



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



# **Qualification Programme**

## **Capstone**

### **Pilot Examination Paper**

#### **Version 2**

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## **Capstone – Pilot Examination Paper** **(Version 2)**

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 – Internal information of the expansion plan
- Exhibit 5 – Member's benefit leaflet
- Exhibit 6 – 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. At each shop, transactions are carried out using cash, Octopus card<sup>1</sup>, 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%.

<sup>1</sup> 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.

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## ***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.

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## **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. [See **Exhibit 5** for the member's benefit leaflet.]

## **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.

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## 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.

*"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.





19/06/2020 (Friday) 10:38

johncheng@gelatocafe.com

Welcome to Gelato Café

To skylam@gelatocafe.com

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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 information [see **Exhibit 4**], leaflet [see **Exhibit 5**] and media coverage [see **Exhibit 6**] for you to familiarise yourself with the business.

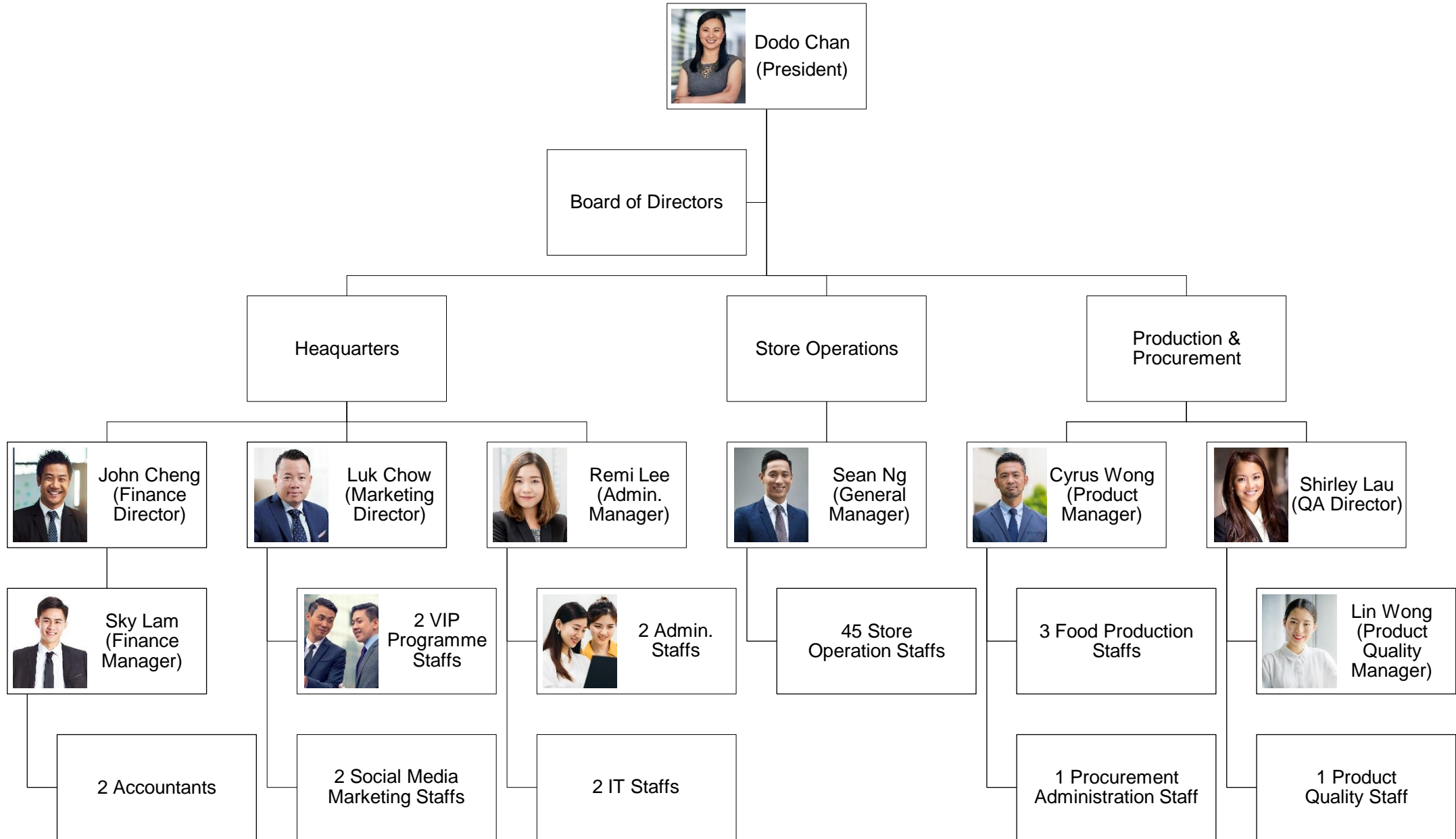
Again, welcome to the team. If you have any questions, please feel free to contact my secretary Linda for help.

**John Cheng**

*Finance Director*

Direct: (852) 2388 8832

Email: [johncheng@gelatocafe.com](mailto:johncheng@gelatocafe.com)



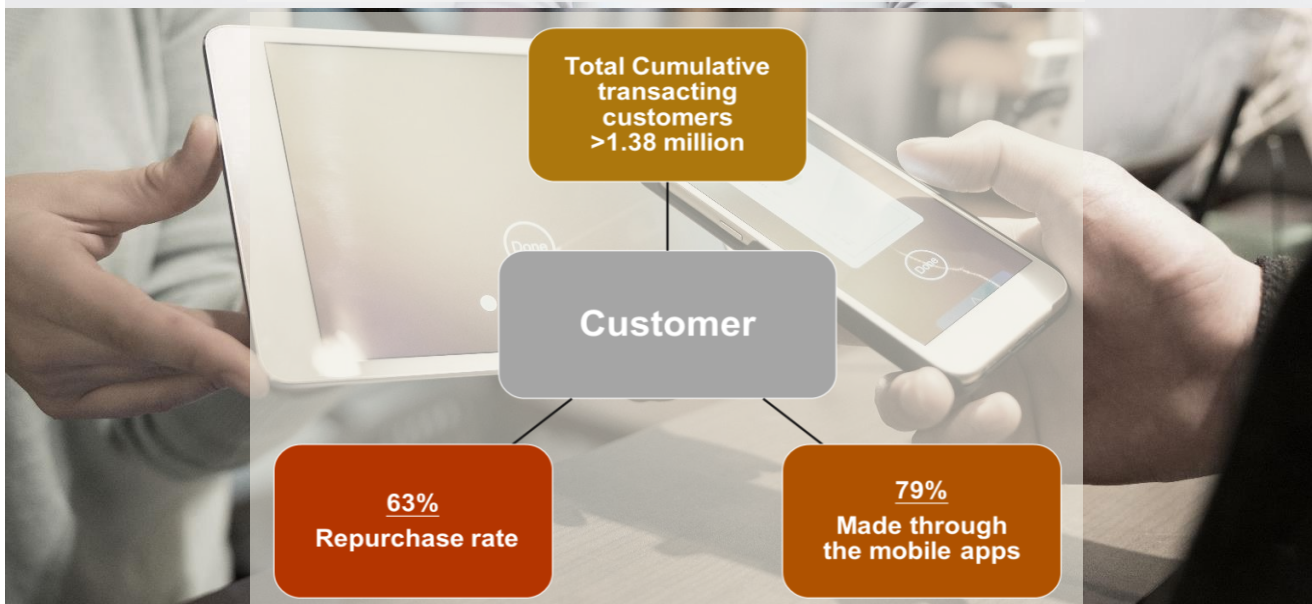
**Financial Summary as at 31 December**

**RESULTS**

	<b>2019</b>	<b>2018</b>
	<b>HK\$</b>	<b>HK\$</b>
Revenue	<u>21,047,341</u>	<u>17,466,673</u>
Profit before income tax	4,353,021	2,926,121
Income tax expense	<u>(773,329)</u>	<u>(697,867)</u>
Profit for the year	<u><u>3,579,692</u></u>	<u><u>2,228,254</u></u>

**ASSETS AND LIABILITIES**

Cash balance	28,350,445	22,689,250
Other assets	<u>47,492,218</u>	<u>45,909,577</u>
Total assets	75,842,663	68,598,827
Total liabilities	<u>(32,922,176)</u>	<u>(27,334,877)</u>
Total equity	<u><u>42,920,487</u></u>	<u><u>41,263,950</u></u>





## THE EXPANSION PLAN

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 4a** 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 4b** for the background of Kyoto-ya]

### **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.





**5% Cash Rebate!!!**

By storing money into our mobile App, you will receive 5% rebate as reward! You can use the stored value to purchase anything at all Gelato Café's.\*

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**HK\$400 for any 10 drinks or gelato!!!**

Get your e-coupons set to redeem ten cups of coffee of HK\$50 or less, or a double-scoop gelato of HK\$60.\*

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**Buy two get one free!!!**

From now until 31 December 2020, you can get one cup of coffee for free at any purchase of two cups of coffee. Come and enjoy the offer with your friends!\*\*

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\* To be used within 1 year of validity.

\*\* You can choose any a la carte coffee of same price or less for free.



# 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 organisations 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.

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.



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# F&B INDUSTRY IN HONG KONG

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.

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#### **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 restaurants 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.



#### **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.





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# Qualification Programme

## Capstone

## Pilot Examination Paper

## Version 2

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

**Capstone – Pilot Examination Paper**  
**(Version 2)**

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

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## **WRITTEN QUESTIONS** (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.

### **Question 1** (25 marks – approximately 80 minutes)

Recently news reported that two children had suffered from serious illness after eating gelato sold by Gelato Café. Gelato Café was not aware of the incidences until the second victim, child of a famous businessman, was hospitalised, although there were already news in town when the first child fell ill. There were a lot of criticisms on Gelato Café's management control and corporate governance, and some alleged that the Company did not care about victims who were not rich. 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.*

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As soon as the Company became aware of the incidences, the production and procurement department started an investigation and submitted the investigation report to the senior management team of the Company. The relevant email and conversations were recorded:

### **Email**

**To:** Senior Management of Gelato Café  
**From:** Lin Wong, Product Quality Manager  
**Subject:** Investigation on Recent Food Poisoning Incidents (Private and Confidential)  
**Date:** 1 August 2020  
**Attachment:** Investigation Report

Dear Senior Management,

Attached please find the investigation report on the recent food poisoning incidents. A summary of the findings from the investigation is provided below.

#### **Production defects**

- Initial evidence revealed that the gelato manufactured by the food factory on the particular dates was mildly defective in both the use of materials and the production process.

#### **Logistic company staff did not follow transportation procedures**

- The staff of the logistic company did not properly follow the regular transportation process when the gelato was delivered from our factory to Gelato Café on the day of the incidents.

#### **Gelato Café staff did not follow food safety policy**

- Our café staff omitted the inspection process for a particular batch of our gelato. The responsible staff were very busy on the date of the incidents.

Our department concluded that, despite the above procedural deficiencies noted, the gelato concerned should not cause any serious illness to consumers in general.

Please feel free to contact me for any further discussion.

Best regards,  
Lin Wong  
Product Quality Manager  
*Gelato Café Limited*

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**Conversations between John Cheng and legal counsel of the Company:**

Legal Counsel: "We have a few options here. If we choose to release only the portion about logistic company, instead of the full internal investigation report, to stakeholders and the public, there is a reasonable chance that a majority part of the blame would be on the logistic company."

John Cheng: "What if we do release the full report?"

Legal Counsel: "Then we could either admit the incompetence or ignorance of our staff to follow proper inspection procedures. Admitting incompetence of staff means that the staff has inspected the batch of gelato but lacks the necessary scientific knowledge to tell if they are safe for consumption. This option would lead to much lower litigation consequence compared to admitting ignorance to follow proper inspection procedures. No matter which way to report the case, it is highly probable that the Company would have to bear some consequence of the two illness cases and be charged of penalties by the Court."

John Cheng: "How much damage are we talking about?"

Legal Counsel: "If we admit staff incompetence, the payment of damages to the injured children could be as high as HK\$20 million. If we admit staff ignorance, the payment of damages could be as high as HK\$60 million."

John Cheng: "I think we could at most afford HK\$20 million. HK\$60 million is way too much for us and will definitely be detrimental to our Company's financials. I also need to speak with my finance team on this."

**Required:**

**Dodo Chan is preparing to discuss this incident in an upcoming board meeting. As the Finance Manager of the Company, you are required to prepare a memorandum to the Board of Directors with advice and recommendations on how the Company should disclose the findings of the inspection report and whether to admit fault to the public or to focus on the possible logistical error committed by the logistics company. You should provide a detailed analysis and reasonable arguments for your recommendations.**

## **Question 2 (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."

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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.**

**Question 3 (25 marks – approximately 80 minutes)**

Gelato Café is planning to open 24 new stores in mainland China by 2022, starting in Beijing and Shanghai. As mainland China is a fast growing and highly competitive market, the time to enter the market is crucial and the organic growth model deployed in Hong Kong may not be viable. The resources required for such a fast-paced development plan is also very demanding. Chan is thus considering various approaches.

An experienced consultant from Shanghai has recently contacted Chan and proposed a franchising arrangement.

Consultant: "We have some local operators that are interested in being a franchisee of Gelato Café. The franchisees will open new outlets and operate the Gelato Café franchise with their own funding and resources in mainland China. They will pay a fixed percentage of revenue as a franchise fee to Gelato Café, and a one-off upfront fee if required. On our side, we will charge a success fee for every franchisee introduced and every outlet opened."

Dodo Chan: "How about business registration in the mainland and initial setup?"

Consultant: "We will take care of these. Business registration can be completed within a short period of time. For the initial setup, we will provide a standard operation procedures (SOP) manual to all franchisees and training to their staff. We will also provide initial setup advice, including selection of site and decoration advice, and inspect for quality and compliance with SOP, to ensure the level of quality is met in each outlet."

Dodo Chan: "I will discuss with my team and get back to you."

Chan is very interested in the consultant's proposal, as franchising enables Gelato Café to increase its coverage in mainland China at a quicker pace, without heavy initial investment nor the no need to bear any operating cost. However, she is concerned about the tax exposure arising from the franchise income in both mainland China and Hong Kong, as well as other risks in relation to franchising in regions of different regulatory requirements. She is also unsure whether the Company's existing structure can accommodate such an expansion using a different business model.



**Required:**

You are required to prepare a memorandum to:

- (a) **Advise on the major risk and exposure of expansion in mainland China through franchising (including but not limited to corporate, operational, financial and taxation); and**
- (b) **Propose any changes in management and/ or operation structure for such expansion, if needed, to mitigate or reduce the potential risks of this new business model.**

\* \* \* END OF EXAMINATION PAPER \* \* \*

# Capstone – Version 2

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## Suggested Solution

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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**

To: Board of Directors

From: Sky Lam, Finance Manager

Date: 15 August 2020

#### **Submission of Report and Recommendation – Hospitalisation Incidents of Children**

In relation to the two hospitalisation incidents of children after eating our gelato, I would like to submit the following report and recommendations for your consideration.

In summary, the two incidents may have occurred due to the following multiple factors identified:

- (i) There was a mild defect in the production process of our gelato products in the two days of the incidents.
- (ii) There were logistic errors in the two days which might have caused the gelato delivered to become deficient for consumption.
- (iii) Our store operation staff committed an error in inspecting the receiving quality of the gelato from the logistics company in the two mornings in question.

At this moment, we have not yet further investigated and finalised the impacts and overall consequence of these deficiencies to the victimised children. Further investigation, including seeking advice from independent experts and food safety laboratories, needs to be carried out. Based on the current findings, I would like to draw your attention to the following possible consequences:

- (i) Our Company may face litigation raised by the parents of the victims, which may cost us penalties and compensation ranging from HK\$20 million to HK\$60 million as advised by our legal counsel.
- (ii) Our Company may also face a reduction in revenue and profitability in the near future due to a damaged reputation and customer criticism.

Given the situation, the following suggestions are submitted for your consideration:

- (a) Our Company always seeks to maintain high business integrity, ethical standard, and corporate social responsibility. Thus, it is not recommended to cover up certain observed errors concerning ourselves and to put the blame on third parties, i.e., the logistics company. This is not only unethical, but if discovered, would cause much more serious consequences to our Company.

On the other hand, if we observe good corporate governance and disclose all the findings with well-prepared remedial actions, although we may suffer more legal damage claims now, this would demonstrate our concerns to customers and show that we are responsible, which could help regain our reputation and rebuild our corporate image, thus leading to a more positive impact on our forthcoming revenues and profitability.

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- (b) Further investigation must be immediately carried out by an independent and qualified agencies to identify the probable consequence for each of the above observed facts on the child illness incidents. If we obtain independent and objective certification that some of our errors did not actually constitute any illness, such evidence would be useful to minimise the legal consequences and negative image to our Company.

Please note that if we cannot obtain any independent and objective certification, our own statements would not be persuasive at all as plausible defence in the Court, and customers will not believe in us.

We shall also engage professionals to perform a review of our internal control and processes to identify any areas of improvement needed.

- (c) No matter what the investigation results are, I suggest that we should first pay visits to the two children and their parents, expressing our deep concerns for their well-being. We may consider bearing some or all medical costs of the two children to show our corporate social responsibility, regardless of whether the illness is caused by our own faults. Our willingness to bear medical costs will demonstrate our goodwill to our stakeholders and help restore our reputation and corporate image to the general public.

Meetings/ training shall be done with all staff to refresh their knowledge and knowhow on the operational processes and emphasise the importance of adhering to the procedures.

The above action points may be shared with the public to demonstrate the Company is taking the incident seriously and is committed to doing better in the future.

- (d) If the Board decides not to disclose any of the above findings, it is important to make sure that the Company can afford any consequence of such a decision in terms of legal perspectives and customer relationships, considering that there is always a chance such findings could be released or become known by outsiders. Again, this is not recommended in my personal view as such damages could be significant and not affordable by our Company.

The above observations and comments are submitted for your kind consideration. If you need any further information or suggestions, please feel free to let me know.

Best Regards,

Sky Lam  
Finance Manager

## **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 utilise 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**

To: Ms Dodo Chan, CEO  
From: Sky Lam, Finance Manager  
Date: XX-XX-XX

### **Potential Impact and Consideration for Expansion in Mainland China through Franchising**

Our Company is considering a proposal on franchising Gelato Café in mainland China. This involves a new mode of business in a new territory with different operational practices. It provides opportunities and challenges to our Company. The associated risks and exposures, as well as any required structural changes, should be carefully considered and evaluated. The following are recommended for your consideration:

#### **(a) Major risk and exposure of expansion in mainland China through franchising**

##### **Corporate setup**

One of the major risks for franchising is on how to protect our brand name and to prevent any issues caused by the misbehaviours of the franchisees. In a remote arrangement, it may be difficult for the Company to note any issues, and follow up actions and response time to crisis will take longer.

Franchising is a different business model and requires different talents and skill sets. Currently, our management does not possess any prior experience for such a mode of business.

One of the key success factors ("KSFs") for our Company in Hong Kong is product differentiation. By franchising, business know-how and KSFs may be replicated by indecent franchisees who may then become competitors.

Mainland China is a region with a different business culture and regulations compared with Hong Kong. As such, we will need to reposition ourselves be prepared for any new learning curves.

##### **Operation**

Quality control of both food and services is crucial as it is one of our key success factors. However, franchisees may not share the same goal and objective as the Company. Franchising to different operators may unavoidably weaken the control on quality.

Different licensing and regulatory requirements in mainland China for F&B business. Though the Company is running its business through franchising, it is still important for our Company to obtain knowledge of industry requirements to avoid getting into trouble with franchisees' acts of non-compliance.



## **Financials**

Credit risk is always a concern for receivables from remote locations. A café business on its own is mainly a cash business that primarily deals with individual customers without any need for credit control. On the other hand, franchising will be a business dealing with corporations (franchisees), and credit control will be an important area for our management's attention.

As our Company has no prior experience with franchising, the setting of financial terms within the franchisees needs to be carefully structured in order not to jeopardise the Company's interest and/or violate any local regulation or attract any unnecessary tax exposure.

Due to the difference in accounting systems and practice, verification of franchisee's revenue will be demanding.

We may need to develop a new Standard Operation Procedure ("SOP") manual and training programs and to enhance various systems. These require upfront investments and may therefore tighten the Company's cashflow.

There may be a need to setup a franchise team and maintain a bigger Quality Assurance ("QA") team, which will increase the overhead costs. Revenue from a franchise fee is mainly tied with outlet revenue, which is highly variable and uncertain. It may take a long time to break even as it depends on the ability of the consultant to source appropriate franchisees and franchisees' performances.

Non-local currency, RMB, is involved in the new line of business. We will have to manage currency exchange exposure.

## **Taxation**

New tax exposure in both mainland China and Hong Kong should be considered as follows:

Collecting income and transferring from mainland China directly to Hong Kong is complicated. The transfer of franchise fee, commonly called royalty income in the mainland China, is subject to withholding tax.

- Under withholding tax arrangement, tax will be withheld and deducted from the franchise revenue and paid to mainland tax authorities by the franchisees before paying us;
- As Hong Kong adopts a territorial basis for taxing profits, whether the franchise fee is Hong Kong-source must be reviewed. Operation tests must be conducted;
- Whether the franchise fee is regarded as service income or royalty income sourced from Hong Kong must be reviewed;
- Based on existing information, the franchise fee will likely not be regarded as Hong Kong-source, as most of the services provided and the intellectual property used are outside Hong Kong;
- Even the franchise fee, wholly or partially, is subject to Hong Kong Profits Tax, the Company may apply for Double Tax Arrangement between mainland China and Hong Kong, and claim for the withholding tax paid in mainland China, which is at a concessionaire rate of 10% currently, as tax credit in Hong Kong profit tax assessment.

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On the other hand, the Company may consider setting up a subsidiary in the mainland to manage the franchise business, then it may involve the distribution of dividend by a mainland company to the Hong Kong holding company, which is also subject to withholding tax of 5-10%, currently.

In either case, careful tax planning and corporate restructuring is recommended, as this may help the Company significantly reduce the ultimate effective withholding tax rate it is subject to.

## **(b) Propose changes in management/ operation structure for franchising**

As franchising is different from the direct operation of a café, changes in organisation structure are required for such a business.

### **Human resources & organisations structure**

- The existing QA team should be revamped in order to cope with the regulatory requirement in mainland China. The travel capability of the team must also be enhanced.
- A training program for franchisees should be prepared.
- As different talents and skill sets are required for franchising a business, a separate, dedicated franchise team with knowledge in franchising in mainland China and travel capability is needed. The team should also be able to take up the role of consultant quickly, which is not only for the sake of saving consultancy fees but also to gain control of the development pace and direction.

### **Financial**

- Research on the market practice must be done in order to define franchise fee structure and level.
- Reporting requirements and regular communication channels must be set up with the franchisees.
- As the tax system in mainland China is different from that of Hong Kong, a tax study is required, and the Company must stay alert to any changes.
- As the business involves RMB as its major currency, monitoring exchange risk is required.

### **Operational**

- The Company should prepare a SOP manual which takes into consideration the regulatory requirement in mainland China.
- A regular review policy should be set in order to monitor compliance with SOP and the performance of all franchisees.

### **System and Technology**

- Due to the change in business model from direct operation to franchising, both the operating and accounting system need to be enhanced to fit the changing requirements.
- The communication system needs to support cross-regional communications: new equipment/ systems such as conference call system or video conference system should be considered.
- May need to consider a new monitoring system for franchising operation when the scale grows to certain level.

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## **Legal**

- Under different jurisdictions, the Company copyright/ brand name protection needs to be considered before being introduced into the new market. A brand name registration must be done.
- Laws and regulations in both Hong Kong and mainland China need to be carefully considered when drafting the franchising agreement, and the Company should stay alert of any change in laws and regulations in both locations.

Best regards,

Sky Lam  
Finance Manager

\* \* \* END OF EXAMINATION PAPER \* \* \*