto', *Harvard Business Review*, Jan/Feb: 131–137.

Eckel, L., Fisher, K. & Russel, G. 1992. 'Environmental performance measurement', *CMA Magazine*, 66(2): 16–23.

Evans, P. 1996. *Tyranny of the Bottom Line: Why Corporations Make Good People do Bad Things*. San Francisco: Berret-Koehler.

Girardi, G. 2000. 'Waste management: business management', *Australian CPA*, 70(2): 32–35.

Gouws, D.G. & Lucouw, P. 1999. 'The process beyond the numbers and ratios', *Meditari Accountancy Research*, 7: 99–122.

Gray, R. 2000. 'Is the planet safe in the hands of business and accounting?' *Accountancy and Finance Update: Africa's Journal for Financial Professionals*, 5(1): 21–24.

Grinnell, D.J. & Hunt III, H.G. 2000. 'Development of an integrated course in accounting: a focus on environmental issues', *Issues in Accounting Education*, 15: 19–42.

Hiromoto, T. 1988. 'Another hidden edge – Japanese management accounting', *Harvard Business Review*, 66(4): 34–35.

Howes, R. 1999. 'Accounting for environmentally sustainable profits', *Management Accounting*, January: 32–33.

Hughes II, K.E. 2000. 'The value relevance of non-financial measures of air pollution in the electric utility industry', *Accounting Review*, 75(2): 209–228.

Ijiri, Y. 1967. *The Foundations of Accounting Measurement: a Mathematical, Economic, and Behavioral Inquiry.* New Jersey: Prentice-Hall.

Ilinitch, A.Y., Soderstrom, N.S. & Thomas, T.E. 1998. 'Measuring corporate environmental performance', *Journal of Accounting and Public Policy*, 17(4-5): 383–408.

Jasch, C. 2000. 'What is environmental costs?' *Social and Environmental Accounting,* 20: 1–6.

Juchau, R. 2000. 'Non-financial performance measures: an Australian survey', *CA Charter (Australia),* March: 48–51.

Kaplan, R.S. & Norton, D.P. 1996. 'Using the balanced scorecard as a strategic management system', *Harvard Business Review*, Jan–Feb: 75–85.

Kleiner, A. 1991. 'What does it mean to be green?' *Harvard Business Review*, 69(4), July/August: 38–47.

Neely, A., Mills, J., Platts, K., Gregory, M. & Richards, H. 1996. 'Performance measurement system design: should process based approaches be adopted?' *International Journal of Production Economics,* 46–47, Dec: 423–431.

Parker, L.D., Ferris, K.R. & Otley, D.T. 1989. *Accounting for the Human Factor.* New York: Prentice Hall.

Quest Quality. 1997. *Solve that Problem! Tools for Quality Improvement.* Surrey, UK: Quest.

Rezaee, Z. 2000. 'Help keep the world green', *Journal of Accountancy*, 190(5): 57–67.

Shimell, P. 1991. 'Corporate environmental policy in practice', *Long Range Planning*, 24(3): 10–17.

Smith, M. 1990. 'The rise and rise of the NFI', *Management Accounting (UK)*, May, 24–26.

Smith, M. 1995. *New Tools for Management Accounting: Putting Non-financial Indicators to Work.* London: Pitman.

Stainer, A. & Heap, J. 1996. 'Performance measurement – a management services perspective', *Management Services*, 40(7): 10–12.

Tatikonda, L.U. & Tatikonda, R.J. 1996. 'Measuring and reporting the cost of quality', *Production and Inventory Management*, 37(2): 1–7.

Todaro, M.P. 1994. *Economic Development*, 5th edition. New York: Longman.

Vaivio, J. 1999. 'Exploring a ''non-financial'' management accounting change', *Management Accounting Research*, 10(4): 409–437.

Skills audit of micro and very small business enterprises in Northern Tshwane: an exploratory study[1]

*Deon Harold Tustin**

The small, medium and micro enterprise (SMME) sector in South Africa has increasingly been targeted in efforts to stimulate employment growth and address rising unemployment. To examine the extent to which micro and very small businesses are equipped to face this challenge, an exploratory study was conducted in the Northern Tshwane area (previously the Bophuthatswana homeland). Since the reintegration of the former Bophuthatswana into the new South Africa in 1994, this area has experienced ongoing increases in unemployment and poverty as a direct result of the discontinuation of Bophuthatswana government subsidies to businesses. Despite this, it seems that the formation of small businesses in Northern Tshwane has been relatively lively since 1994. Instead of initiating business ventures that benefit the society in which they live, however, these new entrepreneurs appear rather to exploit business opportunities for personal gain. Concomitant herewith, the low basic and functional literacy and generic skills levels of the owners/managers and employees of these businesses means that there is a relatively high risk in their medium- to long-term survival rate, especially for micro and very small businesses. Indeed, the survival rate of these new ventures, particularly in the informal sector of the economy, appears to be very low. There is thus an urgent need to develop and broaden the abilities and skills of owners/managers and employees of micro and very small business enterprises. International research shows that improved skills have the potential to enhance managerial competence and human capital, and may lead to higher productivity and wage growth.

Introduction

Subsidies to businesses by the former Bophuthatswana government were discontinued after the reintegration of Bophuthatswana into the new South Africa in 1994. Consequently, a large number of small business enterprises have either closed down or relocated. This has impacted negatively on the economic wellbeing of many peri-urban[2] communities in Northern Tshwane.[3] Increased unemployment and poverty were notable in this area, and skills migration rates showed continued increases. About 20 000 jobs are estimated to have been lost as a result (Joint Education Trust 2002).

In an attempt to address these problems, the micro and very small business sector of Northern Tshwane has been targeted as an important instrument in the regeneration of economic growth in peri-urban areas. Many international studies of the past have shown that small enterprises play a central role as a driving engine for growth, job creation and competitiveness (Garibaldi, in Nottinghamshire Research Observatory 2002). Small business also plays an important role in terms of innovation and productivity growth. Birch's empirical study on the importance of small business in creating most of the new jobs in the USA has been influential in many member countries of the Organization for Economic Cooperation and Development (OECD), including the United Kingdom (OECD 1996).

* Dr Deon Harold Tustin is a senior researcher/lecturer at the Bureau of Market Research, University of South Africa.
E-mail: tustidh@unisa.ac.za

1 This article is based on a research report published by the Bureau of Market Research, University of South Africa.
2 Settlement typology defines 'peri-urban areas' as lower density developments on the urban (city) periphery (CSIR 2002).
3 Peri-urban areas in Northern Tshwane include Temba, Dilopye, Majaneng, Marokolong, Nuwe Eersterus, Ramotse, Sekampaneng, Suurman, Stinkwater and Hammanskraal.

Objective

Central to any economic growth and development plan is a skills strategy aimed at determining whether the skills base of business enterprises is at adequate levels to allow for the creation of new micro and very small business enterprises, and the further development of new ones. The aim of the study was therefore to conduct a skills audit to identify the available skills and future skills needs of established micro and very small business enterprises in Northern Tshwane. A human resources profile of this nature, reflecting current and future skills needs, is a vital component of any strategy aimed at improved business efficiency and competitiveness, which could ultimately support job creation and the social upliftment efforts of local government, the private business sector and the community.

The skills audit mainly investigated the current and future status of specific generic skills types of full-time owners/managers and employees of micro and very small businesses. Generic skills are defined as those that apply across a variety of jobs/occupation groups (UK Department for Education and Skills 2003). Common among generic skills types are information technology,[4] financial/accounting[5] and business trade skills.[6] The development of these skills types is essential for the effective functioning and future development of micro and very small business enterprises.

The skills audit model also investigated the training infrastructure and training practices of micro and very small business enterprises. The reason for including these aspects was that extensive international evidence shows that management and employee training/skills development has a positive impact on small firm performance (Demick & O'Reilly 2000; Management Service 2001; Bishop 1994; Groot 1999a, b; Barron, Berger & Black 1999).

Survey methodology

Scope of the survey

The survey was conducted among 160 micro and very small business enterprises operating in selected peri-urban areas of Northern Tshwane. Based on the assumption that skills needs differ by employment size class, the study defined the micro and very small business sector as including the following types of enterprise.

Survivalist enterprises

Survivalist enterprises are those that have no salaried employees (comprising only an owner). These enterprises usually have a minimal asset value, and generate an income below the minimum income standard or poverty line.

Micro (0) enterprises

Micro (0) enterprises are those in which the entrepreneur (owner) is the only employee. These enterprises are usually not registered for tax or accounting purposes and have a turnover below the VAT registration limit.

Micro (1–4) enterprises

Micro enterprises are usually not formally registered for VAT purposes. These enterprises employ between one and four people, apart from the entrepreneur (owner).

Very small enterprises

Very small enterprises usually operate in the formal market and employ between five and 20 people, apart from the owner/manager.

Because survivalist and micro (0) enterprises both reflect enterprises managed and operated by one person only, they were grouped together for this study. They are referred to collectively as survivalist/micro (0) enterprises.

The classification of small businesses used for the skills audit study closely corresponds with the definitions applied by Ntsika (2001). It should be noted that Ntsika uses a much broader classification for small, medium and micro enterprises (SMMEs). It also includes small (21–50 employees) and medium (51–100 employees) business enter-

4 Information technology skills were defined as including skills in typing/keyboard, basic Internet and e-mail, computer programming, network design, website development, hardware and software support, computer assistance and computer equipment operation.

5 Financial/accounting skills were defined as including recording and accounting of cash and credit transactions, recording payroll transactions, data processing, storage, retrieval and supply of information, maintaining financial records and accounts, recording cost information, preparing financial reports, management of accounting systems, drafting of financial statements, basic, analysis and interpretation of financial statements, cost accounting, preparing business taxation and personal tax computations, computerised accounting systems and spreadsheets and computerised bookkeeping.

6 Business trade skills were defined as including basic business management, customer care, stock control, marketing/communications, merchandise/selling, labour relations, public relations and e-commerce.

prises. Small and medium business enterprises were excluded from the skills audit study. Only micro and very small business enterprises were targeted, mainly because of their high labour absorption ability, the fact that they are suited to isolated and niche markets through their superior ability to adapt to rapidly changing trends and their use of local resources, and because they provide solutions for newly urbanised, unemployed and retrenched entrepreneurs.

Organisation of the survey

A pre-structured and pre-tested questionnaire was used to collect data. The questions in the questionnaire requested information on the following issues: location of business, experience/qualification and generic skills levels of workers, with a specific emphasis on financial/accounting, information technology and business trade skills. To assist owners/managers of micro and very small businesses in identifying typical financial/accounting, information technology and business trade skills, a skills prompt chart was compiled and shown to the owner/manager during the interview. Owners/managers of micro and very small businesses used the skills prompt chart (which reflected the various information technology, financial/accounting and business trade skills) to list current generic skills needs of full-time owners/managers and employees and to identify future needs. Strict quality control was maintained during the survey by means of measures that included proper training of interviewers (as well as close contact with them), checking each interviewer's first round of questionnaires before allowing him/her to continue with the interviews, telephonic call back checks and thorough editing of questionnaires.

Sampling and sample representation

In the absence of an appropriate sample frame, it was impossible to apply a probability sampling methodology. Instead, the selection of micro and very small businesses for inclusion in the survey was based on the judgemental selection procedure. The interviewers that were recruited in the selected areas were asked to identify micro and very small businesses based on the number of full-time staff employed. This procedure ensured that the whole spectrum of micro and very small business enterprises (as already defined) was covered. Based on population estimates (SA Explorer 2000), the micro and very small business enterprises were proportionately distributed across the peri-urban areas of Northern Tshwane.

Almost a third (32.9%) of the survey population eventually interviewed were classified as survivalist/micro (0) enterprises. A further 44.7% and 22.4% respectively were micro (1–4) and very small enterprises. Compared with national estimates by Ntsika (2001), the number of survivalist/micro (0) enterprises surveyed seems to have been under-represented. Ntsika (2001: 45) estimates show that survivalist/micro (0) enterprises account for approximately half (50.9%) of the total number of enterprises in South Africa. Micro (1–4) and very small enterprises make up 19.8% and 20.5% respectively of all enterprises. Based on the national estimates of Ntsika, the sample of micro and very small businesses interviewed seems rather biased towards micro (1–4) enterprises.

Statistical analysis

The statistical analysis was based mainly on a descriptive analysis featuring typical frequency distributions, cross-tabulations and measures of central tendency (such as modes and percentages). These descriptive techniques were used, among others, to capture essential characteristics of the various generic skills under investigation, as well as to capture the proportion of the sample adhering to the specific skills/training issues under investigation. The statistical analysis also included an inferential analysis technique known as a one-sample chi-square test.[7] This statistical test was applied to determine the relationship between skills training and firm size.

Survey results and findings

To ascertain the rate of micro and very small business formation in the peri-urban areas of Northern Tshwane since 1994, the operational period of micro and very small businesses is discussed before the outcome of the skills audit is presented.

Number of years in business

The number of years that micro and very small business enterprises have been controlled/managed by their present owners is reflected in Figure 1.

7 The chi-square is concerned with whether the differences between an observed set of frequencies and a theoretically expected set of frequencies are significant (Martins, Loubser & Van Wyk 1996).

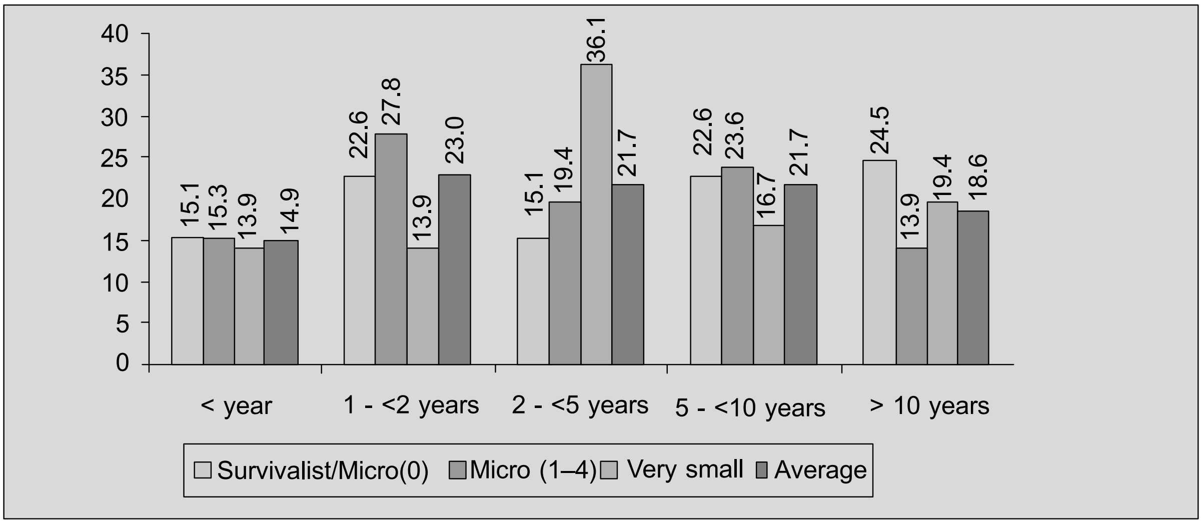


Figure 1: Number of years that micro and very small businesses have been controlled/managed by their present owners

Figure 1 shows that most micro and very small business enterprises (59.6%) have been in operation for less than five years. Overall, 38.0% of the micro and very small business enterprises have been operating for less than two years. Only 30 (or 18.6%) of the micro and very small business enterprises interviewed have been in operation for more than ten years. Most survivalist/micro (0), micro (1–4) and very small enterprises have been operating for more than one year and less than five.

Figure 1 further reflects a relatively high rate of micro and very small business formation since the integration of the former Bophuthatswana homeland into South Africa in 1994. The information in Figure 1 reflects relatively low levels of business experience among micro and very small business enterprises. Based on this finding, the effectiveness and ability of micro and very small businesses to create employment and economic growth remains uncertain.

Skills audit analysis

The skills audit analysis entailed a detailed investigation of the qualification levels of owners/managers and employees as reported by the owners/managers of the micro and very small businesses interviewed. The qualifications and skills levels of full-time staff were analysed. The training of full-time staff and the training infrastructure of micro and very small businesses were also investigated, because developing the abilities and skills of owners/managers and employees through training is crucial for the prosperity of micro and very small business enterprises.

Qualification levels of full-time staff of micro and very small businesses

Figure 2 reflects the qualification levels of the full-time staff (owners/managers/employees) of the micro and very small business enterprises interviewed, by size class. The Figure reflects only the qualification levels of full-time African employees, because this population group represented 97.0% of all full-time workers of the micro and very small business enterprises surveyed.

Figure 2 shows a positive relation between business type and qualification level. For example, a higher percentage of workers in the micro (1–4) and very small business sectors have grade 8–9 or grade 10–12 qualifications, compared to workers in the survivalist/micro (0) sector. In turn, a higher percentage of workers in the survivalist/micro (0) sector (35.9%) have a grade eight and below, compared to those employed in the micro (1–4) and very small business sectors. Of the total survey population, 8.1% of full-time workers have a degree. Only 2.0% of the full-time workers received adult basic education and training (ABET).[8]

It is important to note from Figure 2 that just more than a third (35.9%) of the 53 owners of survivalist/micro (0) enterprises interviewed lack a basic education (grade 9) and functional literacy (grade 7) (Harley, Aitchison, Lyser & Land 1996; Aitchison,

8 Adult basic education and training (ABET) is defined as education provision for people aged 15 years and over who are not engaged in formal schooling or higher education and who have an eduation level of less than grade 9 (Aitchison 2000).

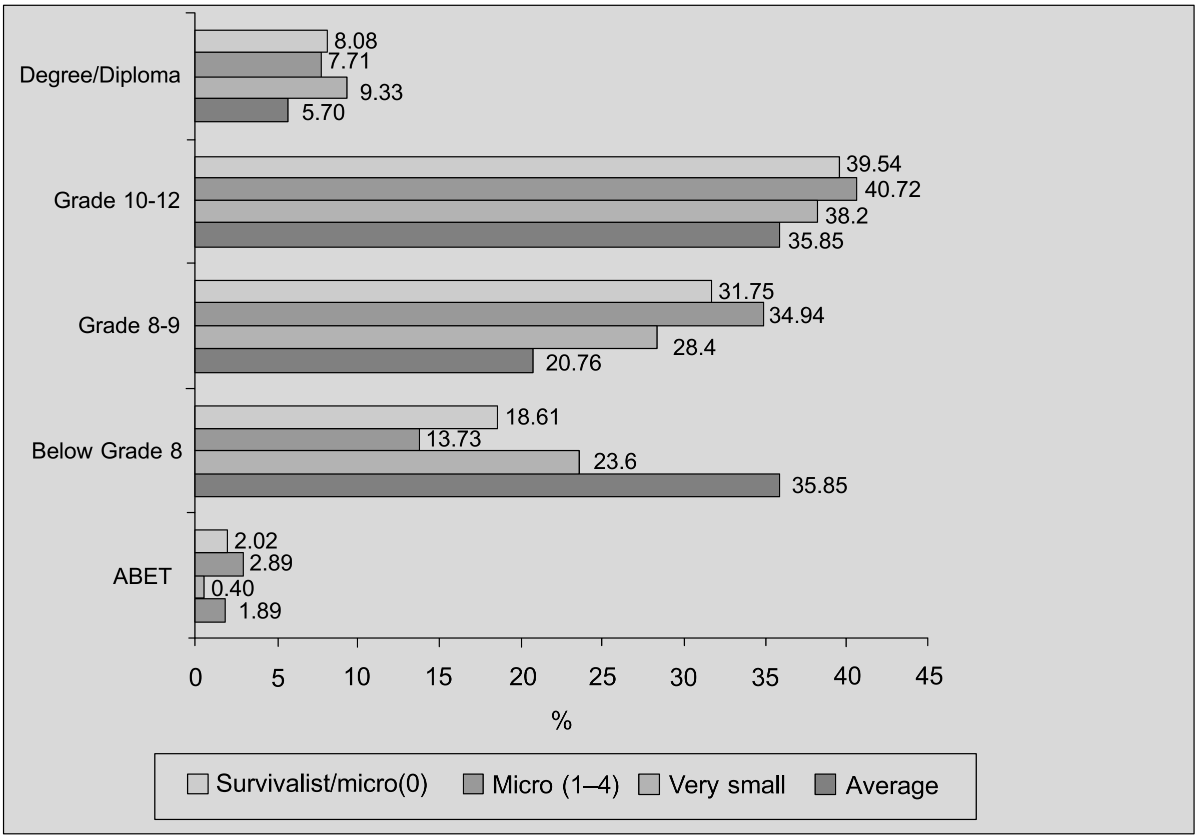


Figure 2: Percentage of full-time African workers, by qualification and business type

Houghton & Baatjes 2000; UNDP 1999). In 1999, the Centre for Adult Education and the Department of Adult and Community Education (1999) estimated that 12.7% of adults (people aged 15 years and older) in Gauteng (a total of 935 781 people) have reached only schooling levels of grade 7 or lower. In terms of basic and functional literacy levels, the survey findings reflect relatively high risks in the medium- to long-term survival rate of survivalist/micro (0) enterprises in particular.

Current and future skills needs

As mentioned, the study specifically emphasised the potential advantage of skills training pertaining to the development of generic skills types. More specifically, financial/accounting, information technology and business trade skills were analysed as typical generic skills types of importance for future micro and very small business development. The outcome of the skills analysis revealed that current financial/accounting, information technology and business trade skills levels of owners/managers and employees are somewhat basic and need to be broadened further (see Tables 1a and 2a). Table 1a reflects the current skills of full-time owners/managers, Table 2a the current skills of employees, Table 1b the future skills needs of full-time owners/managers, and Table 2b the future skills needs of employees of micro and very small business enterprises.

Tables 1b and 2b reflect fairly basic future skills needs and emphasise the shortage of these skills in the current running of micro and very small businesses. The future skills needs listed in Tables 1b and 2b also reflect specific future functional skills needs. At managerial level, owners/managers listed senior, general and production management skills, in particular, as critical functional business trade skills shortages. To increase the potential for micro and very small businesses to function more productively in the future, owners/managers identified the following managerial skills as necessary:

- Senior management skills – for example, oral and written communication, decision-making, conflict management and group/team management skills
- General management skills – for example, recruiting, hiring, training and financial skills
- Production management skills – for example, customer services and safety and security skills.

Table 1a: Current skills of full-time owners/managers by business size

Skills	Survivalist/micro (0)	Micro (1–4)	Very small
Financial/accounting	Recording of and accounting for cash transactions	Recording of and accounting for cash transactions	Recording of and accounting for cash transactions
	Data processing: store, retrieve and supply information	Recording of and accounting for credit transactions	Recording of and accounting for credit transactions
	Recording of and accounting for credit transactions	Recording payroll transactions	Recording payroll transactions
Information technology	Typing and keyboard skills	Typing and keyboard skills	Typing and keyboard skills
		Basic Internet and e-mail skills	Basic Internet and e-mail skills
Business trade skills	Customer care skills	Basic business management skills	Basic business management skills
	Basic business management skills	Customer care skills	Customer care skills
	Merchandise/selling skills	Stock control	Stock control

Table 1b: Future skills needs of full-time owners/managers by business size

Skills	Survivalist/micro (0)	Micro (1–4)	Very small
Financial/accounting	Recording of and accounting for cash transactions	Data processing: store, retrieve and supply information	Computerised bookkeeping system
	Recording of and accounting for credit transactions	Implementing audit procedures/cost accounting	Data processing: store, retrieve and supply information
	Maintaining financial records and accounts	Operating cash/credit management system and analysis/interpretation of financial statements	Preparing financial reports
Information technology	Basic Internet and e-mail skills	Basic Internet and e-mail skills	Basic Internet and e-mail skills
	Computer programming skills	Computer programming skills	Computer programming skills
	Information communication technology skills	Information communication technology skills	Information communication technology skills
		Website development skills	
Business trade skills	Basic business management skills	Public relations skills	Public relations skills
	Marketing/communication skills	Marketing/communication skills	Labour relations skills
	Merchandise/selling skills	Merchandise/selling skills	Marketing/communication skills
		Labour relations skills	

Table 2a: Current skills of full-time employees by business size

Skills	Survivalist/micro (0)	Micro (1–4)	Very small
Financial/accounting	No employees	Recording of and accounting for cash transactions	Recording of and accounting for cash transactions
		Recording of and accounting for credit transactions	Recording of and accounting for credit transactions
		Maintaining financial records and accounts	Maintaining financial records and accounts
Information technology	No employees	Typing/keyboard skills	Typing/keyboard skills
		Basic Internet and e-mail skills	Basic Internet and e-mail skills
Business trade skills	No employees	Customer care	Customer care
		Merchandise/selling skills	Stock control
		Marketing/communication skills	

Table 2b: Future skills needs of full-time employees by business size

Skills	Survivalist/micro (0)	Micro (1–4)	Very small
Financial/accounting	No employees	Recording of and accounting for cash transactions	Data processing, storage, retrieval and supply of information
		Using information technology	Using information technology
		Drafting of financial statements	Basic analysis and interpretation of financial statements
Information technology	No employees	Computer programming	Basic Internet and e-mail skills
		Typing/keyboard skills	Typing/keyboard skills
		Computer equipment operation skills	Computer programming
			Information communication technology skills
Business trade skills	No employees	Stock control	Labour relations skills
		Marketing/communication skills	Stock control
		Labour relations skills	Public relations skills
		Basic business management skills	

Apart from specific managerial skills shortages, the owners/managers interviewed also listed certain clerical skills shortages, including:

- Clerical office skills – for example, typing skills, basic computer skills and keyboard skills
- Clerical stock skills – for example, numeracy (addition and subtraction), clerical and administrative, inventory control, basic mathematics, organisational and customer services skills
- Clerical accounting/bookkeeping skills – for example, basic computer, organisational, communication, basic mathematics, basic filing and automated and manual bookkeeping skills
- Clerical production skills – for example, administrative skills, customer services skills and machine/equipment (calculator and personal computer) skills.

Owners/managers interviewed in the survivalist/micro (0) business sector indicated specific needs for general and production management skills and clerical stock skills. Apart from clerical stock skills, owners/managers interviewed in the micro (1–4) business sector also listed future needs for clerical office and production skills. Future clerical skills needs listed by the owners/managers in the very small business sector included production, stock and accounting/bookkeeping skills.

The preceding analysis of the nature of generic skills types reflects the importance of financial/accounting, information technology and business trade skills for the effective functioning of micro and very small business enterprises. Clearly, owners/managers regard these skills as critical for the effective management and operation of a micro or very small business enterprise. Consequently, the medium- to long-term survival of micro and very small business enterprises that lack these skills is in jeopardy.

Skills training

The rationale for including skills training in the skills audit model is that skills are acquired through formal or informal learning/training, as well as through practice (UK Department for Education and Skills 2003). The supply of skills is also a key factor in determining economic growth and productivity.

Although the need for training is evident from the survey findings, the current training initiatives by micro and very small businesses provides limited evidence that the situation is likely to change in the immediate future. Notable from the survey results is that only one in every five micro and very small businesses has a future skills development plan in place, while as few as 10% maintain training records. The survey results also reveal that 15.5% of micro and very small business enterprises have a training manager or skills development facilitator, while 5.6% have a training committee in place. The Skills Development Levy Act (Act No. 9 of 1999) stipulates that an employer can qualify for government training grants only once it has appointed a skills development facilitator – a person appointed by a company, or a group of companies, to develop and implement the company's skills development strategy for a specific period.

A major concern resulting from the survey findings is that only a third of the micro and very small businesses claim to conduct their own training. No more than 3.8% of survivalist/micro (0) and 2.8% of micro (1–4) enterprises use external training consultants. About a quarter of micro and very small enterprises make use of other businesses to provide training to employees/employers. The survey results clearly show a correlation between the size of the firm and training/skills development, which confirms previous research reflecting a positive correlation between firm size and training (Nottinghamshire Research Observatory 2002). The chi-square test for the study showed a significant relationship (p<005) between training provision and firm size at a 95% level of confidence. This result is also evident from Table 3.

As already mentioned, the development of the abilities and skills of managers and employees is crucial for the prosperity of micro and very small businesses. Extensive evidence shows the positive impact of management and employee training on micro and very small business performance. Demick & O'Reilly (2000) claim that the provision of management training enhances the long-term strategies and managerial competence of small businesses. A study conducted by Management Services (2001) also reports an increase in the financial performance of small businesses following formal training, which also serves to enhance human capital – a major source of sustainable competitive advantage. Other studies suggest that training has a positive impact on employees' wage growth and productivity (Bishop 1994; Groot 1999a, b; Baron, Berger & Black 1999).

Table 3: Percentage of full-time staff attending in-house or external training courses, by business size (2002)

Training	Owners/Managers %	Employees %
In-house:		
Survivalist/micro (0) enterprises	7.6	No employees
Micro (1–4) enterprises	11.4	17.5
Very small enterprises	20.4	30.9
External:		
Survivalist/micro (0) enterprises	3.8	No employees
Micro (1–4) enterprises	5.7	3.7
Very small enterprises	14.3	16.9

The medium- to long-term survival rate of micro and very small business enterprises that lack the skills mentioned, as well as a skills infrastructure, is placed in jeopardy. This has direct implications for increased unemployment and poverty in the peri-urban areas of Northern Tshwane.

Summary and recommendations

Micro and very small business enterprises in the peri-urban areas of Northern Tshwane generally seem to function as independent units and operate mainly to cater for basic monthly household needs. This provides little scope for investment in existing businesses or for exploiting export opportunities that could support growth and competitiveness. The current skills base available to manage and operate micro and very small business enterprises in the peri-urban areas of Northern Tshwane appears to be limited. Generic skills such as finance/accounting, information technology and business trade skills therefore need to be broadened further. Managerial skills that require particular attention in future include computerised bookkeeping skills (financial/accounting), basic Internet and e-mail skills (information technology) and public relations skills (business trade skills). For employees, future skills training should focus on the recording of and accounting for cash transactions (financial/accounting), basic Internet and e-mail skills (information technology) and stock control skills (business trade), among others. Although some generic skills types are currently applied by micro and very small business enterprises, there is serious doubt that the current skills base among micro and very small business enterprises in the peri-urban areas of Northern Tshwane is adequately developed to support the development of this sector over the short term.

Ensuring the possibility of economic regeneration through the micro and very small business sector will require the ongoing enhancement of worker skills. An approach of this nature requires sound planning and strategising by government, private business and the community. In support of this endeavour, this study encourages further research into the trends and dynamics of the skills needs of micro and very small businesses. The skills audit performed in Northern Tshwane should serve not only as an input to constructing future skills development plans for micro and very small business enterprises, but should also be utilised by the public and private sectors to identify strengths and weaknesses, as well as potential threats and opportunities, for the micro and very small business sector from a skills development perspective. A SWOT (strengths, weaknesses, opportunities, threats) analysis could contribute to improved efficiency and competitiveness among micro and very small business enterprises, which in turn would increase the potential of this sector to generate higher output and employment, and ultimately higher economic growth for Tshwane as a whole. Better prospects for community development and social upliftment would flow from increased and sustained economic growth through the micro and very small business sector.

References

Aitchison, J.W.W., Houghton, T. & Baatjes, I. 2000. *University of Natal survey of adult basic education and training: South Africa*. Centre for Adult Education and Department of Adult Education and Community Education, University of Natal, Pietermaritzburg.

Baron, J.M., Berger, M.C. & Black, D.A. 1999. 'Do workers pay for on-the-job training?', *Journal of Human Resources*, 34: 235–352.

Bishop, J. 1994. 'The impact of previous training on productivity and wages', In Leynch, L. (ed), *Training and the Private Sector*. Chicago: University of Chicago Press.

Centre for Adult Education and Department of Adult and Community Education. 1999. *University of Natal survey of adult basic education and training: Gauteng*. Pietermaritzburg: University of Natal.

CSIR 2002. *Sustainability Analysis of Human Settlements in South Africa*. Prepared for the Department of Housing. Pretoria: Council for Scientific and Industrial Research.

Demick, D.H. & O'Reilly. 2000. 'Supporting SME's internationalization: a collaborative project for accelerated export development', *Irish Marketing Review,* 13(1): 34–45.

Groot, W. 1999a. 'Productivity effects of enterprise related training', *Applied Economic Letters*, 6: 369–371.

Groot, W. 199b. 'Enterprise related training: a survey', In F. Van Wierington & G. Attwell, (eds), *Vocational and Adult Education in Europe*. Dordrecht: Kluwer.

Harley, A., Aitchison, J.W.W., Lyser, E. & Land, S. 1996. *A Survey of Adult Basic Education in South Africa in the '90s*. Johannesburg: SACHED.

Joint Education Trust. 2002. Proposal to NPI on the Babelegi community social plan initiative (4 September). Johannesburg: JET Education Services.

Management Services. 2001. 'Training flexes small firms' competitive muscles', *Management Services*, 45(2).

Martins, J.H., Loubser, M. & Van Wyk, H.de J. 1996. *Marketing Research: a South African Approach*. Pretoria: Unisa Press.

Nottinghamshire Research Observatory. 2002. *Skills*

Training in Nottinghamshire: Small and Medium-sized Enterprises (SMEs): Emerging Issues. Nottinghamshire: Learning and Skills Council.

Ntsika. 2001. *State of Small Business Development in South Africa: Annual Review*. Pretoria: Ntsika Enterprise Promotion Agency.

OECD. 1996. *Best Practice Policies for Small and Medium-sized Enterprises*. Paris: Organization for Economic Cooperation and Development.

SA Explorer. 2000. *The SA Explorer: Data World*. Pretoria: Municipal Demarcation Board.

UNDP. 1999. *Literacy education at a distance: developing curriculum for functional literacy*. United Nations Development Programme. Available from: <www.undp.org> [Accessed: 25.9.1999].

United Kingdom (UK) Department for Education and Skills. 2003. *Definitions: The Meaning of Skills*. Available from: <www.skillsbase.dfes.gov.uk>.

Foreign branch operations in a globalised environment: a South African income tax perspective (Part I)

*Maxi Steyn**

The opening up of the South African economy and the relaxation of exchange control regulations has resulted in a dramatic increase in business operations expanding across borders in the past few years. Foreign operations may comprise a separate legal entity, such as a subsidiary created for this purpose, but may also comprise an extension of the existing legal entity in the foreign tax jurisdiction, operated as a branch of the enterprise. This study investigates the key aspects of branch taxation, the main focus area being that of normal income tax under the new residence basis of taxation. Since the potential risk of double taxation increases where such a system is in operation, the study will also investigate the mechanisms available to taxpayers that may limit double taxation. The study investigates normal income tax, both from the perspective of a resident operating a branch abroad, as well as from the perspective of a non-resident operating a branch within the Republic. The study also investigates the effect that a double tax agreement (DTA), concluded between the foreign tax jurisdiction and the Republic, may have on the tax liability of both resident taxpayers and non-resident taxpayers operating branches outside their own tax jurisdiction. It was found that in terms of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention, on which most double tax agreements are based, entities with branches in foreign jurisdictions, which constitute permanent establishments (PEs),[1] may be subject to income tax in the foreign tax jurisdiction. In terms of this model double tax agreement, however, the taxing rights granted to the foreign jurisdiction are limited to the amount of profits earned by the enterprise that can be attributed to the foreign branch operation.

Introduction

The change of the South African tax system to a worldwide system of taxation during 2001 directly affected the taxation of the branch operations of residents outside the Republic. Furthermore, where a worldwide system of taxation is operational, the potential risk of double taxation of the resident taxpayer increases. The taxation of foreign branches of an entity is governed by a legislative framework comprising domestic income tax legislation of the country of residence, the network of double tax agreements (DTAs) entered into by the country of residence, as well as the income tax legislation in the host country.

The primary objective of income tax legislation in the context of cross-border trade, as well as DTAs, is the governance of taxing rights between the country of residence and the host tax jurisdiction in the country where the branch is situated. From the perspective of the taxpayer, it is critical that this legislative framework contain mechanisms that provide for double tax relief, or place restrictions on taxes levied, in order to prevent or limit double

Note

Readers are advised that following legislation promulgated in December 2003, Sections 10(1)(kA) and 9F of the Income Tax Act (Act No. 58 of 1962) were repealed with effect for all years of assessment commencing on or after 1 June 2004 as part of the removal of the designated country exemptions in the Act. Consequently, all foreign branch income will be subject to normal income tax in future, regardless of country of origin.

* Maxi Steyn is a senior lecturer in taxation in the Department of Accounting, University of South Africa.
E-mail: steynm1@unisa.ac.za.

1 Defined in Secion 1 of the Income Tax as a PE as defined in Article 5 of the OEDC Model Tax Convention.

taxation in multiple tax jurisdictions. Double taxation, if not appropriately addressed in such a legislative framework, is regarded as a critical obstacle to the development of economic relations between countries (OECD Model Tax Convention 2000: Introduction Par 1).

Purpose and objectives of the study

The study aimed to investigate and evaluate the key provisions in the Income Tax Act (Act No. 58 of 1962) relating to branch operations in the context of the residence basis of taxation, both from the perspective of a resident with offshore branch operations, and from the perspective of a non-resident operating a branch within the Republic. The study also considered the implications for the tax liability of such a branch in cases where a double tax agreement is concluded between the South African government and the foreign tax jurisdiction. Such an agreement may provide relief by granting exclusive or non-exclusive taxing rights to either tax jurisdiction. It is therefore necessary to consider how the existence of a valid double tax agreement between the Republic and the foreign tax jurisdiction influences the tax liability of both non-resident taxpayers with branch operations within the Republic, and resident taxpayers that operate branches abroad. Since most double tax agreements are based on the provisions contained in the OECD publication entitled *Model Tax Convention on Income and on Capital*, the study evaluated the specific provisions of the OECD Model Tax Convention as a model treaty or DTA, in order to establish the taxing right rules that govern branch operations in foreign tax jurisdictions. The purpose of the study was therefore to formulate a descriptive framework on branch taxation, which integrates and incorporates the international tax principles governing the taxation of foreign branches, as well as the provisions of the current South African legislative framework. This descriptive framework forms the foundation of Part II of this study.

Hypothesised problem

The global tax liability of an entity that operates a branch outside its own tax jurisdiction must be determined with reference to the income tax legislation in the country of residence, the host country of the branch, as well as the provisions contained in a DTA between the respective tax jurisdictions. An investigation of each of these components was thus a necessary point of departure in determining the liability of such a taxpayer. However, in formulating a descriptive framework on branch taxation from a South African perspective, the critical requirement in this regard is investigating the legal interaction between domestic income tax legislation in the various tax jurisdictions, and the provisions of a DTA, in order to place these often conflicting provisions in perspective.

Key focus areas of the study

The following key aspects of taxation have been addressed and considered in this study:

- International tax principles in respect of branches of foreign entities
- The concept of permanent establishment
- RSA taxation of residents operating PEs in foreign tax jurisdictions, including mechanisms to eliminate double taxation as follows:
  - Section 10(1)(kA) of the Income Tax Act[2]
  - Credit in terms of Section 6*quat* of the Income Tax Act
- RSA taxation of non-residents operating PEs in the Republic.

Although the key focus area is normal income tax, brief consideration is also given in the study to Capital Gains Tax (CGT) and Value Added Tax (VAT) of foreign branch operations.

International tax principles in respect of branches of foreign entities

The taxing rights of various tax jurisdictions with regard to foreigners conducting business within their jurisdictions are governed by domestic legislation in the foreign tax jurisdiction, as well as by the existence of a DTA concluded between the two countries. A resident taxpayer operating a branch in a foreign tax jurisdiction is likely to attract taxation in the foreign tax jurisdiction, in addition to taxes in the country of residence, under a residence basis of taxation. This results in potential double taxation, which can be described as the same type of tax (for example, normal income tax) being imposed on the same income, in the hands of the same taxpayer. In terms of Section 108(1) of the Income Tax Act,

2 Section 6*quat* is the section of the Income Tax Act that allows South African residents who have paid foreign taxes to offset these taxes against their South African tax liability (in other words, Section 6*quat* provides for foreign tax credit).

government may enter into a double tax agreement with the government of any country, in terms of which arrangements are made with a view to preventing, mitigating or discontinuing the levy under the laws of the Republic and the other country of tax in respect of the same income, profits or gains. These agreements may contain provisions in order to prevent double taxation or provide reciprocal assistance in the administration and collection of taxes, but may not contain provisions that impose liabilities on taxpayers beyond those contained in the Income Tax Act. The OECD Model Tax Convention forms the basis for international double tax agreements between both OECD member countries and non-member countries such as South Africa, and therefore forms the basis of the extensive network of bilateral income tax treaties between OECD member countries and between non-member countries (OECD Discussion Draft 2001: Part I.A.1).

It is an internationally accepted principle of most DTAs that sufficient physical presence by the foreign entity in the host jurisdiction is a prerequisite in order for the foreign tax jurisdiction to be entitled to impose income tax on the branch operation. The underlying principle in this regard is that once a foreign entity enjoys the benefits of actively participating in economic activities in the host country, it should also contribute towards taxes on the income earned in the host country in such a manner. The concept of a permanent establishment, which is defined in the OECD Model Tax Convention (OECD Model Tax Convention 2000: Article 5), defines and sets out the criteria with which such an operation must comply in order to be classified as a PE for tax purposes. These criteria serve the important purpose of establishing whether the business operation has sufficient presence in the foreign tax jurisdiction to attract taxes in that foreign jurisdiction. For example, merely selling a product abroad would generally not amount to a PE in itself. However, when a substantial business operation, with business premises and employees, is present in the foreign tax jurisdiction for this purpose, such an operation is likely to satisfy the criteria for a PE, in which case the foreign tax jurisdiction may impose income taxes on such operation. Whether any foreign operation satisfies the criteria of a PE would depend on the specific definition of a PE contained in the relevant DTA.

Although the emerging global electronic environment and e-commerce transactions have given rise to much debate in this regard, at present, the criteria for a branch operation to be classified and taxed as a PE in terms of the OECD Model Tax Convention still places significant emphasis on physical presence within the foreign tax jurisdiction. It can therefore be said that as a general rule, in terms of the provisions of the OECD Model Tax Convention (Article 7), a state cannot tax the profits of an enterprise of another state, unless the foreign enterprise carries on business through a PE situated there. Where no double tax agreement exists between the tax jurisdictions, the domestic legislation of the host jurisdiction will determine the extent of the foreign tax liability of the branch operation.

Concept of permanent establishment

The concept of a permanent establishment has a history as long as the history of double tax conventions. At the multilateral level, the wording of the various draft conventions has evolved from the League of Nations drafts of 1927, 1933, 1943 and 1946 through to the OECD Model Tax Convention in 1963 and its revision in 1977 (OECD Discussion Draft 2001: Part I.A.1). The concept of a PE essentially represents a set of criteria with which a business operation of a resident outside its own tax jurisdiction must comply before such an operation will attract income tax in the foreign tax jurisdiction.

'Permanent establishment' is defined in Article 5 of the Model Tax Convention, which in its turn forms the basis of the definition in the Income Tax Act. Since the introduction of the worldwide system of taxation in South Africa in 2001, resident taxpayers are taxed on all income, regardless of source or origin. Consequently, the income earned by a resident from branch operations abroad, which may or may not constitute a PE, is also subject to normal South African income tax. However, where a valid DTA, which contains provisions consistent with those contained in the OECD Model Tax Convention, is in operation between the two tax jurisdictions, the taxing rights of the two jurisdictions are governed by the DTA. Article 7 of the OECD Model Tax Convention specifically governs the taxing rights in respect of a non-resident operating a PE in a foreign tax jurisdiction. In terms of this article, non-exclusive taxing rights are granted to the tax jurisdiction in which the PE operates, subject to a limitation, which is contained in Paragraph 1 of Article 7 as follows:

> The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a perma-

> nent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

This paragraph firstly restates the generally accepted principle of double tax conventions, namely, that an enterprise of one State shall not be taxed in another state unless it carries on business in that state through a PE situated there (OECD Model Tax Convention 2000: Commentary on Article 7, Par II.3). The second important principle contained in Paragraph 1 of Article 7 is that, where an enterprise carries on business in another tax jurisdiction, the other jurisdiction has taxing rights on the profits of that enterprise, but only so much as is attributable to the PE; in other words the right to tax does not extend to profits that the enterprise may derive from that jurisdiction other than through the PE (OECD Model Tax Convention 2000: Commentary on Article 7, Par II.5).

Article 7 therefore serves the important purpose of ensuring a fair and equitable distribution of taxable profits earned by the taxpayer between the two tax jurisdictions, by allocating a limited taxing right, based on the profits generated in the foreign tax jurisdiction, to that tax jurisdiction.

Determining profits for a branch operation of an enterprise may be approached in various ways from an accounting perspective, however, resulting in differences in reported profits for each approach followed. For example, the allocation of head office cost to the branch, which can be done using various allocation bases, will directly impact on the reported profits of the branch. The requirement that only 'profits attributable to the PE' be subject to foreign taxes, thus immediately creates the challenge, from an income tax perspective, of interpreting this requirement and establishing an acceptable methodology for determining or attributing such profits to the PE in accordance with this interpretation. Furthermore, the value or transfer price at which goods and services are provided cross-border to or from the branch will have a direct influence on the reported profits of the PE for income tax purposes. The attribution of profits to the PE, and the methodology that may be followed in order to comply with the requirements of Article 7, will be further investigated in Part II of this study.

RSA taxation of residents operating permanent establishments in foreign tax jurisdictions

Residents are taxed on all accruals and receipts, regardless of source or origin. In the case of corporate entities, a 'resident' is defined in the Income Tax Act as a person (other than a natural person) that is incorporated, established or formed in the Republic, or which has its place of effective management in the Republic. Furthermore, the definition of resident is to be amended[3] for years of assessment commencing on or after 1 January 2004, to exclude any person who is deemed to be exclusively a resident of another country for the purposes of the application of a DTA concluded between the Republic and another country. If a person is classified as being a resident either as a result of being incorporated, established or formed in the Republic, or having its place of effective management in the Republic, such person will thus be taxed on worldwide income, unless, in terms of a DTA, the person is considered to be exclusively resident in another tax jurisdiction.

Since residents are liable for normal income tax on receipts and accruals on a worldwide basis, all income earned from a PE in a foreign tax jurisdiction of a resident will be subject to South African income tax in the hands of the resident. However, expenditure incurred in the production of such foreign income may be deductible from such income, in terms of the Income Tax Act.

Elimination of double taxation of the permanent establishment

Section 10(1)(kA) of the Income Tax Act

A resident that operates a PE in a foreign tax jurisdiction is likely to attract foreign taxes on such income, in addition to the South African income taxes levied on such income. However, where a DTA between the Republic and the foreign tax jurisdiction is in operation, and this agreement is consistent with Article 7 of the OECD Model Tax Convention, the taxpayer enjoys a limitation on the amount of taxation that may be levied on such income, namely, that it may not exceed the amount of income attributable to the PE. Since the profits of the PE will be subject to income tax in both tax jurisdictions, and no exclusive taxing rights are allocated to either tax jurisdiction in terms of the OECD Model Tax Convention, double tax relief must be sought in the Income Tax Act by the

3 Proposed amendment as per the Exchange Control Amnesty and Amendment of Taxation Laws Bill of 2003.

resident taxpayer. These measures are contained in Section 10(1)(kA) and Section 6*quat* of the Income Tax Act. Where no DTA between the Republic and the foreign tax jurisdiction exists, the domestic tax legislation of the foreign jurisdiction will determine the extent of the foreign tax liability.

Relief for double tax imposed on a resident company for income earned from a foreign branch abroad is contained in Section 10(1)(kA) of the Income Tax Act, which exempts such foreign income if certain conditions are met. If this exemption (the requirements of which are contained in Section 9F) does not apply, the foreign income will be subject to South African normal income tax, but credit may, under certain circumstances, be granted against the South African tax liability for foreign taxes paid, in accordance with the provisions of Section 6*quat*.

Section 10(1)(kA) exempts income earned by a resident company from a source outside the Republic, and which is not deemed to be from a source within the Republic, in accordance with the provisions of Section 9F(2). This Section gives two key requirements that have to be met in order for the exemption to apply:

- The income must have been generated, and have been subject to income tax in a 'designated country' as defined in Section 1 of the Act. Designated countries are countries declared as such in terms of the requirements of Section 9(8) of the Act by the Minister of Finance in the *Government Gazette*, based on the requirements that these countries have income tax systems and income tax rates that correspond substantially with those applicable in South Africa; and
- The income must have been subject to income tax at a 'qualifying statutory rate', as defined in Section 9E.

Section 9E defines a 'qualifying statutory rate' as a statutory rate of tax on companies in the relevant country of at least:

- 27% in the case of amounts other than capital gains (income); and
- 13.5% in the case of capital gains.

These rates must be determined after taking into account the application of any DTA that which may be in operation between the tax jurisdictions. Moreover, there may not be any right of recovery by any person in respect of such taxes, other than a right of recovery in terms of an entitlement to carry back losses arising during any year of assessment to any year of assessment prior to such year of assessment. Where the foreign tax jurisdiction imposes a tax on companies at a progressive scale of statutory rates, the statutory rate for the purposes of this definition is deemed to be the highest rate on that scale. These rates compare favourably with the South African normal income tax for corporate entities of 30% on income, and 15% on capital gains (inclusion rate of 50% and corporate tax rate of 30%).

Should the provisions of Section 10(1)(kA) apply to the resident company taxpayer, this would mean that expenditure incurred by the resident company that is attributable to the permanent establishment would not be deductible as allowable expenditure, since Section 23(f) prohibits the deduction of any expenses incurred in respect of any amounts received or accrued that do not constitute 'income' as defined in Section 1 of the Act. Consequently, to the extent that the resident incurred expenditure in the production of the foreign income that is exempt in terms of Section 10(1)(kA), such expenditure will not be deductible in terms of Section 11 of the Act.

Section 10(1)(kA) to a large extent simplifies administration of the worldwide system of taxation for the corporate taxpayer, as well as for the South African tax authorities, in cases where it is certain that the foreign income has already been subject to taxes abroad that largely correspond with the South African tax system and tax rates. The compliance burden on the taxpayer to report extensively on such foreign operations for tax purposes, and to provide evidence of the amount of foreign taxes paid in the foreign tax jurisdiction, which would in the absence of Section 10(1)(kA) be required, is thus largely reduced where this relief is utilised.

Although amounts incurred in the production of exempt income are not deductible in terms of Section 23(f), paragraph 20 of the Eighth Schedule to the Income Tax Act overrides these provisions, and expenditure of this nature may be added to the base cost of an asset under appropriate circumstances for the purposes of Capital Gains Tax (CGT) (Clegg 2003: 114).

Section 25D of the Income Tax Act contains the conversion rules in order to determine the tax liability of residents operating PEs abroad. This section determines that the amount of any taxable income derived by a person during any year of assessment from amounts received by or accrued to, or expenditure incurred by, that person, which are denominated in any currency other than the currency of the Republic, must be determined in the currency used by that PE for the purposes of financial reporting, where that income is attributable to a PE of that person outside the Republic. The amount must then be translated to the Rand value by applying the 'average exchange rate'[4] for that year of assessment.

Credit in terms of Section 6quat of the Income Tax Act

Where the exemption contained in Section 10(1)(kA) is not available to the taxpayer because any of the requirements discussed have not been met, Section 6*quat* provides a credit mechanism for foreign taxes paid to the resident taxpayer. The rebate or credit is available in respect of foreign taxes payable, or paid, on income that is included in the taxable income of the resident, and relates only to taxes, thus excluding any additional liability for interest, fines or any other liability imposed by such foreign tax jurisdiction. Furthermore, no credit is available where the foreign tax is recoverable by any person.

A limitation exists in respect of the amount that may be claimed in respect of foreign taxes paid. Firstly, since Section 6*quat* applies only in respect of income included in the taxable income of the taxpayer, the portion of the foreign taxes that relates to any exempt income will not be allowed as a rebate in terms of Section 6*quat*.

The second limitation is that the rebate is limited to the South African normal tax payable on the foreign income, and is determined by calculating the portion of normal tax payable (before rebates) that relates to the foreign income included in total taxable income. However, in terms of this limitation, Section 6*quat*(1B) allows any excess of foreign taxes above this limitation to be carried forward and utilised as a foreign tax credit in the following years of assessment, for a maximum period of seven years.

It is important to note that the credit in Section 6*quat* is not available for taxes paid in respect of income that is derived from a South African source, or is deemed to be from a South African source.

South African taxation: non-residents operating permanent establishments in the Republic

The definition of 'gross income' given in Section 1 of the Income Tax Act was amended during 2001, and this definition currently determines that non-residents are taxed only on receipts and accruals from a source within the Republic, or on income in terms of Section 9 of the Income Tax Act, deemed to be from a source within the Republic.

Consequently, non-residents operating a branch in the Republic will be liable for South African income tax, but only to the extent that the source of the income is from the Republic, or is deemed to be from the Republic, in terms of Section 9 of the Income Tax Act. In terms of the case law dealing with source, the general principle is that the source or origin of income is the location of the business, capital or service that produces the income, and that the capital that produces profit is located where it is employed. Although each case would have to be considered individually in terms of case law, income derived from a branch operation in the Republic is, in most instances, likely to be regarded as being from a South African source, and therefore subject to normal South African income tax.

The Income Tax Act makes provision for a special tax rate (35%, as opposed to the normal corporate tax rate of 30%), which applies to branch operations of companies that have their place of effective management outside the Republic and carry on a trade through a branch or agency within the Republic. The higher tax rate imposed on these branch operations is intended to compensate the South African fiscal authorities for the fact that non-residents are not liable for Secondary Tax on Companies (STC), and, presumably, a company with its place of effective management outside the Republic is likely to be a non-resident. However, a company incorporated in South Africa, but with its place of effective management outside the Republic, will be considered a South African resident, which may lead to the company being liable for STC as well as being subject to the higher corporate tax rate of 35%. Although this situation may not be likely, such a situation could occur where a company, which was incorporated in South Africa, operates mainly from another tax jurisdiction, but has a branch operation in the Republic. A logical approach to branch taxation would be to link the higher rate of 35% specifically to non-residents operating branches within the Republic. In this way, the objective of compensating the fiscus in respect of profits generated in the Republic that are

4 'Average exchange rate' is defined in Section 1 of the Income Tax Act.

subsequently repatriated to the foreign jurisdiction, without the benefit of STC accruing to the South African fiscal authorities, is rightfully achieved.

The non-resident will only be subject to taxation in as far as the dominating cause of the income is found to be from a South African source, or is deemed to be from a South African source in terms of Section 9 of the Income Tax Act. All the deductions contained in the Income Tax Act (Sections 11 to 24) will be available to the taxpayer, in as far as these expenses were incurred in the production of the income included in the taxable income of the non-resident taxpayer. Should double taxation occur, the foreign jurisdiction is likely to provide relief for any double taxation incurred.

Capital Gains Tax in terms of the Eighth Schedule of the Income Tax Act

Capital Gains Tax (CGT) in terms of the Eighth Schedule of the Income Tax Act arises upon the disposal of an asset, in which case the taxable capital gain, or taxable capital loss, will have to be determined. The definition of an 'asset' is wide, since this definition, contained in Part 1 of the Eighth Schedule, includes property of whatever nature, whether movable or immovable, corporeal or incorporeal, excluding any currency, but including any coin made mainly from gold or platinum, as well as a right or interest of whatever nature to, or in, such property.

In the case of resident taxpayers, Paragraph 2 of the Eighth Schedule determines that all assets of such a taxpayer are subject to CGT in terms of the Eighth Schedule. However, in the case of non-resident taxpayers, the Eighth Schedule applies only to the following assets of a person who is not a resident, namely:

- Immovable property situated in the Republic held by that person, or any interest or right of whatever nature of that person to, or in, immovable property situated in the Republic; or
- Any asset that is attributable to a PE of that person in the Republic.

In case where a non-resident operates a PE in the Republic, all assets attributable to that permanent establishment will thus be subject to Capital Gains Tax when a disposal, or deemed disposal, in terms of the Eighth Schedule occurs.

Furthermore, Paragraph 12(2)(b) of the Eighth Schedule deems the assets of non-residents that become an asset of that person's PE in the Republic, otherwise than by acquisition, as well as assets of such PE that cease to be an asset, otherwise than by way of disposal, as a deemed acquisition and deemed disposal respectively. In both cases, the non-resident is treated as having disposed of such asset for proceeds equal to the market value of the asset at the time of the event, and to have re-acquired the asset at an expenditure equal to the market value. This deemed re-acquisition is treated as being part of the base cost actually incurred in respect of such asset in accordance with Paragraph 20(1)(a).

It should be noted that capital gains arising from the disposal of property of the PE is likely to attract tax in the foreign tax jurisdiction. In terms of the OECD Model Tax Convention, where a non-resident has a PE in a foreign jurisdiction, Article 13 grants non-exclusive taxing rights in respect of capital gains to the tax jurisdiction in which the PE is situated. Consequently, where a non-resident realises capital gains in connection with a PE situated in the Republic, CGT on such gains may arise in terms the Eighth Schedule, and, in terms of Article 13, the gains may be taxed by the Republic. Should double taxation occur in such an instance, relief may be available for the non-resident in the country of residence.

VAT liability

Permanent establishments and 'enterprises' of foreigners in the Republic and VAT liability

Section 7 of the Value Added Tax Act (Act No. 89 of 1991) levies Value Added Tax (VAT) of 14% on all supplies of a vendor of goods and services supplied in the course of an 'enterprise'. An 'enterprise', which is defined in Section 1 of the Act, constitutes an activity carried on regularly or continuously by any person in the Republic, or partly in the Republic, in the course of which goods and services are supplied to any other person for a consideration. Consequently, non-resident taxpayers conducting an 'enterprise', and making taxable supplies in excess of the annual threshold of R300 000 through a branch operation in the Republic, are liable to register for VAT.

Where a foreigner, in particular, transacts with persons in South Africa, it is often unclear whether the nature and scale of the foreigner's activities in South Africa constitute the carrying on of an 'enterprise' in, or partly in, South Africa. The mere export of goods by a foreigner directly to customers (in other words, the customer or customer's agent imports the goods) in South Africa would generally not constitute the carrying on of an enterprise in, or partly in, South Africa. However, the South Africa Revenue Service (SARS) has indicated in recent years that a foreigner would be regarded by SARS as carrying on an enterprise in South Africa for VAT purposes, and hence be obliged to register, if the foreigner grants the use of any trademark or other intellectual property in South Africa and as a result receives regular royalties from a person in South Africa (Clegg & Stretch 2003: 3.7.2). It should be noted in this regard that the foreign enterprise may not have a PE in the Republic at all, since the activity of receiving royalties from the Republic will not in itself constitute a PE, yet these activities are considered sufficient to constitute an 'enterprise' for VAT purposes and to give rise to the resulting South African VAT liability in the hands of the foreigner.

Permanent establishments of South African 'enterprises' abroad and VAT liability

Where a South African enterprise operates an enterprise as a PE abroad, which forms part of an enterprise that is operated in the Republic, the total enterprise constitutes an "activity carried on regularly or continuously by any person in the Republic or partly in the Republic". Such a taxpayer, if making taxable supplies in excess of the annual threshold of R300 000,[5] is thus liable to register for VAT. Although the activities may be carried out partially outside the Republic, the company, which operates partly within the Republic, nevertheless remains liable for VAT on all supplies of goods and services. However, any supplies made outside of the Republic, from any branch or main business thereof, where such branch or main business is permanently located at premises outside the Republic, is deemed not to be affected in the course or furtherance of an enterprise, and consequently, no VAT is levied on such supplies. This proviso, which is contained in the definition of 'enterprise', applies only if the branch can be separately identified, and an independent system of accounting is maintained by such branch. It should be noted that the VAT Act (Section 50) allows for independent registration of branches where such branch is separately identifiable and maintains a separate system of accounting.

The supply of goods and services of an enterprise in the Republic to a branch abroad, which is separately identifiable and maintains a separate and independent accounting system, is deemed to be a supply by the enterprise in terms of Section 8(9). The consideration for any transfer to such independent branches or main businesses, in terms of Section 10(5), is the cost to the South African vendor or the open market value, whichever is the lesser, of the goods or services in question (Section 10(5)). In determining the cost to the South African vendor of originally acquiring the goods or services, it must be noted that the cost includes:

- Any VAT paid when acquiring the goods; and
- Any transportation or delivery costs (including VAT) in the case of goods that were incurred in effecting the transfer to the branch outside South Africa.

Where the goods or services were originally acquired from a connected person by the South African vendor, the latter's cost of acquiring the items must be increased by the amount, if any, by which the open market value of the items at the time of acquisition exceeded the amount actually paid for them.

Although the supply of goods and services of an enterprise in the Republic to a PE or branch abroad which is separately identifiable and maintains a separate and independent accounting system, is deemed to be a supply by the enterprise in terms of Section 8(9), such a supply may be zero rated. In terms of Section 11(1)(i), the supply of goods to, or for, the purpose of such a branch situated in an 'export country' is zero rated if the branch is separately identifiable and a separate accounting system is maintained by the branch. The timing of a deemed supply in terms of Section 8(9) is, in accordance with Section 9(2)(e), the time of delivery of the goods to the branch, or, in the case of services, when the service is performed.

Since the application of double tax agreements does not generally govern taxes such as VAT or similar sales taxes, the liability of taxpayers with regard to South African VAT is not likely to be affected by the existence of a DTA between the Republic and the foreign tax jurisdiction.

Conclusion

Since residents are liable for normal income tax on receipts and accruals on a worldwide basis, the income earned by a resident from a PE in a foreign tax jurisdiction will be subject to South African

5 This annual threshold of taxable supplies exceeding R300 000 is contained in Section 23 of the Act.

income tax in the hands of the resident. Furthermore, expenditure incurred in the production of such income may be deductible in terms of the Income Tax Act. Where no double tax agreement exists between the Republic and the foreign tax jurisdiction, the foreign income tax legislation in the host jurisdiction will determine the extent of the foreign tax liability of the resident entity. Non-residents that operate PEs will be subject to South African income tax to the extent that such income is derived from a South African source, or is deemed to be from a South African source. Double tax relief may be sought by the non-resident in the country of residence.

Where the worldwide system of taxation results in a resident taxpayer being subject to taxes both in South Africa and the foreign tax jurisdiction, double tax relief contained in Section 10(1)(kA), which may effectively exempt such foreign income for the resident company, may be utilised, provided that all the requirements set out in Section 9F are met. Alternatively, the credit mechanism contained in Section 6*quat* is available to resident taxpayers to grant credit against the South African tax liability for foreign taxes paid.

The liability of non-residents to capital gains tax under the South African legislation is limited to disposals of immovable property rights and the assets of PEs within the Republic. However, deemed disposals will have to be accounted for in terms of the Eighth Schedule where assets are transferred to or from the PE of the non-resident from any other part of the enterprise. Residents will, however, be subject to CGT in respect of all assets, irrespective of where these are located. This liability is unlikely to be limited by a DTA since, in terms of Article 13 of the OECD Model Tax Convention, non-exclusive taxing rights in respect of capital gains are granted to the tax jurisdiction in which the PE is situated. However, should this result in double tax, the credit mechanisms contained in Section 10(1)(kA), as well as Section 6*quat*, make provision for relief in respect of both capital gains tax and normal income tax.

Foreigners that conduct an enterprise in the Republic are liable to register for VAT if taxable supplies exceed R300 000 per annum. It should be noted that, in contrast with the requirements for a PE to be present in a foreign tax jurisdiction, physical presence in that jurisdiction is not required for an enterprise to be conducted by the foreign entity. For example, foreigners who supply the use of intellectual property, which is classified as a 'service' in terms of the VAT Act, and who receive only royalty payments from the Republic, are also liable for registration, although this activity is unlikely to constitute a PE in the Republic for the purposes of the DTA. Furthermore, supplies to branch operations abroad by vendors constitute a deemed supply in terms of Section 8(9) of this Act, the value of which is governed by Section 10 of this Act. However, if the requirements of separate identification of the branch and the maintenance of separate accounting systems at the branch are met, the supply of goods to such a branch is zero rated.

References

Clegg, D. 2003. *Income Tax in South Africa*. Durban: Butterworths.

Clegg, D. & Stretch, R. 2003. *Deloitte and Touche VAT Handbook*. Durban: Butterworths.

Organisation for Economic Co-operation and Development. 2000. *Model Tax Convention on Income and Capital. Volume 1 & 2.* France: OECD Publications.

Organisation for Economic Co-operation and Development. 2002. *Discussion Draft on the Attribution of Profit to Permanent Establishments.* France: OECD Publications.

Glossary of terms

Multinational enterprise group (MNE group)

A group of associated companies with business establishments in two or more countries. (OECD Guidelines 2001: Glossary of terms)

OECD Discussion Draft

The publication–titled *Discussion Draft on the Attribution of Profit to Permanent Establishments* issued by the OECD (2002), and which deals with, amongst other aspects, the proposed methodology for applying the arm's length principle to transactions within the same enterprise with a permanent establishment situated in a foreign tax jurisdiction.

OECD Model Tax Convention

The publication entitled *Model Tax Convention on Income and Capital* published by the OECD (2000), which represents the model agreements on which many OECD member countries, as well as non-member countries such as South Africa, base double tax agreements.

Permanent establishment (PE)

An operation of a non-resident in a foreign tax jurisdiction, which complies with the requirements of Article 5 of the OECD Model Tax Convention. (OECD Guidelines 2001: Glossary of terms)

Acronyms

CGT	Capital Gains Tax
DTA	Double Tax Agreement

OECD	Organisation for Economic Co-operation and Development
PE	Permanent Establishment
MNE	Multinational Enterprise
SARS	South African Revenue Service
STC	Secondary Tax on Companies
VAT	Value Added Tax

Foreign branch operations in a globalised environment: a South African income tax perspective (Part II)

*Maxi Steyn**

In Part I of this study, it was found that the OECD Model Tax Convention places a limitation on foreign income taxes imposed on an enterprise that operates a permanent establishment (PE) abroad. The taxing rights of the host jurisdiction do not extend beyond the profits derived by the enterprise that can be attributed to the PE situated in the foreign tax jurisdiction. Part II of the study investigates the internationally accepted methodology for attributing such profits to the PE for tax purposes. Attribution of profits has a direct bearing on the value (transfer price) at which goods and services, provided cross-border, within the same enterprise, are to be accounted for, for income tax purposes. International transfer pricing legislation, on which South African legislation is based, has traditionally been aimed at regulating the value of cross-border transactions between associated enterprises, which are separate and distinct legal enterprises. The study therefore considers the international transfer pricing regime in the context of cross-border transactions within the same enterprise. Since this is a matter of debate among member countries of the Organisation for Economic Co-operation and Development (OECD) at present, it is therefore equally relevant from a South African perspective. The arm's length standard in transfer pricing originated in the context of separate legal enterprises. However, it was found in the study that in accordance with the most recent interpretation of the OECD of Article 7 of the OECD Model Tax Convention, the arm's length standard should also be applied to transactions cross-border within the same enterprise, where a double tax agreement based on the OECD Model Tax Convention is in operation between the Republic and the foreign tax jurisdiction.

Introduction

Although multinational enterprises increasingly transact business without cross-barriers or obstacles, the tax implications of such transactions require explicit recognition of such borders (Borkowski 2002: 1). This is required since the value, or the transfer price, at which such goods or services are transferred between tax jurisdictions directly determines the allocation of profits for tax purposes between parts of a multinational enterprise, and therefore the allocation of profits to be taxed between various tax jurisdictions. Transfer pricing, or the value at which cross-border transactions take place for tax purposes, can therefore deprive governments of their fair share of taxes from corporations, and expose enterprises to possible double taxation (Neighbour 2002: 1). As international business increases, accompanied by international profit manipulation, governments worldwide are elevating transfer pricing to a key political priority (Krishna, Nagarajan, Przysuski & Swaneveld 2002: 44).

It is further evident that tax authorities have also become increasingly adept in the application of economic and business analysis techniques for challenging the arm's length nature of transfer pricing. According to Miesel, Higinbotham & Yi (2002: 2), the ongoing integration of world markets through multinational trading activities has heightened tax authorities' sensitivity to 'true taxable income' within their jurisdictions. They are increasingly concerned that transfer pricing practices are misused to artificially understate the reported profits and taxes due. As a result, not only have the increased activities of multinational enterprises been followed by increased scrutiny of these inter-jurisdictive transactions by tax authorities man-

* Maxi Steyn is a senior lecturer in taxation in the Department of Accounting, University of South Africa.
E-mail: steynm1@unisa.ac.za.

dated to protect their country's share of the taxable income, but in many countries, specific anti-avoidance income tax legislation has been introduced. In addition to anti-avoidance legislation, national regulations, bilateral treaties and international guidelines have been developed to deal with this, and countries are enforcing them with vigour (Miesel et al. 2002: 3).

In most cases, such legislation has been influenced significantly by the OECD Guidelines[1] issued during 1995 (Dodge & DiCenso 2002: 49).The OECD Guidelines are intended to help tax administrators and multinationals by indicating ways to find mutually satisfactory solutions to transfer pricing cases, thereby minimising conflict among tax administrators and multinationals and avoiding costly legislation (OECD Guidelines 2001: Preface Par 15). Because of the international importance of the OECD Guidelines, South African transfer pricing legislation, which was introduced during 1995, is based on these Guidelines. Although South Africa is not a member country of the OECD, the OECD Guidelines are acknowledged as an important, influential document, which reflects unanimous agreement among member countries, reached after an extensive process of consultation with industry and tax practitioners in many countries. According to the South African Revenue Service (SARS) Practice Note 7 of 1999, many countries that are not OECD members also follow the Guidelines, and, consequently, the Guidelines are becoming a globally accepted standard (SARS 1999: Par 3.2.1).

However, transfer pricing legislation internationally (in South Africa, as well as the OECD Guidelines) addresses transfer pricing matters in respect of transactions between associated enterprises that form part of the same group of companies, yet constitute separate and distinct enterprises. The challenge at present is therefore to address transfer pricing issues in the context of cross-border branch transactions within the same enterprise, since tax administrations are increasingly scrutinising such transactions in order to ensure a fair allocation of taxable profits both to the tax jurisdiction of the resident, as well as the jurisdiction hosting the branch operation.

Purpose and objectives of the study

This part of the study will investigate the transfer pricing regulatory framework, and the extent to which this applies to cross-border transactions with a branch within the same enterprise. The anti-avoidance requirements of Section 31 of the Income Tax Act (Act No. 58 of 1962), which specifically governs international transfer pricing in the South African taxation framework, together with the provisions contained in SARS Practice Note 7 of 1999 and in the OECD Guidelines, will be analysed in the study, specifically in order to establish their applicability to cross-border transactions taking place within the same enterprise, with a branch in another tax jurisdiction. This will enable the formulation of a framework that may be applied in order to determine the value at which these transactions should be accounted for, for income tax purposes. Formulating an appropriate transfer pricing policy before such transactions take place not only enables taxpayers to optimise global tax liability by planning in advance, but also reduces the risks of transfer pricing investigations and adjustments to these prices that may lead to increased tax liability and double taxation.

Hypothesised problem

The application of transfer pricing in the context of cross-border branch transactions is not addressed at present by international transfer pricing regulations. OECD member countries recognised this as potentially problematic in an OECD publication of 2001 entitled *Attribution of Profits to Permanent Establishments*, since inconsistent approaches to profit attribution and transfer pricing followed by various countries result in potential double taxation for taxpayers. Within the South African legislative framework, the matter is no less problematic, as South African legislation is largely based on international legislation, as prescribed by the OECD. It is therefore necessary to formulate, within the current South African legislative framework, an approach that is consistent with international tax standards and practice, for attributing profits to a PE, as well as for determining transfer pricing in the context of cross-border branch transactions.

Key focus areas of the study

The following key focus areas were addressed in the study:

1 Organisation for Economic Co-operation and Development. 2001. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.* France: OECD Publications.

- The South African international transfer pricing regime:
  - Section 31 of the Income Tax Act
  - SARS Practice Note 7 of 1999
- Transfer pricing for cross-border transactions with the PE in accordance with Article 7 of the OECD Model Tax Convention:
  - The arm's length principle
  - Profit attribution methods presently used internationally:
    - The relevant business activity approach to profit attribution
    - The functionally separate enterprise approach to profit attribution
  - Allocation of costs incurred on behalf of the PE.

Transfer pricing considerations

Section 31 of the Income Tax Act

Transfer pricing in international agreements has been an important aspect of international tax planning for a considerable length of time. In South Africa, however, exchange controls historically provided some protection against significant manipulation of transfer prices to transfer profits to lower tax jurisdictions in South Africa (SARS Practice Note 7 1999: Par 2.3). A consequence of the opening up of the South African economy after 1994, together with the partial relaxation of exchange controls, was the need for domestic legislation to address transfer pricing issues in a similar manner to what had been done internationally. The introduction of transfer pricing legislation in July 1995 was considered paramount to the wealth and development of South Africa in order to protect the South African tax base (SARS Practice Note 7: Par 2.4).

In South Africa, transfer pricing in the Income Tax Act (Act No. 58 of 1962) was introduced during 1995 in the form of anti-avoidance provisions to prevent taxpayers from manipulating transfer pricing and thus enabling them to transfer profits from South Africa to tax jurisdictions with lower tax rates. This was done by the introduction of Section 31 of the Income Tax Act, effective as from 19 July 1995. Section 31(3) contain the thin capitalisation rules, while section 31(2) contains tax regulations that apply to taxpayers that have international dealings by regulating the pricing of goods and services in cases where an 'international agreement'[2] between 'connected persons'[3] takes place.

Although these provisions in the Act are worded with wide application, SARS provided clarification, particularly as regards acceptable methods for determining transfer pricing, when SARS Practice note 7[4] was issued in 1999. SARS Practice Note 7 of 1999, which is largely based on the OECD Guidelines, aims to provide guidance on transfer pricing methodology as well as approaches and requirements that must be met in establishing an arm's length transfer price for a supply or acquisition in terms of an 'international agreement', as defined in Section 31(1).

Section 31(2) of the Act, read together with Practice Note 7, enacts the internationally accepted arms length principle, namely that supplies of goods and services should take place at a price that might have been expected if the parties to the transaction had been independent persons dealing at arm's length. Furthermore, it grants the Commissioner discretionary powers to adjust the consideration charged for goods or services supplied or acquired in terms of an 'international agreement'[5] between 'connected persons'[6] to an arm's length price, in cases where the consideration for such goods or services was not an arm's length price.

Separate legal entities that are associated enterprises[7] have historically been the subject of transfer pricing issues and international transfer pricing legislation when cross-border transactions between these associated, but separate, legal entities take place. However, a focus on transfer pricing in the context of transactions within the same enterprise with a PE has recently emerged. This is one of the aspects that is discussed extensively in the OECD Discussion Draft entitled *Attribution of Profits to Permanent Establishments* (OECD 2001: 4). This document will be referred to in this study as the OECD Discussion Draft. Transfer pricing in this

2 'International agreement' is defined in Section 31 of the Income Tax Act.
3 'Connected persons' is defined in Section 1 of the Income Tax Act.
4 SARS Practice Note 7: 1999. Section 31 of the Income Tax Act 1962: Determination of the taxable income of certain persons from international transactions.
5 Defined in Section 31(1) of the Income Tax Act.
6 Defined in Section 1 of the Income Tax Act.
7 'Associated enterprises' is defined in Article 9 of the OECD Guidelines.

context has to be considered in conjunction with Article 7 of the OECD Model Tax Convention, which governs the taxation of PEs.

SARS Practice Note 7 (1999: 8.1) describes the arm's length principle as the principle by which a comparable transaction between independent parties is to be used as a benchmark against which to evaluate the transfer prices applied by multinationals. According to Practice Note 7, comparability is fundamental to the application of the arm's length principle (SARS Practice Note 7 1999: 8.1). Although neither Section 31 nor the tax treaties entered into by South Africa prescribe any particular methodology for determining an arm's length consideration, Practice Note 7 states that the most appropriate method in any given case would be the method that produces the highest degree of comparability (SARS Practice Note 7 1999: 8.1.4).

The current South African legislation on international transfer pricing is found in Section 31 of the Income Tax Act, and is effective as from 19 July 1995. Section 31(2) contains tax regulations that apply to taxpayers that have international dealings by regulating the pricing of goods and services where an 'international agreement' between 'connected persons'[8] exists. An 'international agreement' is defined in Section 31(1) as a transaction, operation or scheme entered into between:

- A resident and any other person who is not a resident; or
- A person who is not a resident and any other person who is not a resident, for the supply of goods or services to or by a PE of either of such persons in the Republic; or
- A person who is a resident and any other person who is a resident, for the supply of goods or services to or by a PE of either of such persons outside the Republic; or
- A person who is a resident and any other person who is a resident, where either of such persons, as a result of the application of the provisions of any agreement entered into by the Republic for the prevention of double taxation, is not subject to tax in the Republic.

From this definition, it is clear that the South African international transfer pricing legislation only applies to transactions between associated enterprises, and does not make provision for the arm's length principle to be extended to transfers of goods and services by or to a PE. The section supports the legal view that one part of an enterprise cannot legally contract with another part of the same legal entity.

The definition of 'international agreement' in Section 31(2) provides that:

> Where any goods or services are supplied or acquired in terms of an international agreement and —
>
> (a) the acquirer is a connected person in relation to the supplier; and
> (b) the goods or services are supplied or acquired at a price which is either —
>
> (i) less than the price which such goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length (such price being the arm's length price); or
> (ii) greater than the arm's length price,
>
> then, for the purposes of this Act in relation to either the acquirer or supplier, the Commissioner may, in the determination of the taxable income of either the acquirer or supplier, adjust the consideration in respect of the transaction to reflect an arm's length price for the goods or services.

However, although not included in the definition of 'international agreement', Practice Note 7 states that the arm's length principle applies equally to the transfer of goods and services in cross-border transactions conducted by a person with a connected person, a person's head office with a branch of such person, or a person's branch with another branch of such person, for the purpose of applying the provisions of a DTA (SARS: Practice Note 7 1999: 6.4). The reason for this inclusion in the Practice Note is that tax treaties based on the OECD Model Tax Convention, in Article 7, may be interpreted as requiring transactions between one part of the enterprise with a PE of the same enterprise to take place at an arm's length value.

It is therefore clear that the arm's length principle forms the legal foundation in terms of domestic legislation for determining transfer pricing in international transactions between connected persons that constitute separate legal entities. However, although an arm's length value is not required by Section 31 of the Act where international transactions occur within an enterprise for the supply of

8 'Connected persons' is defined in Section 1 of the Income Tax Act.

goods or services to or from a PE of such enterprise, the relevant double tax agreement between the Republic and the foreign tax jurisdiction may require that it be applied.

SARS Practice Note 7 of 1999

In addition to Section 31, Practice Note 7 issued by SARS in 1999 contains guidelines for determining transfer prices, which is to a large extent based on the OECD Guidelines (Clegg 2003). The purpose of the Practice Note is explained in Par 2.8 as having the objective of providing taxpayers with guidelines about the procedures to be followed in determining arm's length prices, as well as setting out the Commissioner's views on documentation and practical issues that are relevant in setting transfer prices in international agreements (SARS Practice Note 7 1999: 2.8). It is pointed out in Par 3.1, however, that Practice Note 7 is a practical guide and is not intended to be a prescriptive or exhaustive discussion of every transfer pricing issue that might arise, since each case will be decided on its own merits, taking into account the taxpayer's business strategies and commercial judgment (SARS 1999: 3.1).

Since the OECD Guidelines are subscribed to by the Commissioner, these may be considered supplementary information to SARS Practice Note 7 of 1999, as guidance on determining transfer prices in international transactions. It is recognised that these guidelines may be invaluable in the process of determining transfer prices, since, in terms of Practice Note 7, where this Practice Note does not provide specific guidance on a particular matter, the OECD Guidelines should be followed (SARS Practice Note 7 1999: 3.2.2).

Practice Note 7 emphasises that an arm's length price does not necessarily constitute a single price but a range of prices (SARS Practice Note 7 1999: 7.7). An arm's length range is arrived at by applying a transfer pricing method to multiple year data, or by applying different transfer pricing methods (SARS Practice Note 7 1999: 11.4.2). Comparability is fundamental to the application of the arm's length principle. The preferred arm's length methods are based on the concept of comparing the prices or margins achieved in the dealings of connected persons (controlled transactions) with those achieved by independent entities for the same or similar dealings (uncontrolled transactions). In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be highly comparable (SARS Practice Note 7 1999: 8.1.1).

Transfer pricing for cross-border transactions with the PE: Article 7 of the OECD Model Tax Convention

Transfer pricing of transactions between one part of the enterprise and a PE of the same enterprise abroad is not governed by Section 31 of the Income Tax Act, which only provides for transfer pricing regulations between separate legal enterprises. However, the transfer price at which such a transaction is determined is directly influenced by Article 7 of the OECD Model Tax Convention. It is therefore important in this study to critically analyse Article 7, in order to establish how the application of this Article influences the price at which goods and services are supplied to and from a PE located in a foreign tax jurisdiction, where a DTA, which is consistent with Article 7 of the OECD Model Tax Convention, is in operation. Consequently, the principles that apply when attributing profits for tax purposes to a PE of the enterprise, as governed by Article 7 of the OECD Model Tax Convention, will first be considered. This includes analysing the arm's length principle, and determining the extent to which Paragraph 2 of Article 7 of the OECD Model Tax Convention requires transactions with a PE to take place at an arm's length value. It is also necessary to consider the profit attribution methods presently used internationally, and to evaluate the extent to which they comply with the requirements of Article 7 of the OECD Model Tax Convention.

Furthermore, the OECD Discussion Draft issued during 2001, which specifically deals with the attribution of profits to PEs, together with all public commentary received thereon (Business Advisory Committee 2001; Chartered Institute of Taxation 2001; PricewaterhouseCoopers 2001; Taxation Committee of ICC UK 2001; US Council for International Business 2001), is considered to reflect current and contemporary perspectives of the OECD member countries on the interpretation of Article 7 of the OECD Model Tax Convention, and, consequently, extensive reference will be made to this documentation, where appropriate.

Paragraph 1 of Article 7 of the OECD Model Tax Convention states that:

> The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid,

> the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

Paragraph 2 of Article 7 states the underlying principle or methodology that should be used to attribute such profits to a PE, namely that profits should be determined as if the PE is a distinct and separate enterprise dealing wholly independently with the enterprise of which it is a PE, as follows:

> ... where an enterprise of a Contracting State carries on business in the other Contracting state through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment

Distinct and separate enterprise dealing wholly independently

The requirement in Paragraph 2 of Article 7 of the OECD Model Tax Convention that profit attribution should be done as if the PE is a distinct and separate enterprise, dealing wholly independently with the enterprise of which it is a PE, incorporates the view that the profits to be attributed to the PE are those that the PE would have earned if, instead of dealing with the head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the open market (OECD Model Tax Convention 2000: Commentary on Article 7, Par II.11).

According to the OECD Model Tax Convention, this is consistent with the arm's length principle, by which the transfer price determined between the PE and the head office is that which would have prevailed between independent enterprises under similar conditions (OECD Model Tax Convention 2000: Commentary on Article 7 Par 11).

This view is supported in the OECD Discussion Draft (OECD 2001: 4). The following phrase indicates that the arms length principle, which has long been accepted as the international standard for cross-border dealings between associated enterprises, applies equally in the case of a PE:

> The profits attributable to a PE (Permanent Establishment) are the profits that the PE would have earned at arm's length as if it were a distinct and separate enterprise performing the same or similar functions under the same or similar conditions, determined by applying the arm's length principle under Article 7.[9]

It is therefore considered appropriate at this stage to examine the meaning and underlying philosophy of the arm's length principle.

The arms length principle

In a global economy, coordination among countries is a better means of promoting international trade than tax competition. The OECD, with its mission to contribute to the expansion of world trade on a multilateral, non-discriminatory basis, strives constantly to build consensus on international tax principles, thereby avoiding unilateral responses to multilateral problems (OECD Guidelines 2001: P-2 Par 7).

The arm's length principle is one such international tax practice that has become the international norm for assigning transfer prices, since it purports to place business entities on the same economic footing, with no competitive advantage to commonly controlled firms, and no incentive to alter the ownership structure according to tax liability (Borkowski 2002: 7). This principle has therefore become the international transfer pricing standard of most countries and of almost all international tax treaties (Borkowski 2002: 7).

The arm's length principle furthermore provides broad parity of tax treatment for multinational groups and independent enterprises, placing all enterprises on a more equal footing for tax purposes, and avoiding the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of enterprises, regardless of entity type (OECD Guidelines 2001: Chapter 1.B.i 1.7). In removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment (OECD Guidelines 2001: Chapter 1.B.i 1.7).

Moreover, since the principle is widely applied and well understood in the business community and by tax administrators internationally, the application thereof serves the important objective of securing

9 Refers to Article 7 of the *Model Tax Convention on Income and Capital, 2002,* Volumes 1 & 2.

the appropriate tax base in each jurisdiction and avoiding double taxation (OECD Guidelines 2001: Chapter 1.B.ii 1.14).

With the introduction of the international transfer price framework in 1995, South Africa also adopted the arm's length principle, which is recognised in SARS Practice Note 7 as constituting the international norm (SARS Practice Note 7 1999: Par 7.4). The arm's length principle is further legislated in Section 31(2) of the Income Tax Act, read together with Practice Note 7 of 1999, in terms of which the arm's length principle is an explicit requirement to be applied to all international transactions between connected parties.

An arm's length price can best be described as the price that would have been paid between unrelated parties for the same or similar goods under the same or similar circumstances, and therefore constitutes the price that would have been charged in an independent transaction with unrelated parties under the same or similar circumstances (Ho & Lau 2002: 63).

The arm's length principle is described by Miesel et al. as the price that would be negotiated by independent, unrelated parties in the same circumstances as the sale between the associated entities (Miesel et al. 2002: 6). It is therefore based on a sound economic principle, namely that the competitive market is the best way to allocate resources and rewards of risks (Miesel et al. 2002: 6).

According to Borkowski (2002: 7), the arm's length standard has become the international norm for assigning transfer prices, because it purports to place business entities on the same economic footing, with no competitive advantage to commonly controlled firms, and no incentive to alter the ownership structure according to tax liability. It relies on finding comparable transactions, products, businesses or operations. Section 31(2) enacts the arm's length principle and grants the Commissioner the right to adjust the consideration in respect of a transaction to reflect an arm's length price for the goods or services, where any goods or services are supplied or acquired in terms of an 'international agreement' (as defined), at a value not reflecting an arm's length price. This section therefore provides a mechanism by which the Commissioner adopts the internationally accepted arm's length principle for taxation purposes as the basis for ensuring that the South African fiscus receives its fair share of tax (SARS Practice Note 7: 2.7).

Practice Note 7 (SARS 1999: 7.1) describes the arm's length principle as being the overriding principle that transactions between connected parties are to be conducted at a value having the substantive financial characteristics of a transaction between independent parties, where each party will strive to get the utmost benefit from the transaction. The arm's length principle therefore entails finding a comparable transaction between independent parties (an uncontrolled transaction), which should be used as a benchmark against which to appraise the multinational's prices (the controlled transaction) (SARS Practice Note 7 1999: 7.3).

The authoritative statement of the arm's length principle is found in Paragraph 1 of Article 9 of the OECD Model Tax Convention, which provides that:

> when conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly (OECD Guidelines 2001: B.(i) Par 1.6).

By seeking to adjust profits by reference to the conditions that would have applied between independent enterprises in comparable transactions and comparable circumstances, the arm's length principle follows the approach of treating the members of a multinational group as operating separate entities, rather than as inseparable parts of a single unified business. This results in a focus on the nature of dealings between those members (OECD Guidelines 2001: B Par (i) 1.6).

Although the arm's length principle is very well recognised, applied and understood internationally, it is not without criticism. Borkowski states that the trend towards greater globalisation, integration and specialisation increasingly results in situations where the arm's length standard proves to be problematic, since the view is taken that the arm's length standard does not reflect the economical reality of the globally integrated multinational (Borkowski 2002: 7).

A major difficulty associated with the application of the principle is that it is based on the separate entity approach, whereas multinationals are often integrated enterprises. It is through this integration that economies of scale are achieved in logistics, brand development, risk management and technology, and these measures of integration cannot be duplicated in the context of arm's length independent transactions, conducted by two non-integrated businesses performing the same or similar functions and selling the same or similar products. Applying the arm's length standard by breaking a multinational into separate parts generally produces a range of ambiguity, depending on the magnitude of the economies of integration and the relative profitability of the parties (Miesel et al. 2002: 7).

Another difficulty that may hamper the effective application of the arm's length standard arises from situations in which multinationals engage in transactions that independent parties would not undertake, such as maintaining a new associated company at a loss to create market share, or transferring valuable technology to an associated enterprise for no consideration. These transactional relationships among associated enterprises may differ in important and fundamental ways from potentially comparable transactions between unrelated parties. This basic premise renders the search for comparable transactions among unrelated parties rather fruitless, since appropriate adjustments may not be possible in specific contexts, thereby calling into question the strict adherence of the arm's length standard (Miesel et al. 2002: 7).

It has often been recognised that certain difficulties in applying the arm's length principle may arise in practice, but the OECD-led debate in this regard has not produced any justifiable substitute for the arm's length principle, which is still felt to create and ensure the most manageable and stable fiscal climate for enterprises to operate within. Since the principle is widely accepted internationally, taxpayers may expose themselves to unnecessary risks of double taxation, as well as potential conflict with tax authorities, when a transfer pricing approach that is inconsistent with this standard is followed.

It is therefore considered appropriate to briefly consider the methodology used internationally for attribution of profits to PEs, as found to be the methods used per the OECD Discussion Draft, and furthermore to consider the extent to which these various methods used are consistent with the arm's length principle.

Profit attribution methods presently used internationally

Paragraph 1 of Article 7 determines that where an enterprise carries on business in another tax jurisdiction, the other jurisdiction has taxing rights on the profits of that enterprise, but only so much as is attributable to the PE, in other words the right to tax does not extend to profits that the enterprise may derive from that jurisdiction other than through the PE (OECD Model Tax Convention 2000: Commentary on Article 7 Par II.5).

Furthermore, Paragraph 4 of Article 7 state that, insofar as it has been customary in a Contracting State to determine the profits to be attributed to a PE on the basis of apportionment of the total profits of the enterprise to its various parts, nothing in Paragraph 2 precludes the Contracting State from determining the profits to be taxed by such apportionment as may be customary, as long as the apportionment method is in accordance with the principles contained in Article 7. It is further a requirement set out in Paragraph 5 that the method of apportionment be applied consistently from year to year, unless sound justification for a change in method can be provided by the taxpayer (OECD Model Tax Convention 2000: Article 7 Par 5).

The OECD Discussion Draft seeks to determine a single preferred approach in order to obtain international consensus on a common interpretation of Article 7, since the differences in interpretation at present often lead to double taxation.

In Paragraph 33 of this report it is stated that:

> ... a common interpretation of Article 7 should reduce the incidence of double taxation by reducing one common cause of double taxation, namely differences in the way that countries compute the quantum of profits to be attributed to a PE in respect of dealings between one part of an enterprise and another part of the same enterprise. It is also possible that countries will consider changes to their domestic laws that take into account the approach of the Working Hypothesis, once there is international consensus on the interpretation of Article 7.

This raises the question of how 'profits attributable to the PE' should be interpreted. According to the OECD Discussion Draft on Profit Attribution, two broad interpretations exist presently, namely, the relevant business activity approach and the functionally separate entity approach (OECD Discussion Draft 2001: Part B Paragraph 13). These interpretations are briefly considered in the following section. It should be noted that at present, the majority of OECD member countries do not subscribe to the relevant business activity approach.

The relevant business activity approach to profit attribution

Some tax authorities have taken the view that when a foreign enterprise has set up a PE within their territory, it has brought itself within their fiscal jurisdiction to such a degree that all profits that the enterprise derives from their territory, whether from the PE or from other activities, will be subject to taxation within that tax jurisdiction. This is referred to as the force of attraction, since the mere existence of a PE within that tax jurisdiction will result in both income derived from the PE, as well as income derived from the jurisdiction other than through the existence of a PE, attracting income tax in that jurisdiction.

However, in the Commentary to Article 7 in Paragraph 5, this interpretation is not regarded as being an appropriate interpretation of Article 7(1), and the correct interpretation is described as being an approach by which the fiscal authorities of a country should look at the separate sources of profit that the enterprise derives from the country, should apply the PE test as set out in Article 5 of the Model Tax Convention to each source, and should consequently only subject profits to taxation in that jurisdiction if the source of the specific income type is derived from a PE in that tax jurisdiction (OECD Model Tax Convention 2000: Commentary on Article 7 Par 5).

In broad terms, it can be said that the relevant business activity approach advocates a two-stage process: this entails, firstly, the determination of total enterprise profits, and, secondly, the allocation of such profits to each relevant business activity (OECD Discussion Draft 2001: Part B Par 18).

The relevant business activity approach interprets Article 7(1) as imposing a limitation on the profits that should be attributed and consequently taxed in that tax jurisdiction, namely that the profits attributed could not exceed the profits that the whole enterprise earns from the relevant business activity (OECD Discussion Draft 2001: Part B Par 15). This approach would thus include profits and losses of operations by other parts of the enterprise, in other tax jurisdictions, that participate in the relevant business activity. It can therefore be said that the extent of each activity defined will directly influence the quantum of the profit limitation in terms of this approach. For example, the sale of a product (relevant business activity) could be defined as including the activities directly related to the manufacture and distribution thereof, but could also potentially be defined as including activities such as the research and design activities undertaken in respect of the product. In the OECD Discussion Draft, it is submitted that the more broadly the relevant business activity is defined, the greater the likelihood that the performance of other parts of the enterprise will limit the attribution of profit to the PE (OECD Discussion Draft 2001: Part B Par 17).

This approach takes only take realised profits into account, since the accounting profit (which would include realised profits) of the total enterprise is first determined, and then allocated to the various parts of the enterprise based on each main activity within such enterprise. Profit attribution or allocation on this basis may be arbitrary, since this basis will only result in a fair allocation of profits if the allocation basis can be established and justified on a reliable and objective basis. Since this approach does not require each transaction between the various parts of the enterprise to be subject to the arm's length standard, but rather seeks on an overall basis to allocate historical profits to each part of the enterprise, the results of using this approach may be questionable. When using this approach, there is a significant risk not only of manipulation of the allocation basis to take advantage of differing tax rates prevailing in the two tax jurisdictions, but also of an arbitrary allocation basis being used, which does not necessarily reflect the economic reality of the situation.

It is clearly indicated in the OECD Discussion Draft that the OECD does not subscribe to the relevant business activity approach (OECD Discussion Draft 2001: Part B Par 31). This approach is considered less acceptable than the functionally separately enterprise approach, since the latter approach is closely aligned with the arm's length principle. Since the relevant business activity approach does not subject each transaction between a part of the enterprise and the PE of the same enterprise to the arm's length standard, this approach is open to criticism if the basis of profit allocation is not objectively justifiable, and, since not subscribed to by the OECD, is likely to result in double taxation if applied. This study therefore gives only limited consideration to this approach.

It is important to note the wording of Article 7 of the 2000 Model Tax Convention, however, and the Commentary on the Article will have be amended to specifically exclude the relevant business activity approach, since at present, when interpreting Article 7 and its Commentary, this approach does not appear to be in obvious conflict with the provisions of the 2000 OECD Model Convention. In fact, some OECD member countries are of the opinion that this approach is required by Article 7 of the OECD Model Tax Convention, given the precise language used in Paragraph 1 of Article 7 (OECD Discussion Draft 2001: Part 1 A Par 26).

In the public commentary[10] to the OECD Discussion Draft, it was pointed out that such a change to Article 7 will inevitably result in the re-negotiation of bilateral treaties, and may also require changes to domestic legislation in various jurisdictions, which is inevitably by nature a complex process. Moreover, it was pointed out that changes to Article 7 and its Commentary cannot validly change the existing double tax agreements to increase the tax liability of any taxpayer, unless re-negotiated.[11]

Functionally separate enterprise approach to profit attribution

The functionally separate entity approach is the interpretation that advocates that the PE, and profits attributed to it, are treated as if the PE is a distinct and separate enterprise. According to Paragraph 11 of the Commentary on Article 7 of the OECD Model Tax Convention, this is consistent with the arm's length principle, by which all transactions between one part of the enterprise and another should be based on a value as if the transactions were entered into by independent parties under conditions normally prevailing in the market (OECD Model Tax Convention: Paragraph 11 of Commentary on Article 7).

The functionally separate entity approach or interpretation of Article 7(2), in principle, requires transactions between one part of an enterprise and another situated in a foreign jurisdiction to take place at an arm's length value or transfer price. This approach has its origins in the independent enterprise approach and separate accounting approach adopted by the League of Nations in 1933, and can be considered the statement of the arm's length principle in the context of PEs (OECD Discussion Draft 2001: Par 39).

The functionally separate enterprise approach does not interpret Article 7 as imposing a limitation on the quantum of profits that is to be attributed, but as providing confirmation that the right to tax of the jurisdiction in which the PE operates does not extend to profits that the enterprise may derive from that jurisdiction otherwise than through the PE (OECD Discussion Draft 2001: Par B 22).

An important difference between the relevant business activity approach and the functionally separate enterprise approach is that the relevant business activity approach takes realised profits as a point of departure, which are then allocated to the various activities. However, in applying the functionally separate enterprise principle, a profit based on the arm's length principle may be attributed to the PE as a result of a transaction, even though profit may only be realised at a later stage when the goods or services are sold by the PE to a third party (OECD Discussion Draft OECD 2001: Par B 24). The application of the functionally separate enterprise approach may thus result in the taxation of unrealised profits, where goods and services are transferred between the separate parts of the enterprise at an arm's length value, and these goods or services have not yet been sold to a third party at the end of the year of assessment. This circumstance is unavoidable, however, if the separate parts of the enterprise are to be treated as distinctly separate enterprises.

Apart from being consistent with the arm's length principle, the OECD Discussion Draft indicates various other reasons why the functionally separate entity approach is the preferred approach of the OECD member countries, including that application of the principle results in tax neutrality between resident and non-resident enterprises functioning in the same tax jurisdiction, and that administration is simplified, since application thereof does not require that the tax jurisdiction in which the PE operates should try and determine the worldwide profits of the enterprise, as would be the case when applying the relevant business activity approach (OECD Discussion Draft 2001: Par B 30).

Allocation of costs incurred on behalf of the permanent establishment

It should be noted that, in terms of Paragraph 3 of Article 7 of the OECD Model Tax Convention, expenditure incurred for the purposes of the PE, including administrative expenses, irrespective of where the expense is incurred, is allowable as a tax deduction against the taxable income attributed to the PE. Consequently, expenditure incurred by the head office of the PE, such as administrative overheads, may be allocated to the PE when attributing profits to the PE for tax purposes.

---

10 PricewaterhouseCoopers 2001: *Comments on the Discussion Draft on the Attribution of Profit to a Permanent Establishment:* Paragraph 8; Taxation Committee of ICC UK 2001: *Comments on the Discussion Draft on the Attribution of Profit to a Permanent Establishment:* Paragraph 4.

11 Taxation Committee of ICC UK 2001: *Comments on the Discussion Draft on the Attribution of Profit to a Permanent Establishment:* Paragraph 5.

Paragraph 3 of Article 7 states:

> In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere (OECD Model Tax Convention 2000: Article 7 Par 3)

This allocation of costs incurred to the PE would presumably be based on the actual cost incurred, not including a profit margin, since the reference is made to a deduction of an expense incurred, which could be interpreted as a deduction of expenditure equal to the value of the actual cost incurred on behalf of the PE.

However, Paragraph 2 of Article 7 determines that the transfer of goods and services between the PE and head office should take place at an arm's length transfer price, which would therefore incorporate a profit margin, and would thus not be done at a value equivalent to the actual cost of the goods or services. An attempted clarification of this inconsistency is found in the 2000 OECD Model Tax Convention Commentary on Article 7 at 17.1, which states that an arm's length price applies to the internal transfer of property and services, if this is of the same kind that the enterprise, in the normal course of its business, would have supplied to a third party.

The application of this principle and the consequent transfer price (actual cost or arm's length) is not as simple as it may seem, however, since the test of when property or services would fall into the category of being the same kind which, in the normal course of business, is supplied to a third party, may be difficult to apply in practice. For example, a taxpayer that has developed intellectual property primarily for its own use to manufacture a product, may nevertheless decide to grant sub-licence rights in exchange for consideration to a third party. When similar rights are later granted to an associated enterprise, the question may arise whether such supply, if not made regularly, falls within this description of the normal course of business. It is not clear whether the reference to the normal course of business refers to the type of goods or services that the enterprise mainly supplies to third parties, or whether this concept is wide enough to include irregular transactions, such as the disposal of an asset that constitutes a capital asset, that do not form part of the goods and services normally supplied to third parties.

Although the inconsistency that arises between the situations where Paragraph 2 is used, as opposed to Paragraph 3, is briefly discussed in the OECD Discussion Draft, no practical solution to this problem is proposed (OECD Discussion Draft 2001: Par 172–174). It would appear from the report, however, that broad consensus exists among OECD member countries that it would firstly be preferable if the interpretation of Paragraph 3 did not result in a modification to the arm's length principle, and secondly, that the paragraph should be interpreted as having the role of ensuring that expenses of a PE are not disallowed for inappropriate reasons, particularly because the expenses are incurred outside the jurisdiction of the PE, or are not incurred exclusively for the PE (OECD Discussion Draft 2001: Par 174).

It is clear that Paragraph 7 of the OECD Model Tax Convention, or the Commentary on Paragraph 7, will have to be amended in order to incorporate more detailed guidelines to sufficiently clarify the purpose of Paragraph 3 as constituting a provision to ensure the deductibility of PE expenditure only. This amendment would have to specifically exclude the interpretation of Paragraph 3 as a provision that allows transactions between the various parts of an enterprise to take place at actual cost, instead of at an arm's length charge.

Conclusion

The South African legal framework with regard to international transfer pricing, as contained in Section 31 of the Income Tax Act, together with SARS Practice Note 7 of 1999, enacts the arm's length principle for all 'international transactions' as defined. The arm's length standard is not required by Section 31 for the transfer of goods or services to or from a PE of a resident or non-resident enterprise. However, where a double tax agreement (that corresponds with the provisions contained in Article 7 of the OECD Model Tax Convention) is concluded between South Africa and the other tax jurisdiction, the arm's length standard may be required in terms of Article 7 of this agreement.

The arm's length principle is based on the principle of comparability, since applying the arm's length principle in terms of SARS Practice Note 7 of 1999 and the OECD Guidelines entails finding either comparable goods and services, or finding an enterprise that performs comparable functions and assumes comparable risks to the entity compared. In the first instance, the attributes of the goods and services and the comparability thereof are of utmost importance, whereas the emphasis in the second instance is on the comparability of the enterprises as a whole. The most important requirement for comparability to be successful is that none of the differences between the comparables must materially affect the arm's length value established, or, where material differences exists, reliable adjustments must be made to eliminate the effect of these.

From the detailed analysis of Article 7 of the OECD Model Tax Convention, together with the OECD Draft Report, it is clear that the arm's length principle, although not free of criticism, forms the foundation of attributing profits to a PE of the enterprise in terms of Paragraph 2 of Article 7 of the OECD Model Tax Convention. If this approach is followed, the transfer price determined between the PE and head office would be that which would have prevailed between independent parties under similar conditions. Although the arm's length standard is required for transactions between separate associated enterprises in terms of Section 31, it is clear from the OECD Discussion Draft that the contemporary views of the OECD member countries clearly favour the application of this principle also where transactions within the same enterprise take place with a PE in a foreign tax jurisdiction where a

	Company A RSA resident	**Company B RSA resident**	**Company C Non-resident**	**Company D Non-resident**
Republic of South Africa	Head Office	Head Office	Permanent establishment	Permanent establishment
	Cross border transactions	*Cross border transactions*	*Cross border transactions*	*Cross border transactions*
Foreign tax jurisdiction	Permanent establishment	Permanent establishment	Head Office	Head Office
	No valid tax agreement concluded between RSA and foreign tax jurisdiction	Valid DTA consistent with OECD Model Tax Convention (Article 7)	Valid DTA consistent with OECD Model Tax Convention (Article 7)	No valid tax agreement concluded between RSA and foreign tax jurisdiction
RSA tax consequences	• Company taxed on worldwide income, including PE / branch income • Double tax relief – S10(1)(kA) or S6*quat* • Arm's length standard for PE / branch transactions not required	• Company taxed on worldwide income, including PE / branch income • Double tax relief - S10(1)(kA) or S6*quat* • Arm's length standard for PE transactions required by the DTA	• Company taxed on RSA source income and deemed RSA source income at branch tax rate of 35% • Double tax relief in foreign tax jurisdiction • Arm's length standard for PE transactions required by the DTA	• Company taxed on RSA source income and deemed RSA source income at branch tax rate of 35% • Double tax relief in foreign tax jurisdiction • Arm's length standard for PE / branch transactions not required

Figure 1: South African tax consequences of branch transactions

DTA that is consistent with the provisions of Article 7 of the OECD Model Tax Convention is in operation.

In this study, two approaches presently used to attribute profits to a PE – the relevant business activity approach and the functionally separate enterprise approach – were evaluated against the requirements of Article 7 of the OECD Model Tax Convention. The functionally separate enterprise approach constitutes the most acceptable approach to attributing profits to a PE, since this approach requires the application of the arm's length principle on a transactional basis. This approach is then also recognised as the preferred approach to profit attribution by the OECD. It is furthermore clear that this approach is entirely aligned with that of the OECD, as discussed in the OECD Discussion Draft, which advocates profit attribution to PEs on the functionally separate enterprise basis, this approach being consistent with the principle that all dealings with a PE should take place at a value that would have prevailed had the PE been a distinct and separate enterprise.

Although the application of Paragraph 3 of Article 7 may still allow cost incurred on behalf of a PE to be allocated between various parts of the enterprise, it is clear from the OECD Discussion Draft that this interpretation of Paragraph 3 does not reflect the consensus reached among most OECD member countries that this paragraph was not intended to provide an exception to the arm's length rule, but rather to allow the deduction of expenditure incurred, irrespective of where it was incurred. In conclusion, the South African tax consequences of branch transactions are summarised in Figure 1, which presents four potential situations involving permanent establishments where cross-border transactions between the head office and a PE take place, namely:

- Company A – South African resident with a PE abroad, where no valid tax agreement between the Republic and the foreign jurisdiction exists
- Company B – RSA South African resident with a PE abroad, where the Republic has concluded a valid double tax agreement, with provisions that are consistent with Article 7 of the OECD Model Tax Convention
- Company C – Non-resident with a PE in the Republic, where the Republic has concluded a valid double tax agreement, with provisions that are consistent with Article 7 of the OECD Model Tax Convention
- Company D – Non-resident with a PE in the Republic, where no valid tax agreement between the Republic and the foreign jurisdiction exists.

References

Borkowski, S.C. 2002. 'Electronic commerce, transnational taxation and transfer pricing: issues and practices', *International Tax Journal,* 1: 36.

Business Advisory Committee. 2001. Comments on the OECD Discussion Draft on the 'Attribution of Profits to Permanent Establishments'.

Chartered Institute of Taxation. 2001. Comments on the OECD Discussion Draft on the 'Attribution of Profits to Permanent Establishments'.

Clegg, D. 2003. *Income Tax in South Africa.* Durban: Butterworths.

Dodge, B. & DiCenso, G. 2002. Global Transfer Pricing Developments. *International Tax Review,* 49: 51.

Ho, D.H.K. & Lau, P.T.Y. 2002. 'A study of transfer pricing in China', *International Tax Journal*, 62: 78.

Krishna, S., Nagarajan, V., Przysuski, M. & Swaneveld, H. 2002. 'Canada targets transfer pricing transgressions', *International Tax Review*, 27: 50.

Miesel, V.H., Higinbotham, H.H. & Yi, C.W. 2002. 'International transfer pricing: practical solutions for inter-company pricing', *International Tax Journal*, 1: 22.

Neighbour, J. 2002. *Transfer Pricing: Keeping it at Arm's Length*, OECD Centre for Tax Policy and Administration, France, 1: 5.

Organisation for Economic Co-operation and Development. 2000. *Model Tax Convention on Income and Capital.* Volume 1 & 2. France: OECD Publications.

Organisation for Economic Co-operation and Development. 2001. *Discussion Draft on the Attribution of Profits to Permanent Establishments.* France: OECD Publications.

Organisation for Economic Co-operation and Development. 2001. *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. 2001.* France: OECD Publications.

PricewaterhouseCoopers. 2001. Comments on the OECD Discussion Draft on the 'Attribution of Profits to Permanent Establishments'.

Taxation Committee of ICC United Kingdom. 2001. Comments on the OECD Discussion Draft on the 'Attribution of Profits to Permanent Establishments'.

United States Council for International Business. 2001. Comments on the OECD Discussion Draft on the 'Attribution of Profits to Permanent Establishments'.

Glossary of terms

Arm's length principle

The international standard that OECD member countries have agreed should be used for determining transfer prices for tax purposes. It is set forth in Article 9 of the OECD Model Tax Convention as follows:

> where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly (OECD Guidelines 2001: Glossary of terms).

Associated enterprises

Two enterprises are associated enterprises with respect to each other, for the purposes of the OECD Guidelines, if one of the enterprises meets the conditions of Article 9, sub-paragraphs 1a) or 1b) of the OECD Model Tax Convention with respect to the other enterprise. Article 9, sub-paragraphs 1a) or 1b) of the OECD Model Tax Convention, contains the following requirements:

> Where:
>
> (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the Other Contracting State, or
>
> (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the Other Contracting State.

The OECD Guidelines apply at present to associated enterprises, and not to transactions taking place within the same enterprise with a permanent establishment abroad (OECD Guidelines 2001: Glossary of terms).

Independent enterprises

Two enterprises are independent enterprises with respect to each other if they are not associated enterprises with respect to each other (OECD Guidelines 2001: Glossary of terms).

Multinational enterprise group (MNE group)

A group of associated companies with business establishments in two or more countries (OECD Guidelines 2001: Glossary of terms).

OECD Guidelines

The publication entitled *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* published by the OECD (2001). These guidelines provide guidance on international transfer pricing issues and are internationally accepted as the authority on this subject.

OECD Discussion Draft

The publication entitled *Discussion Draft on the Attribution of Profit to Permanent Establishments* issued by the OECD (2002), which deals (among other things) with the proposed methodology for applying the arm's length principle to transactions within the same enterprise with a permanent establishment situated in a foreign tax jurisdiction.

OECD Model Tax Convention

The publication entitled *Model Tax Convention on Income and on Capital*, published by the OECD (2000), which represents the model agreements on which many OECD member countries, as well as non-member countries such as South Africa, base double tax agreements.

Permanent establishment (PE)

An operation of a non-resident in a foreign tax jurisdiction, which complies with the requirements of Article 5 of the OECD Model Tax Convention (OECD Guidelines 2001: Glossary of terms).