



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



Qualification Programme

Capstone Final Examination

June 2022 Session (Pre-seen Materials)

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Capstone – Final Examination

Pre-seen materials provide background information and issues arising on a fictitious organisation that will be featured in the Capstone Examination. They will form the basis of the tasks you need to tackle 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 working days in advance for candidates to prepare for the examination through independent reading, research in industry and news, etc.

The pre-seen materials contain:

- The Case Background of Beauty Kitchen
- Exhibit 1 – Email from Chief Financial Officer, Tom Ho
- Exhibit 2 – Organisational structure of Beauty Kitchen
- Exhibit 3 – Key Operation Data of Beauty Kitchen
- Exhibit 4 – Memorandum to Procurement Team
- Exhibit 5 – Media coverages
- Exhibit 6 – Media coverages

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

Remarks: You are required to print and bring these materials with you to the examination centre on the examination date. No extra copies will be available in the examination centre.

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

Beauty Hotpot: Transforming during the Global Pandemic

"Hotpot – a simmering pot of soup and various raw ingredients – allows friends and family to gather round the table and enjoy a delicious but 'personalised' meal interactively."

Beauty Kitchen ("BK" or "Company"), founded by couple Victor To and Maria Yung in 2011, is one of the leading hotpot restaurant chains in Hong Kong. The Company first started as a private kitchen serving only hotpot to four tables at a time on the tenth floor of a composite building in Tsim Sha Tsui. With its very authentic and unique recipes, the tiny restaurant became the talk of the town within two months of its opening. It was full during lunch and dinner hours every day, making it impossible to secure a seat without prior reservation, which often had to be booked as far as two months in advance even during the non-peak summer season. In five years' time, the Company has earned its first Michelin star, has attracted external investment from a venture capital company ("VC"), and has become a leading restaurant chain in Hong Kong.

History and Development

Having been brought up in a single parent family, Victor has a particularly strong bond with his mother. Victor's mother is a master and teacher of Qigong, an ancient Chinese practice that combines breathing and bodily movements together with meditation. Not only has Victor learnt to practice Qigong with his mother since he was young, but by cooking with her while growing up, Victor has also learnt about the importance of food and nutrition for maintaining good health. As a result, Victor has been brought up with the habits of keeping young and healthy through exercise and nutritional care, which, in turn, have inspired him to become a Chinese Medicine practitioner after graduating with a degree in Chinese Medicine from a renowned university in Hong Kong.

Victor married Maria, a fashion editor of an internationally renowned fashion magazine, in 2009. The couple has always wanted to have their own business; as such, with Victor's initial capital gained from practicing in a local Chinese Medicine clinic for eight years, they founded Beauty Kitchen together in 2011.



"Beauty Kitchen is an unconventional restaurant in a conventional business. People are becoming more aware of the importance of maintaining a healthy lifestyle. Our herbal soup bases bring various health benefits to customers, and customers can learn from our menu what specific food is good for them and what food they should avoid. For instance, you can see that our menu notes that our duck liver and asparagus dishes are not suitable for people with gouty arthritis."

Victor To, co-founder and CEO of Beauty Kitchen

Beauty Kitchen is not a conventional hotpot restaurant. Beauty Kitchen's hotpot offerings, which differ from conventional hotpot, come in vegan-friendly soup bases. In addition, its soup bases are not classified by flavors, but by their various health effects and benefits. For instance, the most popular hotpots of the Company are the *Beauty Pot*, *Detox Pot*, *Invigorator Pot*, *Breathalyzer Pot*, and *Tonic Pot*. The health benefits are brought about by the herbal ingredients used in the soup bases. The couple work together on everything, from the development of the menu and the sourcing of ingredients, to the serving of customers.

Victor's knowledge of Chinese Medicine, in collaboration with Maria's sensitivity to beauty trends and resources in marketing, has helped the restaurant stand out from the crowd. Through Maria's connections, many celebrities in town have been invited to dine at the restaurant, and many of them deeply appreciated the Company's hotpot offerings and recommended them to others through social media platforms. Their photos, taken during their patronage as a token of appreciation, were posted on the restaurant's walls to attract customers. The Company gained a lot of popularity and grew into a local hotpot icon within half a year of operation. Business broke even within the first four months of operation.

Using their personal savings, the couple acquired the property unit of their restaurant within a year after learning that the landlord intended to sell the property. In the second year of operation, they also expanded their operation by renting the unit next door on the same floor, and in the third year they expanded to the upper floor. As operations expanded, the couple employed Sam Lam, an experienced chef, to help them with food sourcing and preparation. They also employed a few staff to help with cleaning and serving. Despite the service area having been expanded, the restaurant was still fully booked, and customers had to make reservations one to two months ahead.

In 2015, Beauty Kitchen won its first Michelin star. The couple was content with the business and never thought of further expansion until the VC from mainland China approached them and offered to invest in the Company during the year. The VC, which actively invests in various businesses in mainland China, had already closed two onshore funds within the past five years. The VC has a particular fondness for consumer businesses, and VC's portfolio generally consists of 30% of investments in food and beverage businesses, 30% in consumer staples, 30% in consumer discretionary and 10% in others. At the time the VC approached the Company, it was working on its first offshore fund to invest in non-mainland companies and had been discussing investment with a few international restaurant chains.

Alan Lee, investment director of the VC, is the person in charge of all the discussions and investment in Beauty Kitchen. Stern and experienced, he has given the couple confidence by giving them various insight and advice on the business of Beauty Kitchen. The couple has also been impressed by the VC's proposal and aspirations to expand their business into mainland China at a comfortable pace after their capital injection. The VC promised they would be very hands off and leave the operation of the Company in the hands of the couple, although they required to be given a seat in the board of the Company upon their capital injection. The VC expects the Company to quickly expand in Hong Kong with the help of their injected capital within three years, then to expand into mainland China using profits and reserves of the Company in the next three years, and finally to get listed in either the stock exchange of Hong Kong or that of Shanghai afterwards.

Finally, after various rounds of discussion, and knowing the VC would be investing in an international restaurant chain which the couple has always admired, the couple accepted the VC's offer of HK\$15 million and the VC became a 15% shareholder in Beauty Kitchen in January 2016.

Since then, Alan has been a non-executive director in the board of the Company. With VC's capital as well as profit from operations, the Company has quickly grown into a leading hotpot chain in Hong Kong within three years. In 2018, Beauty Kitchen, with about 400 employees and 18 restaurants situated in different locations in Hong Kong, won its second Michelin star.

Operations

The Company never stops developing. Victor, as the CEO, keeps innovating new soup bases and hotpot ingredients based on Chinese Medicine theories and practices. With the help of Maria and Sam, the Company rolls out a new menu every 12 to 18 months. New items that suit the trends, changing taste of Hongkongers and seasonality are added to the menu to replace less popular items.

Maria has changed her role from full-time to part-time fashion editor in the magazine company she has worked for since late 2011. The couple consider that maintaining Maria's role with the magazine company is beneficial to Beauty Kitchen's business given the valuable resources obtainable from her role with the magazine company. The Company has indeed enjoyed many such marketing benefits. Despite having to work as part-time fashion editor, Maria spends most of her time handling the Company's operations and takes on the role of chief marketing officer ("CMO"), though she actually works with Victor on every matter they encounter in the business.

Sam, the head chef, is a very talented chef with experience working as head chef in a few five-star hotels. In 2002, he opened his own Sichuan restaurant in Hong Kong, and Sam was reputed as highly probable to obtain a Michelin chef status. However, due to poor management, Sam's restaurant closed after three years. He went back to work in hotels afterwards until joining Beauty Kitchen in 2013. Sam is responsible for management of the kitchen team of each restaurant, ordering and purchasing of inventory, controlling raw material costs, and plating design. He is also a member of the executive team, but he spends most of his time in the kitchen of Beauty Kitchen's restaurants to ensure effectiveness of kitchen operations. Sam leads the chef team and is responsible for the management and training of all chefs. The chef team work closely with the restaurant management team.

The Company delegates certain restaurant level management responsibilities, such as restaurant staff hiring and personalised guest services, to restaurant managers. The headquarters, located in the same place as the Company's first restaurant in Tsim Sha Tsui, maintains control and provides mandatory and support services such as food and ingredient acquisition, promotional campaign, rental matters, repair and maintenance, and food safety risk management to all restaurants.

"The efficacy of our hotpots comes from the power of herbal medicine. All our soup bases are 100% plant based. We do business not only for profit, but more importantly, for educating the community for the benefit of our health, our planet and all animals. There is too much misunderstanding and too many rumours regarding vegetarian-based diets. Our whole family has been vegetarian for about 10 years, and I gave birth to our twins two years ago without any health concerns at all. We want to let people know the power of plants. We want to let people know that the right plants can actually do much more than any piece of meat to your health."

Maria Yung, co-founder and CMO of Beauty Kitchen



To improve efficiency and enhance customer loyalty, in 2015 Beauty Kitchen developed its own mobile application ("App") for customers to obtain a queuing ticket for a table, place orders online, record and make purchases, and enjoy various member benefits. Marketing, along with the development of the App, is handled by Maria and her team. The team is responsible for using advanced mobile solutions to provide enhanced customer experiences. Whenever Beauty Kitchen launches a new menu, the team will market it on the App and various social media platforms to attract customer patronage. The team is also responsible for the centralised arrangement of promotional campaigns and discounts.

The couple is particularly concerned with environment conservation and animal protection. They have set corporate social responsibility as their primary business objective. Therefore, the purpose of developing the App is not only to enhance customer experiences, but also to encourage all staff, and even customers, to go green and paperless. When placing orders, the App or serving staff will advise customers to avoid wastage by not ordering excess amount of food. As an incentive to promote a plant-based diet, the service charge will be waived if more than half of the orders are vegetarian dishes, and an additional 10% discount will be offered if the whole order is vegetarian.

"We assess our restaurant performance not only by sales, but, more importantly, by food quality and safety."

Jun Chan, director of food quality and safety

Beauty Kitchen produces all the soup bases for its hotpot offerings using herbal ingredients, and it allows customers to order various raw food dishes, such as meat, seafood, and vegetables, as hotpot ingredients. The procurement department, led by Carol Lau from headquarters, manages all suppliers and procurements of ingredients and other processed food such as soya sauce for all restaurants. It is also responsible for the management of decoration and renovation services and the procurement of decoration materials, equipment and consumables used in restaurants.

The Company is committed to providing food and service of utmost quality. In order to maintain service standards and food quality across all its restaurants, there are stringent and standardised quality control measures in place within the Company's supply chain and restaurants. The food quality and safety assurance team is responsible for the design and execution of the Company's quality control measures, and for the frequent and extensive quarterly assessments of restaurants based on an exhaustive evaluation checklist covering key aspects of restaurant operations such as evaluation of employee efforts (staff performance, cleanliness, etc.), guest satisfaction (service level, quality of food, etc.), compliance (fire safety requirements, etc.), and financial performance. These performance indicators directly affect the annual bonus of all restaurant staff. There are eight staff in the team, and they are led by Jun Chan, who has over 15 years of experience in food safety practice.

The restaurant management department is led by Alfred Chow, who is assisted by Helen Lo and Linda Hui. The team is responsible for the overall management of all restaurants. Alfred and Helen regularly provide training to restaurant managers and restaurant staff to ensure proper service level is achieved.

Through nonstop innovation of new products, Beauty Kitchen was able to maintain constant same store sales growth of around 10% annually from 2016 to 2019. Its overall table turnover rate was around four times per day in 2019. The average breakeven period of the Company's restaurants was around three to five months.

Macro Environmental Changes

Business went well until February 2020, when Hong Kong was directly affected by the novel coronavirus disease ("COVID-19" or "Pandemic"). To contain the spread of COVID-19, the government of Hong Kong has imposed different control measures from time to time: there was a complete restriction for dining-in at times of more recorded community infection cases, and a reduction of allowable dine-in customers at times of less recorded infection cases.

To survive the Pandemic, many restaurants cut down on both the number of staff and outlets. As there are dine-in restrictions, many restaurants offer a 20% discount for takeaway food to attract business. Some landlords, although not all, are kind enough to offer discounts or rental rebates for several months during the Pandemic. Shopping malls offer shopping and dining coupons to boost businesses for tenants. Unfortunately, many restaurants still have not been able to survive and have ended their businesses.

As hotpot is an interactive meal in which diners sit around to eat together, the business of Beauty Kitchen was seriously affected after a family contracted COVID-19 while having hotpot together. During the Company's worst period, the Company recorded no revenue at all for a consecutive three-month period.

Although the Company's executives were committed to fighting against the negative impact brought by COVID-19, little room for improvement was evident in view of the Pandemic situation. The Company was operating under heavy fixed costs. During months with dining restrictions, the Company had closed nine of its restaurants, sacked more than one-third of its restaurant staff, and requested more than half of its remaining staff to take no-pay leave on a rotational basis. Yet, the Company was still operating at a loss.

For each of its remaining restaurants, the Company applied for the Food Licence Holders Subsidy Scheme under the Anti-epidemic Fund operated by the Food and Environmental Hygiene Department ("FEHD") and successfully obtained a one-off subsidy of HK\$200,000 for each restaurant. The subsidies, despite being barely enough to pay the restaurants' heavy fixed costs such as rent and salary for about two months and a half, did help ease the Company's cash flow during the toughest moment.

The Turning Point

One of the most crucial issues for the Company was solving the backlog of fresh ingredients, such as fish, fruits and vegetables, delivered daily to each restaurant under signed purchase agreements. The management team came up with the idea of selling fresh food directly to customers by having a mini food stall setup next to the reception counter at the entrance of each restaurant. Fortunately, most restaurants were able to sell most of the fresh food before they became spoiled. However, this was not enough to cover the loss of the Company.

Finally, the management team came up with a refined business model. In July 2020, the Company started selling at its restaurant food stalls two newly innovated takeaway hotpot packages: the Vaccination Pot and the Power Pot. These two packages, each selling for HK\$499, include the selected body-strengthening soup base and a comprehensive set of ingredients for two people. Customers can even buy a set consisting of a pot and electronic stove for HK\$119 if needed. Moreover, Beauty Kitchen started providing delivery service.

"We want our customers to sit down, relax, and enjoy freshly prepared food served by us. We don't want them to go home with takeaway in a rush and arbitrarily prepare for their lunch or dinner. More importantly, we don't want to create more waste on our mother earth with one-off cutlery and packaging. Therefore, we don't offer takeaway."

Extracted from an interview in 2016 with Victor, co-founder and CEO of Beauty Kitchen

This is revolutionary to the Company. Beauty Kitchen has never provided take away or delivery services before due to concern over freshness of food and environmental issues. Victor and Maria are extremely worried about the significant environmental impact caused by waste produced from takeaway meals, such as plastic bags, disposable cutlery and food boxes. Therefore, the couple was particularly against the option at the beginning, although they surrendered after considering all the foreseeable loss and even closure of business if nothing were done. The Company's restaurants therefore started selling the hotpot packages, with packaging and cutlery all made with recyclable materials, though at a higher cost.

Beauty Kitchen cooperates with food delivery service providers ("Cooperating Partners"), who charge a certain percentage of the order price as commission or as a service fee. Customers can buy directly from the food stalls or place orders by phone or Beauty Kitchen's App and then pick up the food themselves at the food stalls. They can also place orders via the app of the Cooperating Partners and receive the orders at home.

At the beginning, the Company encountered difficulty in anticipating the sales quantity: about 50% of the prepared soup bases were unsold for the first week. In the second week, there were not enough soup bases prepared for sales. Finally, after around a month of trial and error, most of the restaurants were able to sell all the soup bases they had freshly prepared for the day, despite it being summertime. Beauty Kitchen's soup bases were once again highly sought after by customers. With a further restructuring of staff and with the closure of another three restaurants, the Company was finally able to financially break even, after seven months of loss.

To ride on the upcoming anticipated increased sales during wintertime, in October 2020 the Company transformed its very first restaurant in Tsim Sha Tsui into a mini factory for food production and packaging, and started to provide home delivery service for its freshly produced soup bases and ingredients.

Seeing the ample sales brought by the takeaway hotpot packages, Alan has stepped in and has suggested the team consider extending the sales of the Company's products to supermarkets. The team has welcomed the suggestion; however, some are worried that in order to sell in supermarkets, further processing of the soup bases and other ingredients will be required for an extended shelf life. This would imply a trade-off of freshness and, thus, healthiness. The executive team needs to ensure that the products do not lose the original nutritional value and that they maintain the freshness of ingredients as much as possible. This means it may be easier to sell the soup base alone, as it can be produced and delivered in batches. However, if fresh ingredients are also to be sold, the Company may need to deliver these packages daily to supermarkets to ensure freshness. This will require serious planning in logistics, production, and quality control.

Moreover, the Company needs to consider the impact on cashflow, as the payment terms by large and renowned supermarket chains can be as long as six months. The team has expressed their concern to Alan, who has suggested that he may not be able to alter the payment terms, but can negotiate for a better shelf fee.

Alan also considers this a good opportunity to expand into mainland China using the shelf products, given their good connection with a supermarket chain with presence in both the Mainland and Hong Kong. On the other hand, as the Pandemic seems to be better contained in the Mainland, Alan has also suggested the Company to consider opening its first restaurant in mainland China, either through direct operation or franchise. Alan has reiterated to the couple the need to expand into mainland China as it is a prerequisite for the VC's investment.

The team, although excited about the opportunity, remains cautious of it as they are still concerned with the impact and uncertainty of the Pandemic. While the Pandemic has brought serious disruption to many retail businesses, the team understands that it may also be a good opportunity for them to expand into the Mainland due to possibly lower costs of entry and possibly fewer competitors.

If the Pandemic does not further worsen the economies of both Hong Kong and mainland China, the Company expects its business should be able to resume to 50% of regular operations within the first two months of 2021, and resume to about 80% to 90% of the regular profitability in the second half of 2021.

The management team is seriously considering the best strategy to steer the business both in Hong Kong and mainland China. For Hong Kong, after comparing the increasing profits brought by takeaway and delivery services with the risks and heavy fixed costs of operating a restaurant, the team is hesitating on whether to reopen restaurants again after the situation returns to normal. For the Mainland, the team is considering whether to enter the market by selling pre-packaged food only, by opening self-owned restaurants given much lower costs in mainland China, or by franchise.

As the finance manager of the Company, you (Riz Chan) will be participating in an upcoming strategic meeting with Tom Ho, chief financial officer, to discuss together with the Company executives various business strategies as well as issues currently faced by the Company.

Exhibit 1



08/01/2021 (Friday) 13:48

tom@beautykitchen.com.hk

Strategic task force meeting

To: rizchan@beautykitchen.com.hk

Dear Riz,

We will have a strategic meeting at the end of next month to discuss the important strategies to be adopted by the Company. As this will involve significant financial data and consideration, I would like you and your team to help prepare a presentation that looks into various strategies to aid management decisions. The presentation should include the following areas:

- Current operating strategy
- Opportunities available to the Company
- Expansion strategy
- Financial strategy

Your team may need to liaise with different departments to obtain further operational details. My secretary, Mary, has prepared for you the most updated company structure fact sheet [exhibit 2] and is ready to assist you to arrange meetings, if necessary.

Looking forward to your presentation.

Best,

Tom

Exhibit 2

Beauty Kitchen Organisational Structure

Board of Directors

Executive Directors

- Victor To
- Maria Yung

Non-Executive Director

- Alan Lee

Executive Team

- Victor To, Chief Executive Officer (CEO)
- Maria Yung, Chief Marketing Officer (CMO)
- Tom Ho, Chief Finance Officer (CFO)
- Sam Lam, Head Chef
- Riz Chan, Finance Manager
- Jun Chan, Director of Food Quality and Safety
- Carol Lau, Head of Procurement

Departments (leader)

- Marketing: 6 staff
- Food Quality and Safety Assurance: 9 staff
- Procurement: 6 staff
- Finance: 5 staff
- Restaurant Management: 3 staff

Restaurants

- 9 restaurants
- 198 staff (5-6 chefs per restaurant)

Exhibit 3



For the year ended	<u>31/12/2020</u>	<u>31/12/2019</u>	<u>31/12/2018</u>
Number of restaurants	9	18	17
Number of staff	198	396	375
Average spending per dine in customer	HK\$462	HK\$493	HK\$489
Average spending per food stall customer	HK\$587	N/A	N/A
	<u>HK\$'000</u>	<u>HK\$'000</u>	<u>HK\$'000</u>
Restaurant operation	128,115	730,893	630,720
Delivery services	33,036	-	-
Food stall sales of hot pot set, condiments and food ingredients	49,555	-	-
	<u>210,706</u>	<u>730,893</u>	<u>630,720</u>
(Loss)/ Profit before tax (before FEHD subsidies)	(29,756)	126,445	95,869
FEHD subsidies	1,800	-	-
(Loss)/ Profit before tax	<u>(27,956)</u>	<u>126,445</u>	<u>95,869</u>
Net cash from operating activities	<u>(5,181)</u>	<u>75,967</u>	<u>74,078</u>

Exhibit 4

Memorandum

<BY EMAIL>

To: Procurement Team
From: Maria Yung
Date: 31 October 2020
Re: Issue with takeaway packaging and one-off cutlery

Dear all,

As all of you know, our company promotes environmental conservation, and therefore we have refrained from offering takeaway and delivery services for the past few years. Takeaway or delivery usually means food packed in plastic boxes, cardboard trays and paper bags, napkins, straws, or plastic containers for sauces, which are all further put into evil plastic bags. After the food is consumed, all this solid waste continues to exist and harm our earth. Plastic waste alone adversely impacts over 700 marine species, and we, Hongkongers, are using over 100 million takeaway items of disposable plastic every week!

Unfortunately, facing the backlash of the COVID-19 pandemic, in order to maintain the business and reduce the impact to all our staff and colleagues, we have started providing takeaway and delivery services as of July.

This does not mean that we surrender, nor does it mean that we cannot do more. Apart from the training our restaurant staff just received last week on minimal packaging of takeaway food, I would like our procurement team to put effort into sourcing sustainable packaging materials and tableware from now on. Let us start using sustainable alternative materials like plant fibers in our packaging materials. Use cardboard containers for food produced from modern mills, which consume less energy and resources during production, to replace our plastic and glass materials which are not biodegradable. If the use of plastic is unavoidable, source for new forms of plastics that use plant materials, such as corn, to produce.

We must play a key role in eliminating the global amount of plastic waste. We should never forget our responsibilities towards protecting the environment at all times.

I look forward to having your effort working together for a better world!

Yours sincerely,

Maria

extraNewspapers

ALL ABOUT THE BIG WORLD WE LIVE IN

EXCLUSIVE NEWS TODAY

COVID-19 UPDATES: hotpot family group of 9 confirmed with infection

While we suffer from COVID-19, mother earth suffering from plastic disaster

NGO has revealed an astonishing amount of plastic waste, which increased by more than double from 2019, produced by the rise in use of single use cutlery and packing for food takeaways amid the pandemic. NGO studies estimated that the number of takeaway food orders in the city have reached 3 million every single day, up 55% before the pandemic began.



It is suspected that a family hotpot gathering held on January 26, 2020 (the second day of the Lunar New Year) has spread COVID-19 to a total of 11 of the 19 family members who attended the hotpot event.

This is the largest number of infections within a single group detected in Hong Kong in this epidemic.

Two other patients who did not participate in the hotpot gathering were suspected of being infected by working with patients in the family at the same workplace, bringing the total number of confirmed cases related to the family to 13.

Scholars generally believe that COVID-19 can be transmitted through direct contact, droplets and aerosol pathway. Although it may be difficult to generalize whether eating hotpot will produce "bio aerosol" spreading COVID-19, in fact, getting infected by eating hot pot may involve multiple routes of transmission including droplets or direct contact. From this we can infer that there is a risk of transmission when eating hot pot. Also because eating hot pot usually involves gatherings of many people, this type of social activity is not recommended in the short term.

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THE SUN SHINE

Precipitation: 2% **Humidity: 74%** **Wind: 13 km/h** **10 December, 2020 Thursday**



Shipping rates rising to 'unprecedented' levels
Trade disruption causing containers to 'get stuck' until full loaded