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

Note: This case study is a work of fiction. Any resemblance to actual events or persons is entirely coincidental.

Refer to the Pre-seen case information previously provided and the additional information to answer these questions. 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)

As stated in the case materials, Beauty Kitchen ("BK") suffered from the adverse economic effects caused by the Pandemic. As a result, BK had closed nine restaurants and sacked more than one-third of its staff.

To minimise the adverse effects of the Pandemic, the following analyses and considerations were conducted by the former CFO and his finance manager during the first quarter of 2020:

1. Relevant Cost Analysis on Each Restaurant

   BK carried out a relevant cost analysis on closing-down decisions for each of the 18 restaurants that were operating at the beginning of the Pandemic. Existing costs of each restaurant were identified and classified into fixed and variable elements, and further classified into avoidable and unavoidable costs upon closing. Based on the analysis, nine out of the 18 restaurants could "save" a lot of avoidable costs if they were closed. The other restaurants, on the other hand, would not help much in minimising the total loss during the Pandemic if closed down.

2. Staff Cost Analysis on Each Restaurant

   BK also carried out a staff cost analysis for each restaurant to understand whether the relevant weighting of staff costs to the total costs of each restaurant were drastically divergent. This analysis was carried out because Victor was particularly concerned about the impact to employees if a restaurant was closed. Based on the analysis, Victor considered that there was significant impact to the existing employees of ten restaurants (these ten restaurants were not exact matches of the nine restaurants identified in the relevant cost analysis). For the other eight restaurants, it was considered that the closing down decision would not cause serious impact to the staff who might be sacked upon closure of the restaurants.

3. Staff Relocation Analysis

   It was expected if a restaurant was closed, some of the existing staff might be relocated to other restaurants that would continue to operate throughout the Pandemic. Based on the analysis, less than 15% of the staff could be relocated to other operating restaurants. In other words, if a restaurant was to be closed, at least 85% of the staff would be sacked and would become unemployed.



4. Business and Revenue Forecast and Analysis

   BK carried out a business and revenue forecast and analysis to figure out the possible timing and magnitude of restored business operations and forthcoming revenues. Although the Pandemic was beyond the control of BK, it was expected that business would start to recover from December 2020 onwards. Assuming the Pandemic would not worsen in both Hong Kong and the Mainland in the coming months, it was forecasted that business would resume to 50% of regular operations within the first two months from December 2020 and then resume to about 80% to 90% of the regular profitability prior to the Pandemic.

5. Cash Flow Analysis

   BK carried out a summary cash flow analysis (that is, not a very detailed analysis) for the Company. If BK did not close down certain restaurants nor reduce the staff numbers, it was forecasted that the available cash cumulated from past business could only be sufficient for the Company to operate up to May 2021. This analysis did not take into consideration any possible availability of loan resources or additional capital injection.

All these analyses and assessments had been carried out during the first quarter of 2020. Based on the analyses and recommendations, Victor and the team arrived at the decision to close down nine restaurants and terminate more than one-third of the staff. As the Pandemic situation might change, the management would like to have a review of the analyses and assessments conducted by the previous CFO and his finance manager to see if the closing down decision was made appropriately or not.

You, as the newly recruited finance manager, are required to:

(a) **Write a memo providing your opinion and comments to the CFO. In the memo, you need to give your opinion on whether the above-mentioned analyses were sufficient for the management of BK to make the said decisions. For this purpose, you are not required to carry out any detailed analysis of any individual item listed above in the question data. Rather, you need to analyse and state if these analyses taken together are sufficiently comprehensive enough to make a proper business decision under the circumstances (that is, whether these analyses taken together still miss some important issues of consideration, or it is already sufficient to draw a proper business decision).**

(12 marks)

(b) **Suggest additional analyses (limited to two only) that should be performed before arriving at the business decision of closing certain restaurants.**

Note: It is not necessary to present your answer in memo format. A general discussion and presentation of your answer is sufficient.

(6 marks)

(c) **Write a separate memo and present your opinion to the CFO who wanted to reconsider if this decision of closing nine restaurants and sacking certain staff was an irresponsible decision from the corporate social responsibility perspective.**

(7 marks)

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

In addition to taking cost saving actions to ensure its sustainability during the Pandemic, BK also considered how to grasp any opportunity to expand its business, either in business lines or in business volume, or both. But this was not an easy process for BK, as the situation was quite uncertain not only in Hong Kong but worldwide.

Apart from expanding the service to include also delivery services and sales of packed ingredients and soup bases in Hong Kong, and considering the suggestion of expanding its business into the Mainland through supermarkets, Victor and Maria suddenly came across the idea of expanding their business not in Hong Kong nor mainland China, but the overseas cities. This idea originated from two important phenomena.

Firstly, many Hongkongers had migrated overseas to cities such as Vancouver, Toronto, New York, Los Angeles, Sydney, Melbourne, London, and Manchester. These people had stayed overseas for many years, and they might not have easy access to well-prepared soup bases with good nutritional value. With most of these citizens who might have more faith in Chinese food also suffering from the Pandemic, they should welcome BK's food.

Secondly, apart from those who had already migrated, it was strongly believed that many Hongkongers were going to migrate to overseas very soon. These people were even more used to eating Chinese food. Victor and Maria were therefore quite optimistic in boosting the sales of packaged soup bases in these overseas cities over the next two years. By introducing this business line, BK could obtain pioneering profits at least for a few years.

Victor planned to produce vacuumed dried soup bases for people to bring over with them when they leave Hong Kong. Orders from overseas customers for these dried soup bases would be accepted through the web and shipped directly to them via postal or courier services. Since there was no plan to establish any branch company or permanent establishment overseas, Victor considered it feasible and convenient to start this proposed business. For this purpose, Victor, with the help of his accounting team members, prepared some preliminary financial data for the proposed business line:

Cost of Soup Bases:

Chinese herbal and soup base materials	HK$15 – 40 (depending on the type of soup base)
Cost of Packaging	
- Package bag	HK$3 per bag
- Vacuumed machine	HK$200,000 (functional for 200,000 or less vacuuming operations)
- Parcel box	HK$50 per parcel (with 15 – 25 bags inside each parcel)
Cost of Delivery	
- Posting cost (airfreight)	HK$13 per bag (with less than 600 bags per flight delivery) HK$10 per bag (between 601 – 1,000 bags per flight delivery) HK$7 per bag (with more than 1,000 bags per flight delivery)
Local Transportation	HK$1 per bag in most overseas cities

Note: The above cost calculations only focused on the direct costs of this proposed business line. Other fixed and overhead costs of BK were not yet taken into consideration.

Victor and Maria had made an initial estimation that in most major cities, the following monthly revenue forecasts (with sales price per bag and probability of sales) could be anticipated:

Sales price per bag	HK$80	HK$100	HK$120
Between 500 – 1,000 soup base bags each month	20%	25%	36%
Between 1,001 – 2,000 soup base bags each month	45%	50%	45%
Between 2,001 – 3,000 soup base bags each month	25%	20%	16%
More than 3,000 soup base bags each month	10%	5%	3%

Since the dried soup bases only contain Chinese herbal ingredients without any meat contents, Victor and Maria believed that this would meet the custom regulations of many countries and there would be no problem in delivering the soup bases to overseas customers. They also sought advice from relevant legal and logistics professionals in various countries to confirm this. Moreover, this business line would require little establishment costs, so it would not cause any immediate negative impact to the Company's cash flow problems.

However, VC, who owned about 15% of the issued shares of BK, did not agree with this idea. VC considered that it would be more secure and reliable to expand the businesses into mainland China, as both Victor, Maria and VC's management had much better knowledge and practices in the mainland market. By expanding to the mainland, business forecasts and other operational arrangements would be more easily engaged compared to a completely

brand-new process of selling the soup bases to overseas customers. But VC did not mention anything about their possible actions if Victor and Maria decided to go ahead with the overseas business line.

On a separate issue, since Victor and Maria did not have any experiences in selling overseas, they had some concerns about the initial and preliminary estimations on both the cost and revenue forecasts for the proposed business line. They were afraid of committing estimation errors through the ignorance of knowledge of the overseas markets.

You are required to:

(a) Analyse and evaluate, from an accounting and finance perspective, whether the proposed business line (to expand selling of soup bases to overseas cities) is feasible and profitable based on the initial forecasts prepared by Victor.

Note: You are not required to carry out any actual analysis in detail. A detailed budget income statement or cash flow forecast is not required. An approximate assessment of the proposal based on the given forecast data is sufficient.

(10 marks)

(b) Suggest with good reasons three to four key performance indicators ("KPI") that can be used and relied on by Victor and Maria for the first one to two years to review and evaluate whether the proposed business line is successful/ sustainable or not. Suppose Victor and Maria had decided to go ahead with the overseas business line.

Note: You must produce at least three KPIs for this question. If you produce just one or two KPIs in your answer, it is unlikely that you will be awarded a pass mark for this part. You must also give reasons and justifications on each KPI to demonstrate why you consider this a good KPI to evaluate business success.

(9 marks)

(c) Briefly discuss the various risks (accounting, management, and strategy risks) that need to be considered by BK before executing the proposed expansion plan.

Note: You must state at least ONE risk in any two of the three perspectives (accounting, management, and strategy) to obtain a pass mark. You can discuss risks in all three perspectives, but at least two of the perspectives must be discussed.

(6 marks)

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

In order to tackle the business downturn, which may last for an uncertain period, the management of BK needs to consider additional sources of funds to finance the daily operation for the Company and the newly developed business.

Years ago, the Company acquired a unit in a commercial building to serve as headquarters at a price of HK$20 million. VC offered to buy the property and lease it back to the Company for eight years (5 + 3) at market rate. The proposed acquisition price, HK$25 million, is based on a recent valuation from a well-known professional surveyor and considered to be the fair value of the property. The lease term will be fixed for the first five years at HK$1,000,000 p.a., with an option to renew for another three years, at a maximum of 20% increase in rental, subject to negotiation six months before the end of the first five-year term. VC would like to grant the Company a buyback option at a markup of 20% on VC's acquisition price, exercisable only at the end of the first five years, though the Company has no intention to exercise the option if they finally accept the offer.

The property was developed in the year 2000. As per the Company's records, commercial building allowance claimed last year was HK$200,000 p.a., with the final year of allowance in the year 2025. The property is now mortgaged with a local bank at an interest rate of 4% p.a., the outstanding amount is HK$4 million to be repaid within five years, and there is no penalty for early repayment.

While negotiating on the property deal with Victor, in a recent meeting Alan reiterated the Company's mainland China expansion strategy again, and proposed an expansion opportunity for their consideration.

A few weeks ago, a restaurant chain in mainland China, one of the VC's investments, suffered from serious financial difficulties. Its restaurants were operating at losses for more than a year. Eventually, the VC took 100% ownership of the chain. The chain included six restaurants, all situated in prime locations in Guangzhou and Shenzhen, primarily serving seafood and hotpot. The restaurants targeted at high-spending customers and provided resplendent decoration and luxury services.

Two options were proposed for their consideration:

1. VC will appoint the Company as general manager of the restaurant chain, in charge of the daily operation and responsible for all financial and operational management, including human resource arrangements and staff training. The Company will be entitled to 2% of the turnover as management fee, plus an initial fee for setup and staff training.

2. The Company will acquire all six restaurants from VC, as the first step for the Company to expand into the mainland Chinese market. Acquisition price will be based on a valuation report completed right before COVID-19 with a 60% discount, i.e. priced at about 40% of the valuation before COVID-19. The acquisition price will be settled by issuance of the Company's new shares to VC and no cash payment is required.

Details of any other terms are subject to further negotiation.

Victor and Maria viewed VC's proposal in relation to the property as a sensible arrangement to support the Company's finance during the current difficult moment. On the other hand, they were uncertain about the expansion option. Understanding that there may be room for further negotiation with VC about the detailed terms or even the price, a management agreement may nonetheless lead to a quite different strategic direction compared with a direct acquisition. Thus, the couple needed to seriously consider which business model would be more suitable for the Company's expansion, especially under the current market situation. They would like to have a meeting with the management team to discuss these issues.

As the finance manager, you are required to prepare a memo for management's consideration before the meeting, which should:

(a) Highlight the key accounting and tax implications of the proposed property transaction, and evaluate and recommend if the management should accept VC's proposal, from both strategic and financial aspects.

Note: only a high-level explanation is required; details of the accounting treatment and calculation are not required**.**

(8 marks)

(b) Suggest at least three other terms that may be added to VC's property proposal to help improve business flexibility of the Company, not including the purchase price and the 5-plus-3 years lease period.

(5 marks)

(c) Evaluate the two expansion options proposed by VC in relation to the six restaurants in Guangzhou and Shenzhen, and highlight any areas of concerns the Company should pay attention to during the coming discussion with VC.

(12 marks)

* * * END OF EXAMINATION PAPER * * *