

HKICPA Business Case Competition 2020

CPA & Co.

Overview

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

Audit and Assurance

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

Consulting

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

Tax

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

Advisory

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

Last week, Richard Yip, managing partner Asia Pacific of CPA & Co., attended a technology forum for automation. After the forum, he met David Chan, CEO of Speed Noodle Limited and exchanged their views on recent economic situation.

Richard: 2020 and 2021 will be very tough years after the COVID-19 pandemic.

David: Agree. In fact, business environment has been challenging for recent years.

Richard: How is that?

David: We are holding cash for business expansion, but it is difficult to find suitable premises for new outlets. We are doing more business but the cost is increasing even faster. Also, we are getting into some trouble on the minimum wages implementation. In short, we are looking for professional advices for our future business strategy in all relevant aspects.

Richard: That sounds like a real headache! My firm has been partnering with several clients coming up with workable solutions.

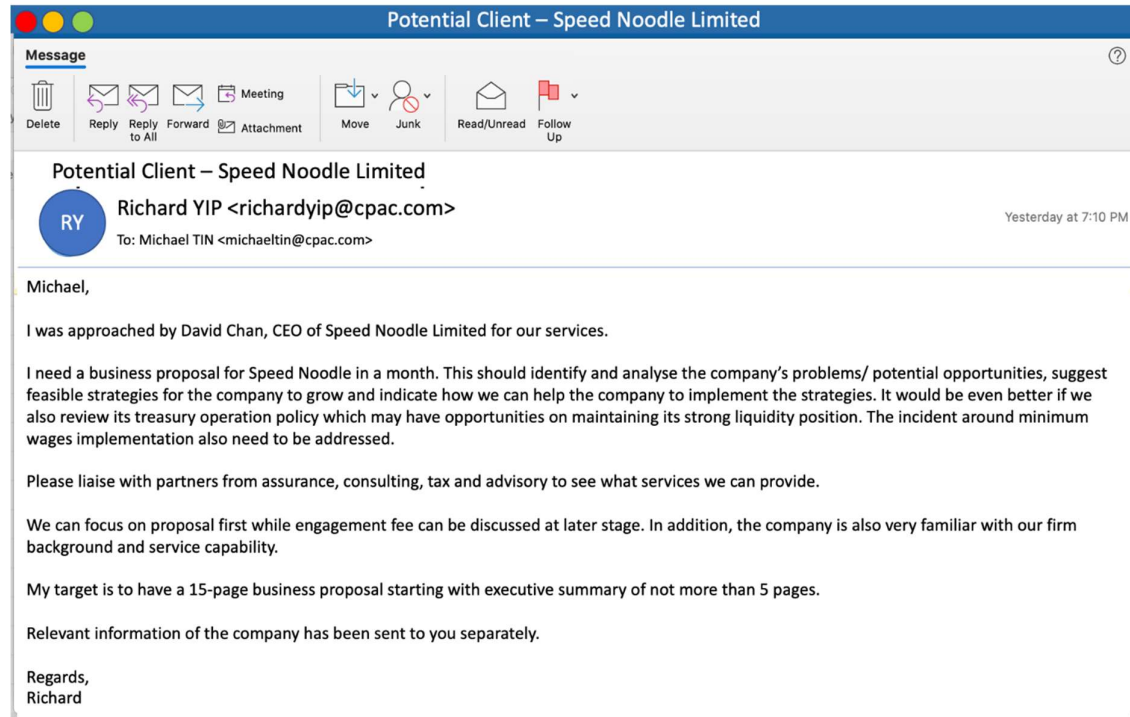
David: Do you think you can help my company for a breakthrough?

Richard: Definitely! Let me have my team analyse your company's situations, and develop a business proposal, and we can re-engage later this month.

David: Great Idea. Looking forward to that.

Your Action – HK Undergraduate

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



Prospective client information – Speed Noodle Limited ('SNL')

Background

Speed Noodle Limited ('SNL') began operations in Hong Kong 39 years ago, as a small family-based company. It was started in 1981 by Matthew Chan and his wife Cindy as a single noodle-specialist restaurant. Matthew and his wife had a dream to pursue for noodles, that's what other fast food restaurants had done for burgers – making them a cheap and cheerful fast food staple. They followed this dream and soon Speed Noodle restaurants began to spring up all over Hong Kong, with up to ten new outlets opened each year. The business continued to develop successfully over time, but it became much more difficult to find suitable premises for new outlets in areas where the company have no existing outlets yet.

Matthew therefore began to expand internationally. He began expansion in North America and then into mainland China.

In 1999, Matthew's cousin, Thomas Chan, was appointed as the Chief Executive Officer of the North American operation, but the operations of this division were restricted geographically to the North Eastern part of the United States. All the Speed Noodle outlets in North America were located in the states of New York and New Jersey. Market penetration had been slow and difficult, and the expansion was proved unsuccessful.

From 2001, SNL began to expand into mainland China, where growth was much faster than in the United States. SNL now has a large chain of fast food outlets in Hong Kong, mainland China and the United States, which are all operated under the name of Speed Noodle Bars ('SNB'). The company also operates a small chain of Hokkien Food House ('HFH') restaurants in Hong Kong. In total, there are now 135 outlets in Hong Kong, 56 outlets in mainland China and 24 outlets in the United States.

The company does not run a franchise model; rather all outlets are owned and operated by SNL. Matthew considered that by franchising Speed Noodle Bars, there is high risk of damage to the reputation of the Speed Noodle brand name.

The family business was listed on the Hong Kong Stock Exchange in 2001, when Cindy retired from the company. Matthew became the Chairman, a position he still holds. For a number of years he has also acted as the Chief Executive Officer (CEO), but in 2008 his son David Chan (a Hong Kong CPA) became the CEO, having spent several years as the Chief Operating Officer. Although there are other Board members, Matthew and David Chan exercise firm control over the business. 60% of the shares in SNL are owned by the Chan family.

More recently David Chan's daughter, Vicky, also became involved in the business. She started up a small side business, supplying the Hong Kong corporate market with in-house catering (lunches and evening functions). This is known internally as the SNL Corporate Catering business unit, and it has now been in operation for just over two years. Vicky is a young (26 years old) and ambitious entrepreneur. She has an Economics degree and has recently become a Hong Kong CPA. This is the first business venture she has been involved with, and may consider herself fortunate that her father had prepared to give her the opportunity to demonstrate her entrepreneurial ability. David Chan puts his trust in Vicky to leverage off the reputation and business of SNB and HFH and is allowing her to run the business with a high level of autonomy. She supplies monthly reports to the CEO and the Board on the performance of the business unit.

SNL has always prided itself on its excellent reputation for workplace safety and its high levels of staff satisfaction leading to strong staff retention rates. Matthew is viewed as a retail business leader in the Hong Kong corporate community and is a chair and member of various business and charitable boards. The entire family are perceived as valuable and philanthropic members of the Hong Kong community.

Recent developments

After a period of fairly rapid growth throughout the 2000s, expansion of the business slowed down in the last two to three years. Although annual sales revenue continued to rise, SNL did not open any new outlets in 2019. It was unable to find suitable new premises in Hong Kong. This acted as a severe constraint on business growth.

Senior management have considered faster expansion in mainland China, but so far the Board has taken a cautious approach. After some problems with operations at a number of outlets in 2012 and 2013, the Board has chosen, since 2013, to focus on increasing revenue and profitability in its existing outlets. Matthew in particular has supported the view that SNL should build up its existing business in mainland China before opening more new outlets there. Competition among fast food companies in the United States is strong: the Board was surprised at the intensity of price competition, which restricts gross profit margins. In addition, the large number of competing fast food companies give consumers wide choice, and it has been difficult to build up sales revenue in the United States outlets. The Board of Directors of SNL do not see any growth opportunities in North America in the foreseeable future.

Competition is also strong in Hong Kong and mainland China. This is keeping prices down, whilst rising costs of materials and labour have put pressure on profit margins.

SNL operates most of its outlets at leased premises. Typically, lease agreements are for periods of 10 – 15 years, with rental reviews every two, three or four years. Shortage of retail outlet space in Hong Kong means that rental costs are rising quickly, and this is also putting some pressure on profit margins. This pressure can be expected to continue as leases come up for renewal.

During the previous financial year, the company ended a long-running legal dispute with the lessor of two Hong Kong premises. As a result of the legal settlement, SNL received a one-off payment, after legal expenses of HK\$2,000,000 during the year. The legal dispute has created bad will between the lessor and SNL, and the Board of SNL is aware that the lessor may be unwilling to renew the leases when the current agreements end. The first lease renewal will be in three years' time.

Although the business did not open any new outlets last year, both Matthew and David Chan agree that SNL needs to look for opportunities for business growth. They believe that sales revenue growth will not continue without substantial new investment. David Chan is also of the opinion that although the company is very profitable, it has weaknesses in the management of costs and working capital. Action to deal with these problems should be beneficial to the profitability. Moreover, they are also considering the impact of social unrest and COVID-19 to the economic environment. It seems catering business will have a very pain period in near future.

The Board of Directors

The Board of Directors has firm leadership from its Chairman, Matthew Chan, and the CEO, David Chan.

There are two other executive directors:

- Robert Yang, Director of Operations. Robert has extensive experience in the fast food business, and was recruited to his position in SNL in 2008, when David Chan became the CEO.
- Kim Ho, Finance Director. Kim is a CPA and has a small accountancy team operating at head office.

Each of them owns a small quantity of shares of the company.

The company also has six non-executive directors; of these four are independent.

Business operations

Due to the nature of the company's main business operations, most of its sales are settled by cash. The only exception is the SNL Corporate Catering business unit, where sales to all corporate customers are on credit terms.

Currently food are all purchased from external suppliers. Purchased supplies are held in SNL-operated distribution centres in the relevant country of operation, from where they are distributed to the local SNB and HFH outlets.

Responsibility for business operations is divided. David Chan has overall responsibility for business performance. Three senior managers report to David. Robert Yang is responsible for the fast-food business operations in Hong Kong and mainland China and is regarded as the 'Deputy CEO' within the company. Vicky Chan has the responsibility for the SNL Corporate Catering business unit, reporting directly to her father David, and not to Robert. Thomas Chan has the responsibility for the US operations, and also reports directly to David.

Financial affairs are the responsibility of Kim Ho, who produces quarterly performance reports for the company. She is also responsible for treasury operations and the management of the company's cash and investments. Her current policy is to hold cash in the three currencies in which the company has business operations: Hong Kong dollars, Renminbi and US dollars, but she has also made some investment in British government bonds.

Summary of financial statements for the year ended 31 December 2019, and comparative figures for the previous year, are shown in Appendix 1. Segment performance figures for the year ended 31 December 2019 are shown in Appendix 2.

Recent incident

The introduction of a statutory minimum wage in Hong Kong of HK\$28 per hour from 1 May 2011 had a large impact on the bottom line of Hong Kong operations and is a contributor to rising costs. All employee wages were increased to reflect the minimum rate of HK\$28 per hour from that date.

On 2 April 2017, SNL released a press release stating their continued support of paying a base statutory minimum wage and highlighting their leadership in this area. The press release also stated that the SNL Board believed strongly in minimum wage protection for Hong Kong workers and called on the corporate community to put support behind minimum wage increases. The press release was written by the marketing department and signed by CEO, David Chan, and the Chairman of the Board and founder of the company – his father, Matthew Chan.

Vicky Chan, head of the SNL Corporate Catering unit, was not involved in this area of the business. It was not known whether she was aware of the press release, but its release was discussed at the last board meeting.

On 1 May 2019, the statutory minimum wage in Hong Kong was raised from HK\$34.50 to HK\$37.50 an hour.

On 10 May 2019, Lucy Lee, a junior chef of the SNL Corporate Catering unit, asked her boss when her pay increase of HK\$3 an hour would be paid: 'My boyfriend works for HFH (another arm of SNL) and he got his pay increase yesterday – when is mine coming through?' The boss reported this request to the manager of SNL Corporate Catering who emailed Vicky, asking when the minimum wage increase would be coming through.

Vicky sent an email to all line managers saying: 'Due to the fact that SNL Corporate Catering is in start-up mode, we are asking all staff to forgo the HK\$3 hourly increase for the time being until the business grows. Please inform staff that the wage increase will be given later in 2020.'

Lucy Lee was told about this and she was furious! She thought: 'Why should my boyfriend get the increase but not me – when we work for the same company?' She decided to complain to her boss who told her to 'be patient and grateful that you have a job'. After much thought, Lucy emailed the CEO directly using her publicly available email address, outlining the situation. She referred to the press release signed by David and his father, Matthew.

David received the email and met with his father Matthew to discuss the situation. He decided not to reply to Lucy until they had a solution.

Additional information – for Hong Kong undergraduates

Treasury operations

Inventory management

Food and consumables costs are a major part of SNL's operating costs, a recent investigation by the Finance Director Kim Ho and her accounts team found that at least 15% of food purchases for SNL's fast food outlets are thrown away.

There are two reasons for this. The company over-orders food from its suppliers. Purchased food items are held in central distribution centres, and surplus purchases are thrown away if they are not ordered by the fast food outlets within about 30 days. The second reason is that the fast food outlets pre-cook many of their products, and quantities that are not purchased by customers by the end of each day are thrown away.

Cash management and dividends

The Board of Directors often discusses cash management and dividend policy at its meetings. In the past two years, the policy of the Board has been to maintain a stable amount of cash holdings and invest the money to obtain a suitable return. This should enable the company to pay a large proportion of its annual after-tax profits as dividends to shareholders. Matthew Chan and David Chan, supported by Vicky Chan, are strong supporters of a high dividend policy. The Chan family holds 60% of SNL's shares.

An argument in favour of high dividend payouts has been that the share price will be higher because many shareholders prefer high income from their investments rather than capital gain.

Trade payables and other creditors

The Chief Operating Officer, Robert Yang, has reported that the company is now having some problems with suppliers in Hong Kong and mainland China about the time SNL takes to pay invoices. Some suppliers are also complaining that SNL is forcing them to accept prices for their goods that leave them with little or no profit margin on their business.

In Robert's opinion, suppliers need to accept the realities of business. SNL deems to be more credit worthy, and as it purchases food products in very large quantities, it is entitled to demand competitive prices.

David Chan is sympathetic to the complaints of suppliers, but he is also responsible for SNL's profitability. He would like to know how much it might cost the company to introduce a policy of prompt payments to suppliers – for example payment after seven or fourteen days of the invoice date. He thinks that for prompt payment on receipt of invoice, however, SNL would be entitled to demand an early payment discount.

Accounts receivable

Most of the company's sales are cash sales. The only exception are sales by the SNL Corporate Catering business unit. SNL does not have staff with much experience in collecting payments from credit customers in the accounts department.

Vicky Chan now thinks that the time may have come to improve the efficiency of trade receivables management, but she does not know whether there is a significant problem or what the potential savings from better receivables management might be. She is also aware that the success of her business unit depends heavily on providing excellent service and building good relationships with major corporate customers. She does not want to risk the loss of business because of demanding faster payment.

Appendix 1: Summary financial statements

SNL Company

Statement of financial position as at 31 December:

	2019 HK\$'000	2018 HK\$'000
Non-current assets		
Property, plant and equipment	1,169,261	1,135,284
Current assets		
Inventories (note 1)	97,131	82,677
Trade and other receivables	43,114	36,433
Prepayments and deposits (note 2)	49,620	54,865
Short-term investments	43,084	–
Cash and cash equivalents	478,878	561,144
Total assets	<u>1,881,088</u>	<u>1,870,403</u>
Equity		
Share capital and non-distributable reserves	491,828	491,828
Retained earnings	1,131,353	1,114,759
Total equity	<u>1,623,181</u>	<u>1,606,587</u>
Current liabilities		
Trade payables	69,262	70,635
Other creditors and accrued liabilities	174,125	171,008
Current income tax liabilities	14,520	22,173
Total liabilities	<u>257,907</u>	<u>263,816</u>
Total equity and liabilities	<u>1,881,088</u>	<u>1,870,403</u>
Number of shares in issue	<u>300 million</u>	<u>300 million</u>

Notes:

- 1 Inventories consist of food and consumable stores.
- 2 Prepayments and deposits consist of deposits and prepayments for rented premises and utilities, and for some purchases of plant and equipment.

Income statement for the year to 31 December

	2019	2018
	HK\$'000	HK\$'000
Revenue	2,984,900	2,665,080
Cost of sales	(2,558,653)	(2,170,966)
Gross profit	426,247	494,114
Administrative expenses	(157,688)	(136,852)
Operating profit	268,559	357,262
Finance income and net income from legal settlement (note 3)	12,926	11,857
Profit before income tax	281,485	369,119
Income tax expense	(46,318)	(60,160)
Profit for the year	235,167	308,959
Dividends	218,573	284,240
Number of shares in issue	300 million	300 million
Earnings per share	78.39 cents	102.99 cents

Note 3:

A legal settlement during the year to 31 December 2019 resulted in net income for the company of HK\$2,000,000.

Expenses by nature

Expenses included in cost of sales and administrative expenses are analysed as follows:

In the year to 31 December

	2019	2018
	HK\$'000	HK\$'000
Cost of food and consumables used	1,061,624	895,467
Depreciation	120,280	104,345
Operating lease rentals in respect of rented premises*	313,415	266,532
Employee cost	713,391	588,983
Electricity, water and gas costs	163,448	143,935
Advertising and promotion expenses	38,654	35,840
Provision for impairment of trade receivables	150	–
Other expenses	305,379	272,716
	2,716,341	2,307,818
Representing		
Cost of sales	2,558,653	2,170,966
Administrative expenses	157,688	136,852
	2,716,341	2,307,818

* For the purpose of this case, assume HKFRS 16 Leases has not been adopted for both year ended 31 December 2018 and 2019.

Appendix 2: Segment performance for the year to 31 December 2019

	HK HK\$'000	Mainland China HK\$'000	North America HK\$'000	Total HK\$'000
Segment revenue	2,396,200	435,800	152,900	2,984,900
Segment gross profit before depreciation and income tax	367,822	48,457	9,968	426,247
Depreciation and amortisation	85,262	25,712	9,306	120,280
Income tax expense/(credit)	40,981	5,387	(50)	46,318

Throughout the financial year, the company operated 135 outlets in Hong Kong plus its corporate catering service, 56 outlets in mainland China and 24 outlets in the United States.

Appendix 3: Trade and other receivables, prepayments and deposits

At 31 December:	2019 HK\$'000	2018 HK\$'000
Trade receivables	24,025	20,172
Less provision for impairment of receivables	(212)	(262)
Trade receivables – net	<u>23,813</u>	<u>19,910</u>
Trade and other receivables	43,114	36,433
Prepayments and deposits	49,620	54,865
	<u>92,734</u>	<u>91,298</u>

The company's sales to customers are mainly on a cash basis. However the company allows credit of between 30 to 45 days to corporate customers for the provision of the corporate catering services.

The ageing analysis of trade receivables is as follows:

At 31 December:	2019 HK\$'000	2018 HK\$'000
0 – 30 days	14,315	12,709
31 – 60 days	4,936	4,438
61 – 90 days	1,420	1,008
Over 90 days	3,354	2,017
	<u>24,025</u>	<u>20,172</u>

Sales to corporate customers were HK\$203,900,000 in the year to 31 December 2019. (2018: HK\$188,790,000).

The trade and other receivables and deposits are denominated in the following currencies:

At 31 December:	2019 HK\$'000	2018 HK\$'000
HK dollar	28,751	26,295
RMB	12,433	8,304
US dollar	1,930	1,834
	<u>43,114</u>	<u>36,433</u>

Appendix 4: Trade payables

The ageing analysis of trade payables is as follows:

At 31 December:	2019 HK\$'000	2018 HK\$'000
0 – 30 days	61,851	63,077
31 – 60 days	4,171	4,199
61 – 90 days	3,240	3,359
	69,262	70,635

The carrying amounts of trade payables are denominated in the following currencies:

At 31 December:	2019 HK\$'000	2018 HK\$'000
HK dollar	47,192	52,103
RMB	19,511	16,455
US dollar	2,559	2,077
	69,262	70,635