

HKICPA Business Case Competition 2021

CPA & Co.

Overview

CPA & Co. (CPAC) is one of the leading professional services firms with offices in 150 countries and more than 250,000 staff. CPAC provides a full range of audit and assurance, consulting, tax and advisory services to local, multinational and growth enterprises clients in the world.

Audit and Assurance

CPAC's Audit and Assurance team provides clients with statutory reporting, auditing, public offering and related advisory services.

Consulting

CPAC's consulting team assists clients in design and execution of programs and solutions in relation to human capital and business operations. It also provides technology services to match the clients' business strategy.

Tax

CPAC has an experienced team of tax accountants and lawyers who help the clients to formulate and implement integrated tax and legal strategies and offer tax compliance services related to business tax, international tax, transfer pricing and tax disputes, etc.

Advisory

CPAC's advisory team provides a wide range of services to help clients address their strategic needs and various risks including but not limited to financial, regulatory and operational risks. In recent years, the team has expanded the range of services to cover corporate finance, merger and acquisition, restructuring and valuations.

Last week, Michael Yip, managing partner Asia Pacific of CPA & Co., attended a webinar on expanding business in new distribution channel. After the webinar, he had a private chat online with Herman Tam, Chairman of Zodiac Fashion Company Limited and exchanged their views on recent economic situation.

Michael: I thought 2021 will not be as tough as 2020 with higher vaccination coverage.

Herman: Agree. But I believe it is still very difficult for fashion business!

Michael: How is that?

Herman: With the major cities locked down during the pandemic, we had a serious hit in revenue as well as the profit last year. This year, with more people vaccinated, hopefully, the social activities will be resumed. However, I am worried about how the company should react to the post pandemic environment. Fashion industry is also challenged for making sizable contribution to climate change and more stringent environment protection policy is expected to come soon. In addition, I am getting into some difficult situations in the previous acquisition case. In short, we are looking for professional advices for our future business strategy facing the challenges and opportunities in all relevant aspects.

Michael: That sounds like an opportunity between us for business development! My firm has always been partnering with clients to resolve difficult situations.

Herman: What do you suggest for my company?

Michael: Let me have my team analyse your company's situations, and develop a business proposal on how we can assist your company, and we can re-engage later this month.

Herman: Great Idea. Looking forward to that.



Your Action – HK Undergraduate

You are working as a senior manager under Michael in CPA & Co. This morning, you received the following email from him.

Potential Client – Zodiac Fashion Company Limited

Message

Delete Reply Reply to All Forward Attachment Meeting Move Junk Read/Unread Follow Up

A special edition on the coronavirus pandemic

MY Michael YIP <michaelyip@cpac.com> Yesterday at 7:10 PM
To: Kate Wong <katewong@cpac.com>

Kate,

I was approached by Herman Tam, Chairman of Zodiac Fashion Company Limited for our services.

I need a business proposal for Zodiac in a month. This should identify and analyse the company's problems/ potential opportunities, suggest feasible strategies for the company and **indicate how we can help the company to implement the strategies**. It would be even better if we also review its treasury operation to help the company under the difficult business environment. I am also expecting analysis and advice for the incident around Eric Kam. You may refer to the relevant information of the company sent to you separately.

Please liaise with partners from assurance, consulting, tax and advisory to see what services we can provide.

We can focus on proposal first while engagement fee can be discussed at later stage. In addition, the company is also very familiar with our firm background and service capability.

My target is to have a 15-page business proposal starting with executive summary of not more than 3 pages.

Regards,
Michael

Prospective client information – Zodiac Fashion Company Limited

Background

Zodiac Fashion Company Limited (ZFC) is a company based in Hong Kong which produces the internationally-successful **Zodiac Fashion** and **ZF Libra** brands of fashion costume. It has a global reputation for good quality, affordable and fashionable clothes.

The company was established, and then owned for over 100 years, by a famous European family that established a global reputation in the fashion industry. In 2005, it was acquired by a wealthy Hong Kong investor, who then sold most of his shares when the company was listed on the Hong Kong Stock Exchange (HKEx) in 2007.

The corporate head office was relocated from France to Hong Kong in 2006.

The company specialises in the design and sale of high-fashion clothing, and the Zodiac Fashion brand has a very strong and positive image world-wide. During the course of one year, the company produces over 15,000 new fashion designs, mainly for well-established items of clothing, and it has a large in-house team of fashion designers. The company's top designers have an international reputation.

ZFC has spent a considerable amount of money to enhance the global reputation of the Zodiac Fashion brand each year. It has co-ordinated advertising campaigns, using top fashion models, with extensive advertising in premium and high circulation magazines and other media. Management believe that its advertising campaigns are effective in promoting the strong image of the Zodiac Fashion brand. ZF Libra focuses relatively more on the younger generation characterized with colours and brands cross-over products.

Company operations

ZFC has a large design team, based mainly in Hong Kong. Most designers work on producing new fashions for the company's main product ranges. For most products, there are four fashion seasons each year, and new fashion items are produced for each season. The four seasons are:

- January to March (spring season)
- April to June (summer season)
- July to September (autumn season)
- October to December (winter season)

Due to the nature of fashion clothing, product items that remain unsold at the end of each season are difficult to be disposed.

Distribution and sales

The company's products are sold mainly through stores. Some of these (retail stores) are managed by ZFC itself and sell only goods of the Zodiac Fashion and ZF Libra brand. Other sales are made through other department stores (wholesale stores), where ZFC is given space for selling its products. There are currently about 800 retail stores and about 7,000 wholesale stores, although the number of retail stores is increasing and wholesale stores have been falling in number.

Most stores are in Europe, particularly the countries in the eurozone. There are also wholesale stores and a small number of retail stores selling Zodiac Fashion and ZF Libra fashion products in Mainland of China but these currently account for less than 10% of sales. There are also some stores in Hong Kong, Japan and the east coast of the USA. A large 'flagship' store was opened in New York in 2017. A small proportion of goods are sold through the internet, and ZFC has established 'e-shops' in several countries.

Production and purchasing

Although all products are designed by the company's own design staff, most manufacturing is outsourced. The company uses a large number of small manufacturing companies and most of these manufacturers are located in Asia, including Mainland of China. The policy of relying on large numbers of small suppliers has been successful in the past, but ZFC has been experiencing difficulties recently in negotiating prices, due to rising costs in manufacturing.

All contracts for the supply of manufactured goods are priced in HK dollars.

The company also has its own manufacturing subsidiary, located in Mainland of China, but it produces less than 5% of the company's total annual requirements by volume.

From pre-ordering to just-in-time purchasing

The company's reputation has been built largely on the success of its fashion designs. It has a design team in Hong Kong. The company displays its fashions regularly at the major fashion fairs around the world, and its design team members are continually searching for new fashion ideas. Most fashion products are designed in advance of each season, orders are placed with manufacturers and the manufactured items are delivered to the retail and wholesale outlets before the start of the season. However, many wholesale outlets reduced their pre-orders of items in 2020, and placed additional orders with ZFC when they knew what sales demand for the season would be.

The design team in Hong Kong have been experimenting with a new just-in-time system of purchasing and production, similar to the system used by the Spain-based fashion goods producer. With this system, only limited quantities of products are manufactured for the start of each season. Members of the sales team in each region check the strength of demand for each product and inform the Head Office in Hong Kong which products are selling well and which are selling badly. Orders for additional quantities of the popular items are then placed with manufacturers, and distributed as quickly as possible to meet the sales demand.

Experiments with this just-in-time purchasing/manufacturing system have been only partially successful, due to the long time taken by external manufacturers to respond to orders for additional quantities of products.

Corporate values and ethics

The company does not have a formal mission statement. However its board of directors has tried to develop the company's reputation for social and environmental responsibility. The company's stated policies include a commitment to sustainable business practices, and recognition of employee rights, social justice and human rights. The company has recently publicised a new design policy that none of its products will be made from fur or the skin of wild animals, and it is expected that this policy will enhance the reputation of ZFC among its customers, especially young customers in Europe.

Market research has shown that customers for ZFC branded products are often socially and environmentally aware themselves, and many of them buy Zodiac Fashion and ZF Libra goods because of the company's reputation for ethical standards. In the past year, the company received several awards from international bodies in recognition of its ethical policies.

Year ended 31 December 2020: financial highlights

The company incurred loss for the year ended 31 December 2020. Due to COVID-19 pandemic, many countries were locked down and the retail stores in these countries were closed for a period and making a loss as a result.

The company's annual sales revenue and profit had been falling since the outbreak of COVID-19 pandemic. Although there has been some recovery in the global economy in late 2020, consumers' demand remains low in some European countries, such as Italy and Spain.

Sales turnover of retail stores decreased by 50% in 2020 and turnover of wholesale 'point of sale outlets' (POS) fell as well. Difficult economic conditions, particularly in Europe, meant that consumers had less money to spend on fashion goods and were resistant to price increases.

Although selling prices of fashion goods were stable, ZFC had to pay more to its suppliers. Suppliers, particularly those in Mainland of China, suffered from both wage increases and much higher prices of raw materials such as cotton. Cotton prices rose by 15% and 25% respectively for lower-quality cotton and high quality cotton during the year. Wage costs for suppliers rose by over 10%. The management are aware that some suppliers and customers are experiencing financial difficulty and may become insolvent and run into liquidation. Looking ahead, costs for suppliers in Mainland of China are expected to rise continually in coming years, due to the generally high rate of price and cost inflation.

There were also some losses from adverse exchange rate movements. Most of ZFC's costs are in HK dollars while most of its income are in euros.

Profits fell from HK\$5,108 million in 2019 to a loss of HK\$4,952 million in 2020.

The decline in profitability in 2020 was due to a combination of various causes, namely higher prices from suppliers, who experienced large increases in employment costs and materials costs; and drastic drop of revenue due to city lockdown around the world.

Operations managers have been looking for ways to reduce costs by improving efficiency, but results to date have been insignificant.

Summary of financial statements for 2020 are shown in Appendix 1, together with some other performance data.

Sales

An analysis of sales turnover in 2020, and comparisons with previous years, is shown below:

<u>Product line</u>	2020		2019	2018
	HK\$ million	% of sales	% of sales	% of sales
Women's fashion	6,440	41.5	40	44
Men's fashion	2,548	16.4	15	13
Kids' fashion	<u>2,796</u>	<u>18.0</u>	<u>21</u>	<u>22</u>
Zodiac Fashion	11,784	75.9	76	79
ZF Libra	<u>3,741</u>	<u>24.1</u>	<u>24</u>	<u>21</u>
	<u>15,525</u>	<u>100.0</u>	<u>100</u>	<u>100</u>

<u>Region</u>	2020		2019	2018
	HK\$ million	% of sales	% of sales	% of sales
Mainland of China	1,506	9.7	7	6
Europe	12,590	81.1	85	85
Other	<u>1,429</u>	<u>9.2</u>	<u>8</u>	<u>9</u>
	<u>15,525</u>	<u>100.0</u>	<u>100</u>	<u>100</u>

<u>Distribution channel</u>	2020		2019	2018
	HK\$ million	% of sales	% of sales	% of sales
Retail	8,418	54.2	51	44
Wholesale	<u>7,107</u>	<u>45.8</u>	<u>49</u>	<u>56</u>
	<u>15,525</u>	<u>100.0</u>	<u>100</u>	<u>100</u>

During 2020, some wholesale customers in Europe became insolvent and went into liquidation. During 2020, a number of loss-making stores in Europe were closed.

There has been a change in the mix of sales to wholesale customers starting from 2019. Fewer sales were pre-orders by customers, purchasing goods at the start of each season in anticipation of sales demand. More sales were obtained through short lead time orders, as wholesale customers responded to demand in their stores.

Competitor

The main competitor in Mainland of China is **Platinum Fashions Limited (Platinum Fashions)**. This is a Hong Kong based company that has retail outlets in more than 50 cities, where its brands are well-established and popular. This company has a 25% share of the total market for fashion clothes in Mainland of China. Most of its sales are low-priced fashion goods, but it has begun to develop a new brand range with a higher focus on quality and fashion. The new brand was launched two years ago and it accounts for about 8% of the Platinum Fashions' total annual turnover. If ZFC decides to enter the Mainland of China market, Platinum Fashions will be a major competitor.

Recent incident

In March 2018, the operations director of ZFC, Eric Kam, recommended to the board of directors that the company should purchase a fashion design company based in Hong Kong, Ron Fashion Limited (Ron Fashion). This was a private company with extensive experience in designing fashion clothing for markets in Asia. The full board of ZFC considered this recommendation and decided to make an offer for the acquisition. After friendly negotiations, 100% of the shares in Ron Fashion were purchased in August 2018 for a substantial price, in cash.

The chairman of ZFC, Herman Tam, was visited one week ago by Peter Zhou, the Deputy Operations Director, who said that he had acquired some disturbing information about the acquisition of Ron Fashion, which he had found by accident when searching through the e-mail folders of Eric Kam. It appeared that before recommending the purchase of Ron Fashion to the board of ZFC, Eric Kam had bought a substantial quantity of shares in Ron Fashion from a retiring director, and had paid a low price for them. He had used a company owned by his mother-in-law as a nominee to make the purchase, in order to keep his identity hidden. When ZFC bought Ron Fashion, Eric Kam made a large personal profit from the sale of his shares. Peter Zhou said that he was giving this information to Herman Tam in confidence, and expected his identity as the informer to be kept hidden.

Herman Tam immediately visited Eric Kam in his office, to ask whether this information was correct. He did not tell Eric Kam how he had obtained the information, but Eric Kam suspected that a person in his office must have been the informer. Eric Kam confessed that the information was correct, and that he had been aware when his mother-in-law bought the shares in Ron Fashion that their other major shareholders would be pleased to receive a takeover bid from a company such as ZFC.

Eric Kam has, to date, been an excellent Operations Director and Herman Tam stated his expectation to the rest of the board and also to the financial media that he wants Eric Kam to be appointed as CEO of the company when the current CEO retires in a few years' time.

Herman Tam was shocked and disappointed by Eric Kam's confession, and was not sure what to do. He did not know whether Eric Kam has acted illegally or was in breach of any regulations or code of conduct, and he was not sure what action (if any) should be taken against Eric Kam. He therefore invited two individuals to a private meeting, to ask for their views and advice. These were people that Herman Tam had known for many years, and respected greatly. One of them is James Ding, an enforcement officer at HKEx. James Ding is also a friend of Eric Kam, and they play golf together frequently. The other person is Ella Poon, a senior manager in Pluto Investments, an investment fund that owns shares in ZFC. She has been a great supporter of ZFC and was recently responsible for a decision by Pluto Investments to buy an additional 1% of the equity shares of ZFC.

This meeting was held today. At the meeting, Herman Tam explained the situation in confidence, including details about how the information was obtained from Peter Zhou. It was agreed that if the story was made public, there would be risks that some investors would sell their ZFC shares and the share price might fall. James Ding and Ella Poon were asked for their advice about the action, if any, that Herman Tam should now take.

Appendix 1: Summary financial statements for 2020 for ZFC

Consolidated statement of profit or loss for the year ended 31 December 2020

(All figures are in HK\$ million unless otherwise stated)

	2020	2019
Turnover	15,525	33,750
Cost of goods sold	<u>(7,917)</u>	<u>(15,702)</u>
Gross profit	7,608	18,048
Staff costs	(4,186)	(3,730)
Distribution costs	(1,150)	(1,146)
Advertising costs	(674)	(598)
Depreciation & amortization	(4,441)	(3,954)
Other operating costs	<u>(2,074)</u>	<u>(2,330)</u>
Operating (loss) profit	(4,917)	6,290
Interest income	89	86
Finance costs	<u>(28)</u>	-
(Loss) profit before taxation	(4,856)	6,376
Taxation	<u>(96)</u>	<u>(1,268)</u>
(Loss) profit after taxation (attributable to shareholders)	<u>(4,952)</u>	<u>5,108</u>
Dividends: interim paid and final proposed	0	4,070
EPS (basic), in HK\$	(HK\$4.50)	HK\$4.64

Consolidated statement of financial position as at 31 December 2020

(All figures are in HK\$ million)

	2020	2019
Non-current assets		
Intangible assets	1,030	1,045
Property, plant and equipment	<u>4,217</u>	<u>3,946</u>
	<u>5,247</u>	<u>4,991</u>
Current assets		
Inventories	3,037	2,757
Receivables and prepayments	3,488	3,403
Cash and cash equivalents	<u>928</u>	<u>4,461</u>
	<u>7,453</u>	<u>10,621</u>
Total assets	<u>12,700</u>	<u>15,612</u>
Equity and liabilities		
Equity attributable to owners of the parent company		
Share capital	110	110
Reserves	<u>5,727</u>	<u>10,679</u>
Total equity	<u>5,837</u>	<u>10,789</u>
Non-current liabilities		
Bank loans	1,900	0
Deferred taxation	<u>256</u>	<u>270</u>
	<u>2,156</u>	<u>270</u>
Current liabilities		
Trade payables and accrued expenses	3,720	3,541
Taxation	512	1,012
Bank loans repayable within 12 months	<u>475</u>	<u>0</u>
	<u>4,707</u>	<u>4,553</u>
Total equity and liabilities	<u>12,700</u>	<u>15,612</u>

Appendix 2: Other performance data, 2020

Other information

(All figures in HK\$ million)

<u>Sales through distribution channels</u>	2020	2019
Retail	8,418	17,213
Wholesale	<u>7,107</u>	<u>16,537</u>
Total	<u>15,525</u>	<u>33,750</u>

<u>Inventories at 31 December</u>	2020	2019
Finished goods	2,946	2,637
Consumables	<u>91</u>	<u>120</u>
Total	<u>3,037</u>	<u>2,757</u>

<u>Receivables and prepayments at 31 December</u>	2020	2019
Trade receivables	3,071	2,781
Less: Allowance for non-payment	<u>(343)</u>	<u>(212)</u>
	2,728	2,569
Prepayments	<u>760</u>	<u>834</u>
Total	<u>3,488</u>	<u>3,403</u>

Nearly all trade debtors are wholesale customers. Nearly all sales in retail stores are for cash (immediate payment in full).

<u>Receivables analysis: days since invoice issued</u>	2020
1–30 days	1,580
31–60 days	635
61–90 days	152
Over 90 days	214
Past due but not impaired	<u>490</u>
At 31 December 2020	<u>3,071</u>

The amounts past due but not impaired are amounts receivable that were renegotiated during the year and which would otherwise have been reported as 'bad debts' to write off.

<u>Allowances for non-payment</u>	2020
At 1 January 2020	212
Increase in allowance in 2020	286
Amounts written off as uncollectable	(122)
Effect of changes in foreign exchange rates	<u>(33)</u>
At 31 December 2020	<u>343</u>

Additional information – for Hong Kong undergraduates

Treasury operations

Inventory management

The analysis of working capital management shows that inventory levels are too high, and that most of the inventory consists of **unsold goods**. A problem for the fashion industry is goods that are unsold at the end of a season are very difficult to sell in the subsequent season. These inventories are held in both retail and wholesale outlets around the world.

Receivables Management

The **increase in receivables** in 2020, in spite of falling sales through wholesale outlets, has annoyed Wayne Tsai, CFO. He knows that the rest of the board of directors will want an explanation for this situation, and will want to hear the measures that the company can take to improve the situation.

Accounts Payable Management

Wayne Tsai is aware that a substantial number of the manufacturing firms that supply ZFC are in **financial difficulty**. Many of these manufactory firms, produce only Zodiac Fashion and ZF Libra products. Wayne Tsai is concerned that a large number of these suppliers might collapse in the next year or two. He is wondering whether the risks associated with upstream supply chain could be reduced.