Hong Kong Institute of Certified Public Accountants
香港會計師公會

Hong Kong's CPA Qualification
香港會計師專業資格

Qualification Programme

Capstone

Pilot Examination Paper

Version 1

Published in August 2021

Capstone – Pilot Examination Paper
(Version 1)

Pre-seen materials provide background information and issues arise about the fictitious organisation that will be featured in the Capstone Examination. It will form the basis of the tasks that you can expect during the examination.

It is essential to be familiar with the pre-seen materials before sitting the Capstone Examination. The pre-seen materials are available five business days in advance for candidates to prepare for the examination through independent reading, research in industry and general business news, etc.

The pre-seen materials contain:

- About you, Sky Lam and the Case Background of Gelato Café
- Exhibit 1 – Welcome email from the Finance Director, John Cheng
- Exhibit 2 – Organisational chart of Gelato Café
- Exhibit 3 – Financial summary of Gelato Café
- Exhibit 4 – Background of Bel Ristorante
- Exhibit 5 – Background of Kyoto-ya
- Exhibit 6 – Internal memos of Gelato Café
- Exhibit 7 – Media coverages of Gelato Café

Additional information will be provided on the day of the examination which comprises supplementary information that expands upon the background in the pre-seen, along with the examination task requirements.

Candidates must bring these materials with them to the examination hall on the examination day.

Gelato Café

"Gelato Café is not only about gelato. It's more about the culture and atmosphere that we bring to our customers who are meeting friends or just want to hang out in a comfortable environment. With our success in Hong Kong, mainland China is our next target."

Dodo Chan, founder of Gelato Café Limited

Gelato Café Limited (the "Company") is a Hong Kong-based restaurant chain founded by Dodo Chan ("Chan"). The Company owns *Gelato Café*, a chain of six stylishly designed cafés in Hong Kong. With aggressive plans to expand into mainland China and open 24 new stores by 2022, you, Sky Lam, have recently been hired as a member of the Company's finance department [See **Exhibit 1**].

History of the Company

Gelato Café was founded in Hong Kong by Chan, who spent over 15 years in the marketing industry before beginning her entrepreneurial journey. Chan ventured into Gelato Café after quitting her previous job in 2013. She bought a commercial gelato maker from Italy and started developing gelato of different flavours in a small factory unit in Tsuen Wan. She flew abroad every other month to look for ideas, ingredients, and innovations for her food production. She spent one or two days a week traveling to different spots of Hong Kong in order to understand the consumer market and find a suitable store location. After two years of preparation, Chan introduced the first Gelato Café to Hongkongers in August 2015.

"As an avid foodie, I believe in premium quality. Our staff are committed to providing the most rewarding experience to our customers in every single step: from the sourcing of ingredients to innovation, production, and to the serving of our products."

Chan, founder of the Company

Chan's philosophy is to cultivate an air of *"good food, good mood, and good life"* in Gelato Café. With great passion in design and hospitality, Chan is committed to bringing her customers the most unique gelato and the highest quality coffee experience. Targeting the young lifestyle-seeking and non-price-sensitive generation, the first Gelato Café is a stylishly designed outlet with floor-to-ceiling windows that provides premium quality coffee, gelato, and a stunning view of Victoria Harbour from Kennedy Town. Food and drinks are all priced at the higher end.

To promote the brand, the Company launched various social media marketing campaigns to increase customer engagement. By checking in online and sharing a selfie taken at Gelato Café, customers can obtain store coupons if the post achieves a certain level of popularity online. The marketing campaigns have been recognised as great successes, and the store became internet-famous site in only a month after first launching. Every day, the store not only attracts gelato and coffee lovers from the local community but also tourists from all over the world to "make a pilgrimage" to the internet-famous store.

Following the first Gelato Café's success, five more outlets were subsequently opened within four years in various commercial districts, including Central, Tsim Sha Tsui, Causeway Bay, Mongkok, and Quarry Bay. The Company has further added to the menu a range of innovative flavours and choices, among which the affogato al caffè (expresso poured on vanilla gelato) has become the most popular choice of customers. Over the years, Chan has also built a solid network of relationships with celebrities in town, from TV stars and key opinion leaders to successful businessmen, all of whom are fans of Gelato Café. The support of these people is indispensable to the success of Gelato Café.

Operations

Store Management

Chan has engaged a third-party software house to specifically develop a centralised management system, which includes a POS and an ERP system, for the Company. This system links up all transactions in store outlets with real time access by the Company's headquarters unit. At each shop, transactions are carried out using cash, Octopus card[1], mobile payments such as Alipay and Apple Pay, or credit cards. Cash is counted and reconciled every day at business close by store managers who decide on the amount of cash kept at the store and who are responsible for depositing the rest into the Company's bank account daily. Store managers are encouraged to deposit the cash daily in the afternoon before the banks close, but they retain the freedom to do so the following morning if they are busy.

"We are not a traditional business, but one driven by technology. Our mobile app allows us to stay connected with our customers and interact with them anytime and anywhere."

Chan, founder of the Company

Chan is consistently wary of store-cash management and prefers cashless transactions. She thinks that the control in the current cash management system is too loose and is thus seeking ways to improve it. As such, she has engaged the software house to add to the existing system a mobile app for customers' use which provides a platform for a customer membership program and guides customers through the entire purchase process under a self-served cashier-less manner. The mobile app was launched in March 2019.

The centralised management system has helped streamline the Company's operations and enhance operational efficiency in store operations and supply chain management. In addition, the membership system and payment system have collected big data for the Company that can be used to analyse customer behaviour. Data shows that as of 31 December 2019, there were over 1.38 million cumulative transacting customers with a customer repurchase rate of over 63%.

1 Octopus, launched in 1997, is a predominant contactless stored value smart card for travelling and making electronic payments in online or offline systems in Hong Kong.

Procurement

The Company procures a variety of high-quality raw materials for the purpose of making gelato, coffee, and other food and beverage items served. Chan does all the sourcing of these raw materials, mainly milk and cream, directly from leading farms in Australia and New Zealand to ensure their freshness. Fresh fruit is sourced daily from trusted local suppliers to produce cold-press drinks served in the stores. Chan also handles the importing of coffee and condiments from quality distributors by herself. Coffee, gelato, and other machines are bought from prominent suppliers with local warranty services for quality assurance.

The procurement team sources other equipment and consumables such as cups, straws, cutlery, and a broad range of packaging materials from several suppliers. The Company has maintained good relationships with their suppliers. The team is also responsible for analysing daily inventory levels to decide order placement and ensure order fulfilments in stores. Chan believes the Company has stringent quality control standards and measures in place.

Quality Control

The Company sets stringent specifications for dairy products and raw coffee beans acquired based on taste, moisture, origin, and grade. The quality assurance ("QA") team conducts sample testing on each batch of products received to screen for quality defects. The Company also engages third-party inspection agencies to perform regular on-site testing in their suppliers' factories.

Licenses and Compliance

The Company has a set of standard internal protocols in place as guidance for the opening of new stores. These protocols clearly list all necessary licenses and permits required for store operation, such as business registration, food safety licenses, and fire safety permits.

Store Renovation and Equipment

To maintain consistency in brand image, the Company has an in-house design team responsible for store design, decoration, and renovation. A third-party contractor, who has been working with the Company since the first store, is engaged in carrying out all necessary renovation work at stores.

Each shop is equipped with several commercial coffee machines and other equipment, such as ice machines and freezers. Each store is also equipped with an ice cream display freezer, for which the Company has entered into three-year rental contracts with a third-party vendor providing refrigeration and catering equipment solutions.

Key Economics

For the year ended 31 December 2019, the Company reported total revenue of around HK$21 million, representing a year-on-year increase of 21%. Gross profit margins for gelato and coffee were around 65% and 78%, respectively. Every day, gelato is freshly made by the commercial gelato machine in the Company's factory unit and delivered to all Gelato Cafés by a third-party logistics company. Currently, the Company has entered into fixed term leasing agreement with landlords for all its six stores and the factory unit. The Company adopts a straight-line depreciation policy of three years for its property, plant, and equipment.

Employees

The Company has three major operating units: headquarters, store operations, and production and procurement. Chan has served as the president of the company since incorporation. She steers the Company according to her strategic direction and has sole discretion in most decision-making processes of the Company. She also leads the production and procurement unit that has two departments: the product department and the QA department. The product department is led by Chan directly. The QA department is led by Shirley Lau, QA director of the Company. Prior to joining the Company, Lau worked as the QA manager of a local restaurant group. She has a bachelor's degree in hotel management.

There are two departments and an administrative unit in the headquarters. The finance department is led by John Cheng, finance director of the Company, who joined the Company at the beginning of 2016. Cheng is a member of the HKICPA and has 20 years of experience in the finance industry. The marketing department is led by Luk Chow, marketing director of the Company. Chow is a reputable marketing expert in the industry with over 18 years of experience and is an ex-colleague of Chan.

The store operations unit is led by Sean Ng, general manager of store operations. Ng joined the Company in April 2015. Prior to joining the Company, he worked as the store manager of a renowned coffee shop chain in Hong Kong. Ng is a certified barista and has led the Company's team to win the gold medal at the RASV Australian International Coffee Award in 2016.

All staff sign standard full-time employment contracts with the Company. The Company provides commission-based compensation to all store operation staff and performance-based bonuses to all other staff. Comprehensive training, including but not limited to food safety, equipment operation, and food production, are provided to all store operation staff before they commence work. [See **Exhibit 2** for a simplified organisational chart of the Company.]

Customer Incentive Scheme

Apart from the various social media marketing campaigns, the Company has launched different incentive schemes to attract customers. The Company has engaged a third-party software house to create a membership app (the "App") that allows customers to become members of Gelato Café, enjoy membership privileges, and to store coupons and money.

There are different kinds of incentive schemes offered by the Company to attract customers:

Cash Rebate

In order to receive cash in advance to support the cash flow of the Company, the Company offers a 5% rebate to customers by storing money into the App as prepayment. The stored value can be used to purchase any product at Gelato Café's stores within one year.

E-coupons

Customers can purchase e-coupons in a set of 10 at HK$400 that can be used to redeem a cup of coffee of HK$50 or less or a double-scoop gelato of HK$60. Coupons expire within one year after purchase.

Discounts

Gelato Café does not directly offer discounts on its in-store items. However, the stores occasionally offer promotions such as "*buy two, get one free*" campaigns to attract more customers. Customers can choose any coffee of the same price or lower from the menu for free.

The membership app also allows customers to place orders, make payments, and take delivery at the stores, removing the need for customers to queue up at the cashier. About 79% of Gelato Café's orders are made through the mobile app.

The Road Ahead

Chan is content with the success of her business. However, competition in Hong Kong is strong. In order to maintain Gelato Café's leading position in Hong Kong, more effort must be put into the business. Chan is determined to expand the business, either horizontally or vertically, locally or internationally.

The Expansion Plan

Chan is passionate about expanding the business of the Company both locally and internationally. Unfortunately, the food and beverage ("F&B") industry in Hong Kong has been severely disrupted by a pandemic in 2020. The pandemic has caused immediate and enormous uncertainties and even long-term impact to businesses worldwide. In particular, the food and beverage industry has been seriously impacted, with earnings for the industry in Hong Kong dropping by 43%.

Chan is cautiously considering whether the Company should slow down or even pause its expansion plans.

Despite the recent economic downturn, Chan is confident in maintaining Gelato Café's leading position in Hong Kong, but further expansion in Hong Kong and maintaining its growth momentum may not be easy. As such, Chan is considering adding to the Company a high-end Italian restaurant chain, the Bel Ristorante, in collaboration with the prestige Bel Group in Italy. The new restaurant will target high-end customers and non-price-sensitive generations. By collaborating with the prestigious Bel Group, Chan believes that the Company will be able to reach a new level. The Bel Group has a strong reputation and financial background, but has little experience in the mainland market. The Bel Group considers Hong Kong a key entrance point for that. Chan is confident that with the experience and reputation gained from Gelato Café, as well as support from celebrity fans, Bel Ristorante will be another success. However, running an upscale restaurant is very different from running a café. Chan is concerned about the abundant time and resources required for such a business. From setup funding to human resources requirements, such an upscale restaurant is expected to be much more demanding than Gelato Café. [See **Exhibit 4** for the background of Bel Ristorante]

On the other hand, Chan came across a local acquisition opportunity in early 2019. Kyoto-ya is a matcha-themed restaurant serving sweet and savoury dishes and drinks. The brand, owned by the Ueda family, is a pioneer in the production of roasted matcha (Japanese green tea) and originated in Kyoto in Japan 233 years ago. It has since held a leading role in the green tea industry in Japan, where there are currently 15 Kyoto-ya branches. Kyoto-ya was introduced to Hong Kong three years ago under franchise. Sales have been deteriorating over the years, and the owner of the Hong Kong franchise with four outlets wants to exit the business. Chan considers this brand to be very valuable and complementary to the business of the Company. She believes that the deteriorating performance of the outlets is simply due to poor management and a failure to foster the valuable brand culture. The local franchise is still available for sale as no buyer has yet been identified. With the disruption caused by the pandemic, Chan believes she can bargain for a price lower than the fair value of the assets and that a favourable deal can be completed within a short period of time. [See **Exhibit 5** for the background of Kyota-ya]

"In mainland China, there is a continued thirst for a premium quality life delivered through premium quality food."

Chan, founder of the Company

Expansion into mainland China is imprinted on the roadmap of the Company. Chan has set an aggressive plan to expand into the mainland and open 24 new stores by 2022. The Company hopes to penetrate the fast-growing mainland market starting in economically vibrant regions such as Beijing and Shanghai, then moving into other first-tier cities such as Guangzhou and Shenzhen where there are large concentrations of middle-class families. Better education and rising incomes have allowed the affluent middle class to aspire for iconic and luxurious lifestyles and to increase their spending on auxiliary goods and luxury services, such as spa treatments and other wellness activities. The Company plans to spread the store network in areas with high demand for lifestyle services, such as premium shopping malls and university campuses.

The sharing of lifestyles via social media such as WeChat, Weibo, Dianping, and Douban has become a norm in mainland China, especially among the younger generations. This will put a spotlight on brands with the right quality and services that are able to win the heart of consumers. With Gelato Café's experiences in social media marketing, Chan and Chow believe they can create another success in the mainland market.

To maintain the brand's quality, it is critical to maintain direct control of store operations. However, opening new stores could be very costly and time-consuming due to the licensing procedures in the mainland. Franchising, which is popular among scores of multinational brands entering into mainland China, is an alternative Chan is considering. Chan is still wondering which option is the most effective way of expansion for the Company.

<u>Exhibit 1</u>

19/06/2020 (Friday) 10:38

johncheng@gelatocafe.com

Welcome to Gelato Café

To skylam@gelatocafe.com

Dear Sky,

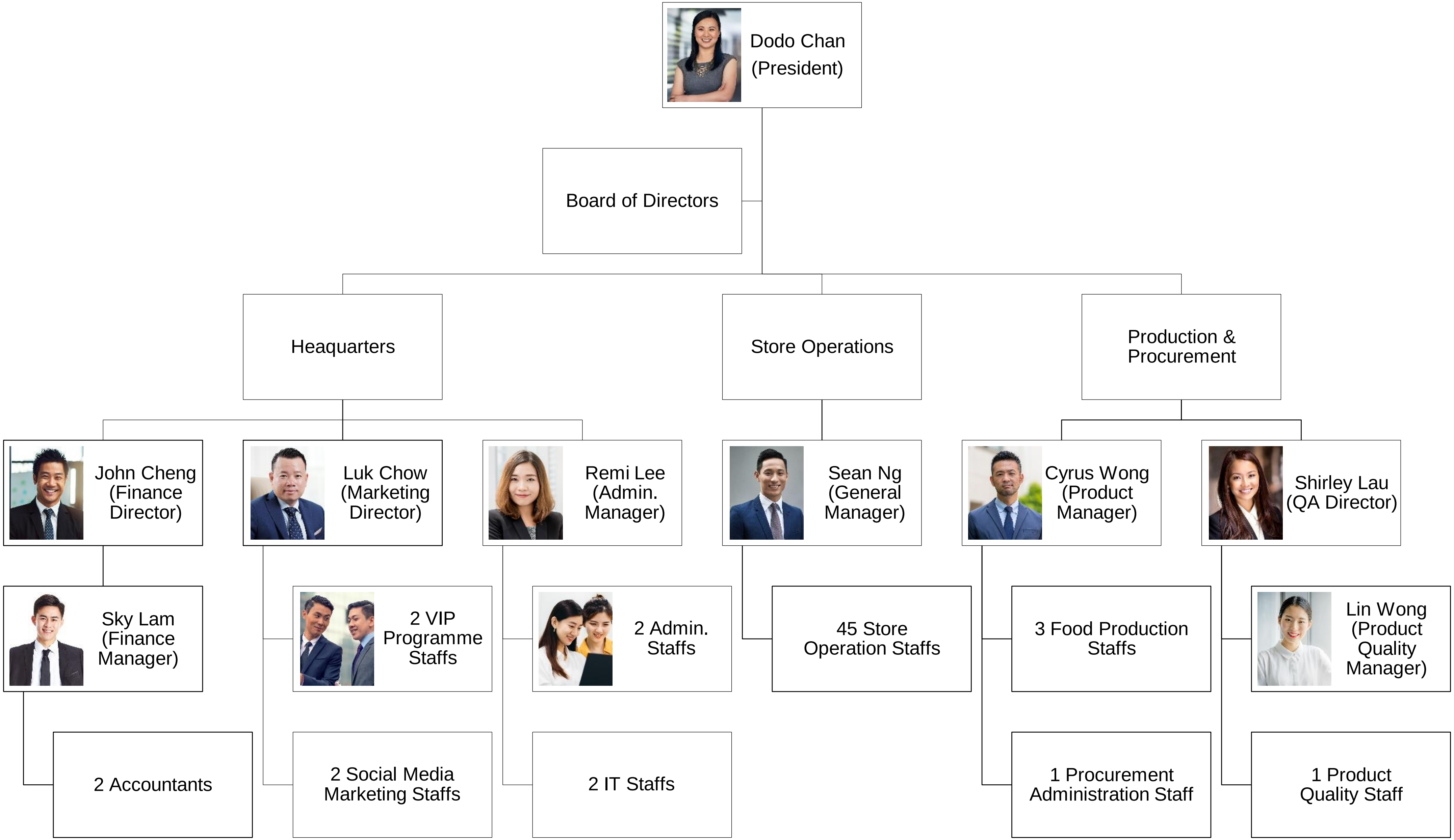
Welcome to Gelato Café! We are excited to have you joining and becoming an integral part of the finance team, taking care of the financial reporting of the company. More importantly, you will also become a member of the strategic task force that is responsible for corporate strategy, such as the expansion plan of the company.

I am on business trip and will be back next Friday. I have attached here an organisation chart of the company [see **Exhibit 2**], financial summary [see **Exhibit 3**], some internal memos [see **Exhibit 6**], and media coverage [see **Exhibit 7**] for you to familiarise yourself with the business.

Again, welcome to the team. If you have any questions, please feel free to contact my secretary Linda for help.

John Cheng
Finance Director
Direct: (852) 2388 8832
Email: johncheng@gelatocafe.com

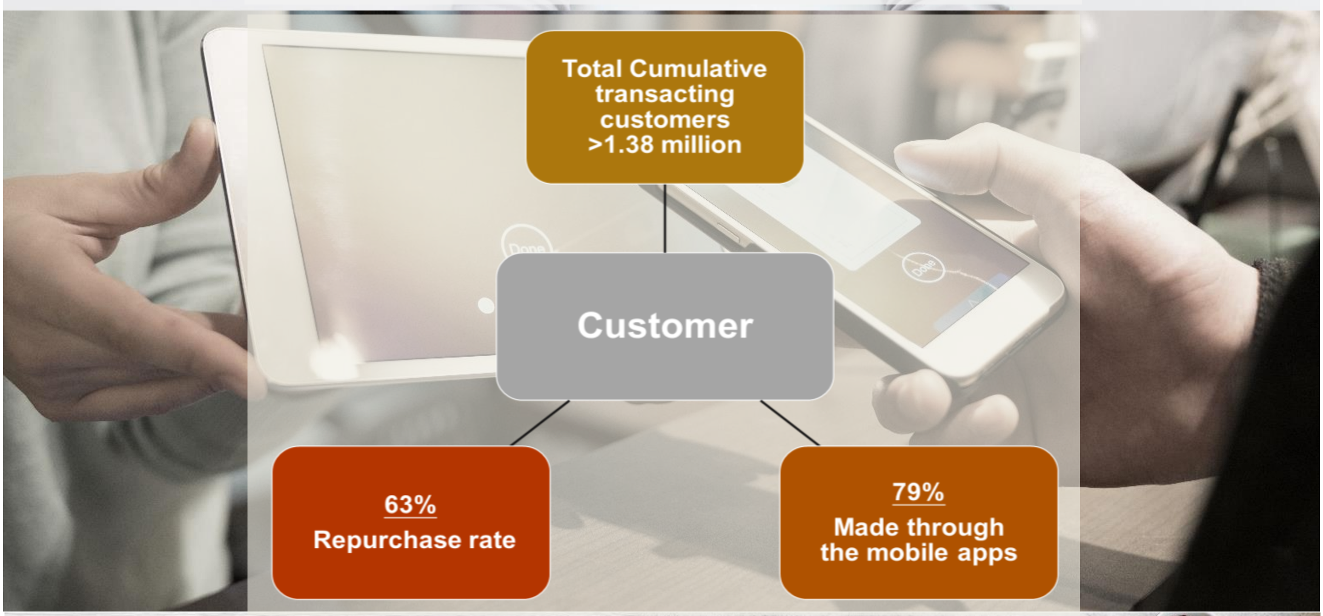
Exhibit 2



Dodo Chan (President)
Board of Directors
Heaquarters
Store Operations
Production & Procurement
John Cheng (Finance Director)
Luk Chow (Marketing Director)
Remi Lee (Admin. Manager)
Sean Ng (General Manager)
Cyrus Wong (Product Manager)
Shirley Lau (QA Director)
Sky Lam (Finance Manager)
2 VIP Programme Staffs
2 Admin. Staffs
45 Store Operation Staffs
3 Food Production Staffs
Lin Wong (Product Quality Manager)
2 Accountants
2 Social Media Marketing Staffs
2 IT Staffs
1 Procurement Administration Staff
1 Product Quality Staff

Financial Summary as at 31 December

RESULTS	2019	2018
	HK$	HK$
Revenue	21,047,341	17,466,673
Profit before income tax	4,353,021	2,926,121
Income tax expense	(773,329)	(697,867)
Profit for the year	3,579,692	2,228,254
ASSETS AND LIABILITIES		
Cash balance	28,350,445	22,689,250
Other assets	47,492,218	45,909,577
Total assets	75,842,663	68,598,827
Total liabilities	(32,922,176)	(27,334,877)
Total equity	42,920,487	41,263,950



- ITALIAN -

Background of Bel Ristorante

The Bel Ristorante, owned by the Bel Group, is a well-known high-end Italian restaurant chain in Italy. Founded in Bologna by the Beluca family in 1939, the Bel Ristorante is deeply rooted in the culture of Bologna -- a city renowned for its impressive lasagna and fantastic gelato. The original Bel Ristorante is considered one of the landmarks of Bologna, and is frequented by celebrities and members of the Bologna Football Club 1909.

The Bel Group is planning to expand their business into Asia, in particularly, mainland China. They consider Hong Kong a good location to start with, and are looking for an experienced local business partner. The planned setup will be using the same brand, "Bel Ristorante", together with the original prestigious menu and recipes, and the Bel Group will assign one of their renowned Italian chefs with a Michelin star as the master chef for the Asian chain.

The Bel Group is keen on having control of the Asian chain, but is open for discussion as to the shareholding percentage.

Background of Kyoto-ya

Kyoto-ya is a matcha-themed restaurant serving sweet and savoury dishes and drinks. The brand, owned by the Ueda family that pioneered the production of roasted matcha (Japanese green tea), originated from Kyoto in Japan 233 years ago and has since held a leading role in the green tea industry in Japan. There are 15 branches of Kyoto-ya in Japan ("Kyota-ya Japan").

Helena Li, while traveling in Japan with her husband in 2016, came across a Kyota-ya restaurant. Attracted by the theme and taste, Li decided to bring the branded restaurant to Hong Kong. The rich couple immediately reached out to the owner of the brand and were able to conclude a franchise agreement within three months. The franchise fee was agreed at a fixed percentage of turnover, with a minimum guarantee per outlet per annum. Subsequently, the first restaurant was opened in 2017 ("Kyota-ya Hong Kong").

Li has hired two office staff members to help her manage the business. For each restaurant there are five staff members, all under direct full-time employment with Kyota-ya Hong Kong. For ease of management, all ingredients and ready-to-serve products are directly bought and shipped to Hong Kong from Kyota-ya Japan. The novelty and taste of Japan helped attract a lot of business for the first local Kyota-ya in Causeway Bay. Within one year, Li opened another three restaurants, all in prime shopping malls in Hong Kong.

Sales of the other three restaurants are, although still making a profit, not as promising as the first restaurant. To cope with the high rent and decrease in sales, Li has asked her staff to substitute some of the ingredients and products with local alternatives. By doing this, the gross profit margin of the company doubled.

However, sales have kept deteriorating over the years. In 2020, all four outlets have operated at a loss over the past six months and working capital/ cash deficit has been financed by Li's funding. The leases of all four outlets are due to expire in December 2022. Li has lost interest in managing the business and has started looking for a buyer to acquire her Hong Kong franchise and the outlets.

MEMORANDUM

<BY EMAIL>

Date: **11th January 2019**
To: **Executive Directors, Senior Management**
From: **Sean Ng, General Manager**
Re: **Food and Beverage Industry in Hong Kong**

Dear Sirs,

Pursuant to management's discussion last Friday, I am writing to provide an overview of the food and beverage ("F&B") industry in Hong Kong for management's perusal as follows:

Overview

The F&B industry in Hong Kong is extremely competitive. The total market revenue for the fourth quarter of 2019 amounted to HK$26 billion, recording a 14.3% decrease compared to that of 2018.

The industry is easily affected by fluctuations in both the local and global economy and the financial markets. It is subject to strict licensing requirements and compliance with various operational standards such as fire safety requirements and ventilating systems. There are also a lot of inherent and industry-specific risks to be cautious of. For instance, risks relating to instances of unforeseeable food contamination and food-borne illnesses are unavoidable. Other risks include:

Failure to obtain or renew necessary licenses and permits or to maintain existing certifications

Laws and regulations require F&B operators to obtain and maintain various approvals, catering licenses, and permits in order to operate the business in Hong Kong, mainland China, or other regions or countries. In the mainland, restaurants are required to fill out an Environment Impact Registration Form and to pass the necessary fire safety verification or fire safety inspection. The required approvals, catering licenses, and permits can only be obtained upon satisfactory compliance with the applicable laws and regulations on food hygiene and safety, environmental protection, and fire safety. Most of these licenses require renewal and accreditation, subject to regular examination and verification by relevant authorities.

Intense competition in the catering service industry

The catering industry is intensely competitive with respect to taste, quality, consistency, price, ambiance, service, location, etc. F&B faces significant competition from locally-owned resturants to regional and international chains. Any inability to successfully compete with these competitors in markets could have material adverse effects on business, operations, cash flow, or financial condition.

Failure to detect, deter, and prevent all instances of fraud or other misconduct committed by employees, suppliers, and other third parties

Restaurant business can be adversely affected by negative publicity, whether accurate or not. Negative publicity can arise from news or allegations in any form of media. Reports on public health concerns and media reporting on catering service providers affect customer perceptions. Negative publicity could materially harm a business, brand, or operations.

Please feel free to disseminate this memo to staff in your department as appropriate. Should you have any queries or need any further clarification, please feel free to contact me at my direct line 54321 or seanng@gelatocafe.com.

Yours faithfully,

Sean Ng
General Manager

The DAILY NEWS

ALL ABOUT THE BIG WORLD WE LIVE IN

24 September 2020

What is Perception Management?

- ✓ **Perception** has a bigger impact on our thinking process than reality. Perception can be positive or negative. It relates to how we think about anyone or anything based on the stimuli we receive or select to receive, regardless of reality. Because of one's strong belief, once perception is formed, it is sometimes difficult to separate myth from fact, image, or reality.
- ✓ Perception, however, can also be easily managed or altered with the aid of digital and social media. This can be used positively or negatively. For example, individuals or organizations may use this to create propaganda; they may also use digital media to create a positive impression for stakeholders.
- ✓ Unfortunately, unethical individuals may attempt to benefit themselves by persuading others with false information.

FIRST DECLINE IN THE FOOD AND BEVERAGE INDUSTRY IN TWENTY YEARS

The F&B industry in Hong Kong had been seriously hit by the pandemic and plummeted by 14% in the second quarter of 2020 compared to 2019.

Employees were forced to take no-pay leave upon restaurants temporary closure amid pandemic outbreak.

Market sentiment recorded worst in the last twenty years.

FASHION TYCOON DIVORCED SOCIALITE AMID RUMORS OF CHEATING

Sixty-two year-old fashion tycoon Chong Yan Tam has divorced his 25 year-old socialite wife Helena Li amid rumors of cheating with local actor and singer Ray Chow. The couple married three years ago and Helena Li had since been frequently involved in high society. According to a person familiar with the matter, their marriage came under a prenup. With evidence of cheating held by Tam, Li is very likely to have to surrender all properties given to her by Tam and receive no alimony. Employees of Kyoto-ya, the restaurant chain opened by Li, revealed that they were owed two months' wages

Hong Kong Institute of Certified Public Accountants
香港會計師公會

Hong Kong's CPA Qualification
香港會計師專業資格

Qualification Programme

Capstone

Pilot Examination Paper

Version 1

Time Allowed	4 hours
Examination Assessment Allocation Written Questions	 75 Marks All THREE questions are compulsory

Capstone – Pilot Examination Paper
(Version 1)

You are advised to allocate your time as below:

Suggested time allocation (by marks):

Marks	Approximate time in minutes
1	3
2	6
3	10
4	13
5	16
6	19
7	22
8	26
9	29
10	32
11	35
12	38
13	42
14	45
15	48
16	51
17	54
18	58
19	61
20	64
21	67
22	70
23	74
24	77
25	80

<u>WRITTEN QUESTIONS</u> (Total: 75 marks)

Refer to the Preseen materials previously provided and the additional information provided below. You should Answer ALL of the following questions. Marks will be awarded for logical argumentation and appropriate presentation of the answers.

<u>Question 1</u> (25 marks – approximately 80 minutes)

Recently, the news reported that two children suffered serious illness after eating gelato sold by Gelato Café. Gelato Café was not aware of the incidents until the second victim, the child of a famous businessman, was hospitalised, although rumours of the incident had already been circulating immediately after the first child fell ill. This led to strong criticism of Gelato Café's management control and corporate governance, with some alleging that the Company did not care about victims who were not rich. As a result, many parents stated that they would no longer visit Gelato Café.

THE
SUN SHINE

Local News *29 July 2020, Wednesday*

28 ill in HK after eating gelato

28 people were reported ill after eating gelato from Gelato Café in Hong Kong. Fifteen, including the 5-year-old boy of local tycoon Raymond Wong, were hospitalised. Symptoms included diarrhea, vomiting and stomach cramps, with two children reporting chills and low-grade fever. Products were recalled from all shops for inspection. Officers from the Food and Environmental Hygiene Department were seen obtaining samples of gelato from all shops of Gelato Café to check for potential contamination. Test results were negative.

"I called Gelato Café to complain about my child getting sick after eating their gelato, but the person told me that he could have eaten something else that made him sick!" said the mother of a child being hospitalised.

As soon as the Company became aware of the incidents, management conducted an urgent investigation within the Company. Initial evidence revealed that the gelato manufactured by the food factory on the particular dates were mildly defective in both the use of materials and the production process, but it was opined by food hygiene officers of Gelato Café that such deficiencies would not cause serious illness. It was also found that the staff of the logistic company did not follow the regular transportation process when delivering the gelato to Gelato Café, and the concerned Cafés happened to be particularly busy on the date of the incidents, leading to staff having therefore skipped the regular inspection process set out by Gelato Café for that batch of gelato.

This evidence was only available to the senior management of the Company. If the Company chooses not to release the full internal investigation report to stakeholders and the general public, the majority of the fault would likely be put on the logistic company. The Company would only need to admit that they could not identify the deteriorated quality level of the batch of gelato after inspection because the inspection staff in charge were incompetent and lacked necessary scientific knowledge.

On the other hand, if the Company chooses to release the full report, much of the blame would likely be on the Company as the hygiene officers had allowed the use of gelato that was mildly defective.

According to the advice of the legal counsel of the Company, no matter which way the Company chooses to handle the matter, it is highly probable that the court will likely rule that the Company will have to be liable for legal damages. Making reference to precedent cases in Hong Kong and other countries, admitting to incompetence of staff could lead to compensation of as high as HK$20 million, while admitting to ignorance of staff to follow proper inspection procedures could lead to compensation of as high as HK$60 million. Both are undesirable, but a cost outlay of HK$20 million would still be affordable by to Company, while an amount of HK$60 million may cause a cash flow deficit problem.

Required:

You are required to:

(a) **Prepare a memorandum to the Finance Director to advise on whether the Company should disclose all the initial investigation findings and the related financial impacts (if any) to the auditors, taking into account any financial reporting and auditing standards and Company Law that may be applicable.**

(b) **Evaluate and analyse if there will be any cash flow problem due to the potential legal damages. What factors should be considered in identifying possible methods to solve the deficit, if any?**

Note:

1. You are not required to provide a detailed cash flow analysis or budget. A summary analysis of the basic accounting figures would be sufficient.

2. You are not required to prepare an actual proposal to solve the deficit problem.

<u>Question 2</u> (25 marks – approximately 80 minutes)

Due to an unseen pandemic that started in February 2020, Hong Kong citizens have to stay away from dining in restaurants (including Gelato Cafés) as a safety measure to avoid spreading the disease, whether voluntarily or mandatorily. As a result, some customers believed they would not be able to use their e-coupons before the expiry date. In March, Gelato Cafés began receiving enquiries from individual customers on whether the expiry date of the e-coupons could be extended for three to six months so that they could use them after the pandemic.

After receiving numerous enquiries from customers, a meeting was held in early April to discuss whether such an extension request should be accepted in order to retain customer loyalty and as a means to contribute to corporate social responsibility during the pandemic.

At the beginning of the meeting, Chan commented:

"With our long-established aim in providing quality food, quality service, and quality life, and to contribute positively to society, we should take care of our customers' request and extend the expiry period of coupons by at least six months. This would help maintain a positive customer relationship and further enhance our customers' loyalty to our Café. Thus, I believe we should go ahead with this decision."

John Cheng, finance director, alerted Chan and others to the financial impacts of this decision:

"Although this may not be welcomed, I must remind everyone that ever since the start of the pandemic, our revenue and profit have dropped quite a lot. We are fortunate to have sold many e-coupons before the pandemic, and we could recognise part of the income as these e-coupons expire. This would help us increase our reporting revenue and reduce our negative operational results. If we suddenly extend the expiry date, we will not be able to recognise the revenue this financial period any more according to the Hong Kong Accounting Standards. If this happens, our financial report will show an even worse result this year.

Moreover, if we extend the expiry dates of the sold e-coupons, customers will not need to buy new e-coupons from us soon. This will affect our expected revenue and cashflow for the coming months. I have estimated that if we extend the expiry dates, based on the number of currently outstanding e-coupons held by customers, our revenue may be reduced by 20% next year unless there is an unexpected increase in customer consumption rates. Can we bear such a reduction in revenue and profit this year, and a possible decrease of 20% in revenue next year? Personally, I would rather decline the customers' request and explain to them our own difficulties during this period."

Cyrus Wong, product manager, suggested that the food costs could be reduced to compensate for the possible reduction in revenue:

"It will be too late to change the food recipe and reduce food costs for the current financial year. However, if we really wish to extend the expiry date of e-coupons, I think we can modify our recipe by using raw materials of lower cost to produce gelato. The modified recipe will not cause any health concern, although our gelato may no longer provide the same level of nutritional value to our customers as before. But this could be a temporary solution for the time being. We can change back to our normal recipe in the future when revenue and profitability levels return to normal."

Chan reiterated that she aspired to maintain her mission and promise to customers and to contribute to corporate social responsibility even at the cost of reporting less revenue and profit. Of course, she wished that the negative financial impact could be minimised while maintaining the best quality food products. She asked everyone in the meeting to consider if there could be any better solution that could satisfy both the objectives and constraints.

Required:

(a) **Analyse the major impacts of extending the expiry dates of the sold e-coupons on the financial reports for the current year and the subsequent year.**
Note: Calculation is not required.

(b) **Based on the opinions and suggestions made by Dodo Chan, John Cheng, and Cyrus Wong, analyse and suggest, with justifications, which alternative action could be taken regarding the request of the customers on e-coupons. You may recommend any other alternative actions not mentioned in the meeting for this purpose.**

<u>Question 3</u> (25 marks – approximately 80 minutes)

Despite the downturn in the economy and the uncertainty ahead, Chan believes it is a good opportunity for the Company to expand its business with a much lower investment cost. Chan is considering which growth strategy would be the most appropriate to apply while balancing the potential risks to rewards of the Company.

There are two investment projects under consideration: the Bel Ristorante and the Kyoto-ya. Chan thinks that both investments are good, as the preliminary financial projections of both projects suggest a satisfactory investment return. However, she has not yet decided which direction the Company should go. Forming a strategic alliance with a well-known organisation will project a completely different strategic direction to the Company compared to the direct acquisition of an established restaurant chain. She therefore has called for a management meeting to discuss the growth strategy.

Financial Projections for the two projects

Project Bel (assume one outlet):

HK$'000	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	6,000	9,000	12,600	15,120	16,632
Gross Profit	3,900	6,300	8,820	10,584	11,642
Profit before Tax	60	720	1,260	1,512	1,663
Profit after Tax	50	601	1,052	1,263	1,389
Operating Cashflow	1,050	1,601	2,052	2,263	2,389
Initial setup costs + Capex	7,000				

Project Kyoto-ya (acquisition of four outlets):

HK$'000	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue	8,000	12,800	17,920	19,712	21,683
Gross Profit	4,800	9,600	13,440	14,784	16,262
Profit before Tax	80	1,024	1,792	2,365	2,602
Profit after Tax	67	855	1,496	1,975	2,173
Operating Cashflow	467	1,255	1,896	2,375	2,573
Acquisition Costs	8,000				
Capex	2,000				

Required:

To prepare for the upcoming meeting, you are required to prepare a report to:

(a) **Analyse and evaluate the two investment opportunities. Your report should include feasibility analyses of both investments, financially and strategically, from both the management and shareholders' perspectives, and how each investment could fit in the Company's current strategy.**

(b) **Compare the two investment projects and recommend which one is preferable, if only one investment could be materialised. Justify your choice.**

* * * END OF EXAMINATION PAPER * * *

Capstone – Version 1

Suggested Solution

The suggested solution for the Capstone Examination is provided for illustrative purpose only. It is meant to help candidates in their revision and learning and to illustrate the expected structure of the answers and the coverage and depth of knowledge relating to the particular requirements. The suggested solution may be longer than what the candidates are expected to produce in the actual examination. As the Capstone Examination simulates real-life situations based on an integrated case study, the suggested solution may not and is not intended to cover all the valid points that can address the requirements of the examination questions. In the actual examination, candidates will be awarded points for valid answers that may not be covered in the suggested solution.

WRITTEN QUESTIONS

Suggested Solution 1(a)

To: John Cheng, Finance Director

From: Sky Lam, Finance Manager

Date: XX-XX-XX

Disclosure of initial investigation findings to the auditors

I would like to provide the following information, analyses, and suggestions for your review and consideration on whether we should disclose the relevant findings and the financial impacts (if any) of the incidents to the auditors.

According to Hong Kong Companies Ordinance Ch.622, directors of a company must prepare a set of financial statements annually that gives a true and fair view of the financial position and financial performance of the company. Furthermore, the director must present the set of financial reports including the auditor's report and other required documents to shareholders in the annual general meeting held each year.

Auditors, for the purpose of preparing the auditor's report, must be delegated with rights and privileges to gain access to our accounting and financial information, and to obtain any other information and understanding from us. Since the auditor is required by law to comment on whether the financial statements present a true and fair view of the financial position and financial performance of a company, whether we need to disclose the initial findings to the auditors depends on whether such disclosure is necessary to give a true and fair view of the accounts.

There is no legal definition or elaboration of what constitutes a true and fair view of the accounts. We shall make reference to the applicable Hong Kong Accounting Standards (HKAS) and Financial Reporting Standards (HKFRS) as guidance. According to *HKAS 37 - Provisions, Contingent Liabilities and Contingent Assets*, if we believe a probable obligation will likely arise from certain past events, we will need to either provide a provision of liabilities in the accounts or disclose the contingent liabilities in the notes to the accounts. Failure to abide to this standard practice may suggest our financial statements not showing a true and fair view of the financial position of our company.

As we are not sure whether the parents of the victims would sue us or not, we are not yet certain about the possible obligation. It would therefore be more appropriate to quantify the potential impacts and disclose the contingent liability in the notes to the accounts in accordance with *HKAS 37*, and there is no need to provide any provision at this moment. Such a disclosure must be done as the contingent liabilities are quite material to our financial position and financial performance, otherwise we would not be able to justify why we do not do so.

Moreover, as the incidents have already been widely reported, our auditors should probably be alerted to these incidents. We should therefore proactively disclose the findings to the auditors to facilitate their work. If we do not disclose the findings to them, auditors may consider there are limitations in the audit and may not issue an unqualified (clean) audit report. This will further damage our reputation and financial viability.

Last but not the least, it is our company goal to always achieve excellent corporate governance and high business integrity. One way of maintaining our excellent practices is to disclose all the findings to the auditors irrespective of the legal requirements and whether the auditors have heard about the incidents or not.

Should you require any further information, please feel free to let me know.

Best Regards,

Sky Lam
Finance Manager

Suggested Solution 1(b)

Based on the financial summary stated in Exhibit 3, the Company's cash balance was HK$28,350,445 as at the financial year end of 2019. This indicates that the Company could afford a compensation of about HK$20 million without running into a serious cash deficit. However, a compensation of about HK$60 million would be disastrous to the Company's operations.

Furthermore, the current profitability and cash flow situation as stated in Exhibit 3 suggests that the Company could likely maintain profitable and positive cash position along with its business operations. It would thus be more feasible for the Company to arrange for financial resources if the expected compensation is around HK$20 million, but it would be much more problematic if the expected compensation is around HK$60 million.

When a company needs additional financial resources, there are various ways and resources to achieve this purpose, such as raising additional capital or obtaining loans from financial institutions.

In deciding which method(s) is/ are more appropriate for raising funds, a company needs to consider various factors:

(i) Whether the proposed method is feasible or not would be the first issue to consider. For instance, seeking bank loans is generally easy for well-versed companies, however it could be difficult during certain times--for instance, during the Financial Tsunami near the end of 2008 and in early 2009, when most banks were not willing to grant any new loans to business entities. In addition, securing a loan may depend on whether the Company has an existing relationship with the banks. If not, it may be difficult to build up new relationships with banks with the current incident.

(ii) A combination of different means should be considered as sometimes the amount obtained from one method may not be sufficient to meet the financial needs of the company. Other methods may include, for example, rights issues. However, this method requires investors'/ shareholders' confidence in the Company, which may be difficult at the time of incidents. This method also does not guarantee that the required amount can be obtained.

(iii) Most of the time, obtaining external funding may either lead to a dilution of controlling power of existing shareholders, or constraints in future operations of the business entity through contractual obligations (such as the prescribed level of current and acid ratios in bank load contracts). This means it is especially important for private or family-owned entities to carefully consider the impact and consequence before adopting this method when raising funds.

(iv) Some solutions, e.g., issuing bonds, may take a long time to implement. This also depends on the marketability and market acceptance of the company's bonds by investors.

(v) No matter which method is chosen, it is important to consider and compare the costs involved. It is also important to note that costs do not mean monetary costs alone.

Suggested Solution 2(a)

Effect on revenue and accounting impact are threefold:

(i) Delayed consumption

According to *HKFRS 15 Revenue from Contracts with Customers*, revenues from a customer should be recognised only when the entity satisfies its performance obligation by transferring a promised good or service (i.e., an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset. Extending the expiry of coupons will cause the total amount of revenue recognised in this financial year to be reduced to the extent of the value of extended coupons not used within this financial year. If the revenue amount deferred to the next financial year is material because of the extension of the coupon expiry date, careful consideration must be made on such impact.

(ii) Breakage

Under *HKFRS 15*, any non-redeemed pre-paid (forfeited) coupons and credits are referred to as breakage. An expected breakage amount in receipts in advance is determined by historical experience and is recognised as revenue upon sales in proportion to the pattern of redemption by customers.

If the expiry dates of the e-coupons are extended, firstly, revenue recognition will be deferred to be within the extended validity depending on the actual consumption date. At the same time, with the expiry extended, the actual forfeiture will be less for the current year, and therefore an adjustment will be required to reverse a portion of the breakage back into receipts in advance. This will reduce the current year's revenue and defer it to the future.

At the same time, as the expected breakage amount is determined by historical experience, this will reduce the expected breakage applied for next year, therefore reducing next financial year's recognition of breakage income upon new sales of coupons. As such, effects on revenue of the next financial year will be on both sides.

On the other hand, if the Company does not extend the expiry date, forfeiture for the current year is likely to be higher than the expected breakage due to the pandemic. As such, the Company can revise the expected breakage higher for the next year and recognise a higher breakage income upon sales of coupons.

(iii) Reduction in purchase of new coupons for the next year

Apart from the deferment of recognition of revenue in the current financial year, it is also possible that the revenue in the next financial year be reduced because customers may not buy more e-coupons because of the extended validity of the e-coupons. In this respect, the decision to extend the expiry date of e-coupons must be carefully considered, unless the relevant amount of deferred revenue is considered immaterial.

(iv) Others

Although such extension, if granted, may impact revenue in the future, there will not be any impact on cash flow in terms of coupons already sold. In addition, if this possible action would affect the deferred tax issue, deferred tax items need to be re-calculated. However, this is not necessarily a major concern for the current consideration.

From a non-financial point of view, although there is no contractual obligation to extend the expiry dates of the e-coupons, it is admissible that the decision to allow for the extension of the expiry dates of the e-coupons may let customers feel that the Company is socially responsible and cares for their needs. This advantage could compensate for the possible loss of revenue in this and the next financial year. Moreover, this action is fully aligned with the Company's vision of maintaining excellent corporate governance and business integrity.

Suggested Solution 2(b)

It is suggested the Company should consider the following actions:

(i) Extend the validity of coupons (that will expire soon) by 3 months from their original expiry dates.

This action will, on one hand, respond to the request of customers who hold coupons, while, on the other hand, it will only result in a deferment of revenue and profitability as it is only a 3-month extension. The Company may choose to explain to customers why only a 3-month extension is granted and may also consider further extension upon the end of the 3-month period depending on the situation. By extending only the coupons that are close to expiration, the impact on revenue recognition will be confined.

(ii) Allow the expiry date of unused coupons to be extended if customers buy a new set of coupons.

The Company can offer a 5-10% discount for customers to buy a new set of coupons, and, by doing so, their existing unused coupons can remain valid with the expiry date extended either for a fixed period, e.g., 3 to 6 months, or to the same date as that of the new e-coupons.

With the Company's app in place, customers can buy e-coupon over the app without the need to visit the physical stores. This will create a win-win situation for both the Company and customers. Customers who participate in this scheme benefit from having their coupons extended for a much longer period. For the Company, sales will be boosted during the pandemic, and operating cash flow will be enhanced with these sales. Providing other discounts for longer periods can also be considered, as this can actually be considered a means of promotion for the benefits of boosting sales.

(iii) Customers can also choose to donate their unused coupons to underprivileged families or nursing centres, where the Company will deliver food and beverages greater than the amount of donated coupons to provide care and support to needy people during the pandemic. In return, customers can either receive reward points for future use, cash coupons, or discounts for use during their next patronage within a certain period. However, the Company must be aware that there will be specific accounting treatments for certain customer incentives given, for instance, reward points. Customers may feel better under such an arrangement as they are doing good, while the Company can contribute positively to society. With more corporate social responsibility demonstrated, the Company's image will be enhanced.

(iv) As another alternative the Company can consider providing home and office delivery during the pandemic. This would not only enhance the Company's service level but also create a new line of business and, at the same time, allow customers to utilize the expiring coupons. Although there will be extra delivery costs to the Company, the Company can set a minimum order amount for delivery, thus pushing the use of coupons, increasing sales during the pandemic, and offsetting the delivery costs. If delivery is provided, it is very important for the Company to pay attention to quality control during the delivery process so as to avoid any spoilage of food which could cause food poisoning.

(v) Companies always have to strike a balance between quality and cost, which in turns affect profitability. The Company, if necessary, may indeed lower the quality of the gelato to save costs, however the Company must ensure there is no health concern on the gelato of lower quality. In the meanwhile, it is worth considering if the lowered quality may (or may not) make the flavour less attractive to customers, which will in turn reduce revenue despite a lowered cost, the Company's image, and reputation, particularly if this becomes known to customers. A careful choice must be made.

(vi) Any other reasonable suggestion as relevant to the situation.

Suggested Solution 3(a)

To: Dodo Chan, CEO

From: Sky Lam, Finance Manager

Date: XX-XX-XX

An Evaluation of the Proposed Investment Projects - The Bel Ristorante & The Kyoto-ya

Introduction

The following report is an evaluation of the two investment proposals -- namely, the Bel Ristorante and Kyoto-ya. The report will consider whether the projects fit in the Company's strategy and market position and will analyse their financial viability and feasibility.

ANALYSIS

Suitability

Suitability of a proposal is concerned with whether it fits in an organisation's current market position and objectives.

Our Company is targeting the young lifestyle-seeking and non-price-sensitive generation, and our products are priced at the higher end. We have built a solid network of relationships with celebrities in town, including TV stars, key opinion leaders, and successful businessmen.

The Bel Ristorante Deal

The Bel Ristorante, a high-end Italian restaurant chain, fits in the profile of our Company and shares a similar market strategy in terms of both food quality and services levels.

It also matches our Company's growth strategy and may be considered as an advantage for our entering into the mainland China market.

As it is a brand newly introduced to the Hong Kong market, leveraging our existing social network may be a cost-effective approach, especially for a similar segment of target customers.

As the growth potential of Gelato Café's existing market seems to be limited, introducing a new line of restaurant chain may help the Company overcome this limitation.

The Kyoto-ya Deal

Kyoto-ya, the matcha-themed restaurant chain, is a well-known and long-established brand name in Japan.

The poor performance in the past may have created a negative image for the brand in Hong Kong. Re-building the brand from a negative image is relatively costly and requires heavy investment in terms of time and effort.

The poor performance in the past may imply mismanagement of the existing franchisee, in which our Company may require a re-structuring of management/ staff, which will be costly and time-consuming as our Company has no prior similar experience.

Acceptability

Acceptability is concerned with whether stakeholders will support a strategic proposal. The reaction of different stakeholder groups will often be influenced by the risks and rewards that the proposal offers.

The Bel Ristorante Deal

As the Bel Ristorante is a brand-new start up, there is more room for discussion with the partner, and we will have more flexibility in the financial planning. The pace of growth can also be managed accordingly.

Our experience in the Hong Kong market will help us work on a reliable financial projection.

We may also consider accepting the Bel Group's equity investment in the business, so that our financial risk and exposure can be better managed.

However, as the Bel Group is keen to have control over the business, this may create potential conflicts in further development, as we intend to use the Bel Ristorant as a major part of our Company's development in the future.

The Kyoto-ya Deal

Acquisition price is always regarded as a major point of consideration in an acquisition deal. For the Kyoto-ya deal, under the current situation, our Company seems to be on the stronger side of the negotiation and can likely bargain a favourable price, which will lower our entrance costs and reduce the investment risk.

Through the acquisition, we will be able to obtain the assets, knowledge, and experience, including the operating problem faced before, within a short period of time. This will shorten the setup time and learning curve, hence improving the financial performance of the investment.

It is worth noting that the recent personal affairs of Li that is leading her divorce may indicate her financial needs and urgency in disposing the business. This likely allows us to further lower the acquisition price of the deal.

On the other hand, acquiring entities with poor historical performance always means inheriting problems from previous management and/ or operation, which may drain our Company's financial and non-financial resources and may even negatively affect the existing business. For example, the committed lease agreement and inherited employees are issues to be addressed.

Although the purchase price may be favourable, the poor financial performance of the four outlets may require further injection of funding before turning into profit. Cash flow needs to be carefully examined.

Feasibility

Feasibility involves assessing whether an entity has sufficient resources and competencies to implement a strategy successfully.

The Bel Ristorante Deal

The Company has opened six cafés before and has relevant experience in relation to operational or regulatory requirements for new store openings. With everything under consensus between our Company and the Bel Group, there should not be any problem in the opening of new outlets from an operating point of view.

Financially, with the support from the Bel Group and with the good business performance of our Company, funding should be reasonably convenient to accommodate unless an extremely fast expansion is required, which should not be the case.

Though the shareholding percentage arrangement with the Bel Group has not been finalised, assuming a 50:50 basis, our Company will require HK$3.5 million as initial investment, which is equal to ~80% of our past two years' profit. We can therefore meet the funding requirement based on the operating profit generated without the need to request additional funding from third parties/ shareholders.

In view of the complexity of the food and services provided, running a high-end Italian restaurant may be more complicated compared with operating Gelato Café. However, contributions from the Bel Group may help counter such difficulties.

The Kyoto-ya Deal

Our experience will be helpful in enhancing the business of the four non-performing outlets.

Leveraging on our existing social network, we will likely be able to promote Kyoto-ya in a cost-effective way.

However, our Company has no prior experience with acquisitions, and the poor performance of the Kyoto-ya outlets may reflect that the existing operators do not know how to fix the issues or may not even be aware of what the problems are. These operational issues may require an in-depth investigation and may not be easily overcome.

In addition, we may not be able to detect any hidden risks or exposure in the acquisition. Whether the brand owner will continue to grant the franchise to our Company after the acquisition is also another important matter to consider. Before confirming such an acquisition, it is important for us to meet the brand owner to understand their intention and to agree on a continuity agreement.

To finance a new investment, the most popular sources of funding are:
(i) the Company's internal fund;
(ii) borrowing from third parties, such as bank loans; and
(iii) shareholders' injection of new funds.

Based on the financials of the Company and considering the proposed investment of HK$10 million, the required funding represents more than 230% of the recent two years' profits. Thus, purely relying on internal funding is not an appropriate solution.

As a medium-sized private company, raising external funding for the acquisition of a loss-making business that we have little experience with may not be easy. The funding sources are limited, and the finance cost may be high even if funding is available. Our Company or shareholders may be required to provide some forms of guarantee/ indemnity when taking up a bank/ third party loan, if available.

We may therefore consider a mixture of (1), (2), and/ or (3) to finance the new investment to lower the financing costs.

Change of management, system, structure, or staffing, if needed, will involve a lot of resources which may be costly or even not available to the Company.

Financial Analysis:

	Bel	**Kyoto-ya**
	HK'000	*HK'000*
Revenue	59,352	80,115
Gross Profit	41,246	58,886
GP ratio	69%	74%
Profit before Tax	5,215	7,863
(as % of Revenue)	9%	10%
Profit after Tax	4,355	6,566
(as % of Revenue)	7%	8%%
Operating Cashflow	9,355	8,566
Initial costs + Capex	7,000	10,000
Return on Investment	62.2%	65.7%
Payback	~ 4 years	~ 5.5 years

The above table summarises the financial projection of the two projects for first five years of operations. Apparently, Kyoto-ya provides better revenue and slightly better profitability but with a much higher investment amount. On the other hand, Bel generates better cashflow and hence a shorter payback period for the investment.

Suggested Solution 3(b)

EVALUATION

Strategy

Both deals fit the strategic direction of the Company.

Nevertheless, building a long-term relationship with a well-known strategic partner, the Bel Group, adds value to the potential development opportunity in mainland China, which includes provision of financial and operational resources. As a private company, this is considered valuable support.

Capital funding

Liquidity is always one of the key success factors for a company's development, and cash flow management is therefore very important. Direct acquisition of a loss-making business requires our Company's own funding in case no bank loan is available. Even if a loan could be arranged, stringent covenants may be imposed on our Company which may limit our future development. More importantly, additional funding may be required to support the acquired business before it turns around, which may create further cashflow burden. As a result, our Company may suffer from higher cash flow pressure.

On the other hand, partnership helps reduce pressure on funding, especially when the partner has a strong financial background, and our Company can negotiate for a favourable shareholding based on our intended capital contribution.

Profitability

In term of profitability, the Kyoto-ya deal projects better profitability and return on investment. However, the comparison is based on the acquisition of four outlets in the Kyoto-ya deal compared to the setup of one outlet for the Bel deal, with a different level of investment amount.

Cashflow

The Bel Ristorante deal projects a much better cash generating ability with a lower investment amount. As a result, a more promising payback period is projected (4 years compared to 5.5 years).

Risk management

Outright acquisition provides a higher chance of return than a joint venture. However, it bears a higher risk at the same time. Both investments involve new business development with high levels of uncertainty. Therefore, risk management is critical, especially for a private company with limited funding sources.

The Kyoto-ya deal proposes 100% acquisition of a loss-making business, which poses a higher risk to our Company even though the acquisition price could be lower.

The risk of the Bel Ristorante deal would be shared by our partner, and with our partner's financial and operational support, the risk level will further be reduced.

Implementation

In view of the aggressive expansion plan in mainland China, our Company will face more pressure on the availability of resources in the near future. At the same time, the opening of new restaurant chain will be demanding from both financial and operational perspectives.

Though the acquisition of an existing business does not require a full brand-new setup compare with a new joint venture arrangement, turnaround of a loss-making business will require no lesser resource deployment and management attention, if not more.

RECOMMENDATION

After evaluating the two proposals from strategic, financial, and execution aspects, the Bel Ristorante deal would be recommended, as it fits in the Company's existing strategy as well as future development and is expected to be financially and operationally viable and less risky. The introduction of a joint venture partner with a strong financial background will also be beneficial for us to ensure availability of sufficient resources to execute our development plan. We will be able to focus on the area of our own strength, especially on the marketing side, and ride on the support from our partner to operate the new high-end Italian restaurant. Synergies are expected.

* * * END OF EXAMINATION PAPER * * *