# Case Background and Questions

## Telly Toys Limited

### Overview

Tim Yeung and his wife May began their business about 25 years ago in Hong Kong, selling toys on a market stall. Through hard work and selling ability, they were able to develop and expand their business, and after a few years they opened their first toy shop. Their success in business continued. They incorporated the business 15 years ago as Telly Toys Limited (TT Limited).

Over time, they increased the number of retail stores and they now have 20 large stores in Hong Kong and mainland China. Three years ago, following a series of financially successful years, the company acquired public company status and a listing on the Hong Kong Stock Exchange (HKEx). As a result of the initial public offering by the company, Tim and May now own just 40 per cent of the company's shares.

Tim and May both continue to work in the business. Tim is the Chairman and Chief Executive Officer. May, who was already a qualified accountant when she started in business with Tim, is the Chief Finance Officer, responsible for general office administration as well as finance. Joining them on the board of directors is Tina Chan, who is responsible for retail operations in the company's stores, and Simon Lam, who is the director responsible for procurement of toy products for retail. The company also has four non-executive directors, although Tim and May both question the value of the contribution of these directors to the company.

### The market for toys

Until a few years ago, there had been a strong and growing market for toys in Hong Kong. Much of the manufacturing takes place in mainland China, Thailand, Indonesia and Malaysia, but major global companies have a large share of the manufacturing market. These global companies pay licensing fees to produce toys based on popular children's TV and film characters, commission their manufacturing from businesses in Asia and advertise and promote their products extensively. They sell their products mainly through retail companies and wholesalers.

Consumer demand for toys, in spite of a recent setback in global sales, is expected to remain strong in the long term, due to demographic changes and an increasing proportion of young people in several large countries. However, consumer tastes change quickly and there is a trend towards a much shorter life cycle for products, and more digital technology in toys. One toy retailer has commented that: 'Children are getting older younger.' To satisfy consumer demand, manufacturers need to spend extensive amounts of time and resources on research and development, and to innovate continually.

Manufacturers compete with each other largely on the basis of product quality, play value and price. Product safety is a major issue, for both manufacturers and retailers.

Toy retailers buy products from a number of different manufacturers. They seek to buy and re-sell the most popular products, but it is difficult to predict demand accurately, and retailers usually have to sell slow-moving items during sales periods at a deep discount to their original price. In an attempt to improve sales turnover, some toys retailers are experimenting with 'click and collect' online selling, where customers order goods online and collect them the next day from their local toys store or another collection point.

Retailers advertise their stores locally to customers, but rely on manufacturers for the advertising and promotion of products and brands.

## Profitability in the toy business

Although the market for toys has grown over the years, there has been a downturn in the past two years due to depressed economic conditions. Hong Kong has also been affected by a reduction in the number of foreign tourists, many of whom shop in Hong Kong's retail centres.

However, toy manufacturers have in general performed much better than toy retailers. This has been partially due to the strength of the US dollar, the currency in which the largest manufacturers trade. A strong US dollar has reduced their product costs and improved their gross margins.

In comparison, retailers have experienced some difficult times. Manufacturers have been reluctant to reduce their prices to retailers, and consumer demand for toys has been weaker, since toys are not a 'necessity'. Therefore, in these difficult economic conditions, customers have been less prepared to buy toys, except at very attractive prices.

In the past, manufacturers have provided retailers with a catalogue of their products for the next few months, and retailers decided which products to buy and in what quantities. They indicated their purchase intentions to manufacturers about three months in advance, and manufacturers planned their production schedules accordingly. More recently, there has been an increase in the frequency with which retailers have placed an order about three months in advance, but have subsequently reduced it or even cancelled it. Many retailers have also been making much more extensive use of just-in-time (JIT) purchasing, in an attempt to match their purchases to customer demand. As a result, manufacturers have found it much more difficult to predict demand quantities from retailers. This has led to conservative production scheduling by manufacturers and supply shortages for some of the most popular products.

## Operations

TT Limited has a warehouse in Hong Kong. Deliveries of goods from suppliers are initially held in the warehouse, but most are promptly distributed between the company's stores. An IT system tracks the location of stores items and sales, so that if one store runs out of a particular product item, replacement items can be transferred quickly from the central warehouse or another store. The IT system for tracking inventories and sales is in the process of being upgraded; there have been discrepancies in the past between inventory records on the system and actual inventories held in the stores and the warehouse. These discrepancies are caused by theft of items from stores, damaged items being discarded, and unrecorded customer returns. The new IT system is expected to improve the reliability of the inventory data.

Each store is divided into departments or sections. There are sections for toys for children of different age groups, and sections for digital and 'outdoor' toys. Each section has a floor manager, who reports to the store manager. Store managers in turn are accountable to Tina Chan, the Operations Director. Each store manager is responsible for staff training and service quality. Service quality is monitored partly by customer feedback and partly by market research organisations, who send in 'secret shoppers' to monitor activities in both TT Limited's stores and in the stores of competitors.

Sales volumes are seasonal. Sales peak in the period before Christmas and in the run-up to the Chinese New Year. The sales periods when retailers seek to dispose of their unsold items are in the late summer and in January.

Responsibility for promoting the company's stores to customers is shared by Tina Chan and the store managers. Tina arranges in-store promotions for the company. Store managers are each responsible for promoting their own store through social media, and for the stores' layout and operational efficiencies.

Most products sold through the company's stores are bought with cash by customers and taken away at the time of sale. TT Limited has established a small online selling operation, where customers can order items online for delivery to their homes. In addition, customers buying goods in store can ask for their purchases to be delivered to their homes: TT Limited makes a delivery charge for sales below a certain value and provides free deliveries for sales above this threshold amount.

Purchasing is an important part of the company's operations. The company needs to match, as close as possible, purchases with customer demand. Unfortunately, purchases have to be made in advance of knowing what sales demand for each product will be. As a result, TT Limited sometimes under-purchases items for which there is unexpected strong demand, and has difficulty in obtaining re-supply from the manufacturer. On the other hand, the company has difficulty in re-selling all its purchases of many items, and as a result it has to try to sell unsold items at a discount during the sales periods.

Some items are not sold even during sales periods. The company has an ethical policy of donating all its unsold items to hospitals and children's care homes, rather than re-selling them at heavily discounted prices to budget (low-price) retailers.

Simon Lam is the director with responsibility for purchases. He bases his sales orders on data provided by Tina Chan about expected sales demand in the company's stores. He tries to use just-in-time purchasing to reduce inventories, but has difficulty negotiating with many suppliers about the period between placing orders and receiving delivery, as well as about prices.

Simon is frustrated by the slow sales turnover that the company is currently experiencing, and the large proportion of items that are sold at a discount. Even though he approves of the company's ethical policy, he is unsatisfied with the large quantity of toys the company gives away to hospitals and children's homes.

At the moment, the company does not have its own credit cards, and it has not operated any form of rewards scheme for regular customers. However May Yeung has now started to look into the possible benefits from having both a company credit card and a loyalty rewards scheme as a means of improving sales.

## Financial performance

TT Limited, like other retailers, has been through a difficult two-year period. The initial response of the board to the downturn in consumer demand was to carry on with business as usual, and wait for the economic condition, and the toy market to recover. As a result, the company did not open any new stores in 2014 and 2015.

However, the board is concerned about the fall in annual profits. In the year up to 31 January 2016, profit after taxation was less than half the profit in the previous year. May Yeung has produced an analysis of the cost of sales and gross profit, which she believes will help to explain the deteriorating performance (See Appendix 2).

There has been no sign of economic recovery yet, and the board of directors has scheduled a lengthy meeting to discuss, amongst other things, the company's financial performance and strategic initiatives to restore growth to the company's business.

A summary of the financial results for the year ended 31 January 2016 is shown in Appendix 1.

## Cash flows and financing

TT Limited, like other retailers, has to buy goods from manufacturers and hold them until they are sold to customers, and sales are seasonal. The company also pays in advance for the rental of its stores. Cash flow is therefore subject to large variations between months. Although the company believes that it has strong cash flow, there are certain times of the year when it operates at a cash deficit. During these times, the company makes use of a credit facility that May Yeung negotiated with the company's bank. This facility, which allows the company to borrow up to HK$30 million, is nearing the end of the negotiated term. May Yeung is hoping to arrange an extension to this facility for a further three years.

All borrowings by the company from banks are at a floating rate of interest. When arranging extensions to maturing loans, banks have recently increased the margin above their base rate at which TT Limited is required to pay interest.

Although TT Limited makes most of its purchases of toys in US dollar, it does not hedge any foreign exchange transaction exposures.

## Share price and dividends

The company acquired its stock market listing three years ago. The board intended to pursue a policy of continual dividend growth each year, but in the most recent year, dividends were maintained at an unchanged level, at 41.7 cents per share or HK$50 million in total, due to the disappointing financial performance. The annual dividend per share and the company's share price since its listing on the HKEX are as follows:

| Year ended 31 January | **2013** | **2014** | **2015** | **2016** |
|---|---|---|---|---|
| Dividend per share (cents) | 37.0 | 39.5 | 41.7 | 41.7 |
| Share price: | | | | |
| High for the year (HK$) | - | 16.91 | 14.93 | 12.60 |
| Low for the year (HK$) | - | 16.38 | 12.04 | 10.34 |

The current share price is HK$11.87.

## Strategic Studies for Future Development

The directors of the company are keen on exploring opportunities to substantiate profitability and growth. Thus, a strategy study group is established to investigate any further development strategies suitable for the company. Below are four possible strategies which could be adopted as the core strategy for TT Limited in 2016 and 2017:

(i) Market penetration/consolidation/cost control – Consolidation strategy through seeking to maintain market share, and implementing cost controls.
(ii) Market development – Growth by expansion of current products in new markets.
(iii) Product development – Growth by new products in present markets.
(iv) Withdrawal – Withdraw underperforming products from the market.

## Product Safety Issue

TT Limited sells a range of toy products in its first ever co-branding arrangement with a Mainland China toy manufacturer, Tiger Toys. The range of products is 'Jungle Land' which is a range of small tigers and accompanying natural environment figurines (such as caves, trees, other jungle animals). It is aimed at children aged 4-6 and is designed to stimulate imaginative role-playing jungle and animal play. The Jungle Land range is one of TT Limited's most successful products, as the brand is exclusive to Tiger Toys and has a cult following in boys aged 5 and 6 in Hong Kong and Southern mainland China. It is also sold through other toy retailers in Australia and New Zealand. This is the first time any TT Limited products have been sold in these two countries.

All figurines for Jungle Land are made by the Chinese manufacturer Tiger Toys in their factory in Foshan, Guangdong Province. TT Limited is in a co-branding arrangement with the manufacturer and Tiger Toys is an independently-owned and unaffiliated company.

Tiger Toys derived 75 per cent of its revenue from the co-branded Jungle Land in 2015. Jungle Land accounted for 10 per cent of TT Limited total revenue in 2015.

Tiger Toys is privately owned and operated by the Tong family, with Daniel Tong as CEO and Operations Officer. He is also a Hong Kong CPA. Daniel has discovered that the latest batch of Jungle Land figurines are all painted with a different surface paint, and that this surface paint contains dangerous levels of lead. After conducting an internal investigation (which takes two weeks), he discovers that the last six months of production have all been affected by this issue. All figurines made in this time have been painted with the lead paints.

This is an extremely serious issue. Excessive lead in Chinese-made toys has been a major issue globally in the past, with approximately twenty million toys from the US toy conglomerate Mattel being withdrawn in 2007 because of the danger of lead poisoning. Since then, Chinese manufacturers have updated their suppliers and processes. However, a change of suppliers six months ago has led to a collapse in quality control procedures in this area at Tiger Toys.

Daniel has received the report from his internal, extremely private, investigation into the issue. There are two months' worth of stock currently in the factory. However, the first four months of affected product have been supplied to TT Limited, and sold into all markets. One range of figurines was the highly promoted new 'lion family and cubs', all of which have been painted with the lead-based paints.

Now that his fears have been confirmed, Daniel panics. He decides to think about the next steps over the next 48 hours and tells Aimee Chan, the second in command of Tiger Toys who carried out the investigation, not to do anything for now.

# Appendix 1

**Summary financial results of Telly Toys Limited**

**Income statement for the year ended 31 January 2016:**

| | **2016** | **2015** |
|---|---|---|
| | **HK$000** | **HK$000** |
| Revenue | 1,034,237 | 1,065,257 |
| Cost of Inventories Sold | (426,108) | (407,502) |
| Gross profit | 608,129 | 657,755 |
| | | |
| **Operating costs:** | | |
| Employee costs | (221,768) | (211,861) |
| Occupancy costs | (108,325) | (106,167) |
| Property repairs and maintenance | (16,730) | (18,080) |
| Depreciation | (77,621) | (77,594) |
| Other costs | (102,130) | (96,295) |
| Total operating costs | 526,574 | 509,997 |
| | | |
| Operating profit | 81,555 | 147,758 |
| Finance costs | (17,321) | (16,226) |
| Profit before taxation | 64,234 | 131,532 |
| Taxation | (10,598) | (21,703) |
| Profit after taxation | 53,636 | 109,829 |

CPA Hong Kong Institute of Certified Public Accountants 香港会计师公会

QP Hong Kong's CPA Qualification 香港会计师专业资格

## Appendix 1 (con't)

**Statement of financial position as at 31 January:**

| | 2016 | 2015 |
|---|---|---|
| | **HK$000** | **HK$000** |
| Property, Plant and Equipment | 575,755 | 549,735 |
| | | |
| **Current assets** | | |
| Inventories | 186,126 | 166,434 |
| Trade receivables and prepayments | 30,838 | 31,958 |
| Cash and cash equivalents | 105,008 | 140,552 |
| | 321,972 | 338,944 |
| | | |
| **Current liabilities** | | |
| Trade payables | 129,833 | 119,408 |
| Other payables | 33,902 | 32,683 |
| Tax liabilities | 6,104 | 9,420 |
| Bank borrowings | 12,905 | 15,306 |
| | 182,744 | 176,817 |
| | | |
| Net current assets | 139,228 | 162,127 |
| Total assets less current liabilities | 714,983 | 711,862 |
| | | |
| **Non-current liabilities** | | |
| Borrowings | 258,558 | 259,711 |
| Other non-current liabilities (Deferred tax liabilities) | 15,587 | 14,949 |
| | 274,145 | 274,660 |
| Total assets less total liabilities | 440,838 | 437,202 |
| Share capital and reserves | 440,838 | 437,202 |
| Number of shares | 120,000,000 | 120,000,000 |

# Appendix 2

May Yeung, working with Tina Chan, has established that the deterioration in gross profit is due partly to higher purchase costs, but also to an increase in discounting during sales periods, and an increase in unsold inventory that was given away to hospitals and children's homes.

**Their analysis**
**Year ended 31 January 2016**

- 70% of sales were at full retail price.
- 27% of sales were at a discount averaging 40% off the full retail price.
- 3% of purchases were given away to hospitals and children's homes.

As a consequence, the average selling price of items was 86.2% of the full selling price, calculated as follows:

| | |
|---|---|
| 70% of items sold at 100% of full retail price | 0.700 |
| 27% of items sold at 60% of full retail price | 0.162 |
| 3% of items given away | 0.000 |
| **Average selling price as a % of full retail price** | 0.862 |

**Year ended 31 January 2015**

- 74% of sales were at full retail price.
- 24% of sales were at a discount averaging 38% off the full retail price.
- 2% of purchases were given away to hospitals and children's homes.

As a consequence, the average selling price of items was 88.88% of the full selling price, calculated as follows:

| | |
|---|---|
| 74% of items sold at 100% of full retail price | 0.7400 |
| 24% of items sold at 62% of full retail price | 0.1488 |
| 2% of items given away | 0.0000 |
| **Average selling price as a % of full retail price** | 0.8888 |

May and Tina have therefore established that the fall in the gross profit margin in the year ended 31 January 2016 was due partly to bigger discounting and mismatch with customer demand, not just to changes in the ratio of purchase costs to sales revenue.

# Appendix 3

**Analysis of sales**

| **Year ended 31 January** | **2016** | **2015** |
|---|---|---|
| | **HK$000** | **HK$000** |
| **Sales of toys:** | | |
| Children, up to age 5 | 289,588 | 297,372 |
| Children, ages 6 – 12 | 238,063 | 255,483 |
| Children, aged over 12 | 165,478 | 203,399 |
| Digital toys | 184,206 | 149,222 |
| Outdoor toys | 156,902 | 159,781 |
| Total sales | 1,034,237 | 1,065,257 |

## Questions for Candidates

*(Percentage allocation represents expected coverage of your written report. The topics are of equal importance and grading is based on overall content and presentation.)*

Part A (85%)

Analyse the profitability of TT Limited over the past 2 years.

Recommend a strategy/strategies that you consider suitable for the company to improve/substantiate profitability and growth.

Part B (15%)

From the perspective of Aimee Chan, subordinate of Daniel Tong, state the ethical issues you are facing.
By applying the HKICPA Code of Ethics, what action(s) do you need to take?

** This case question, all companies, brands, names, persons, financial data and figures portrayed in this case scenario are fictitious. No identification with actual companies, brands, names, persons, financial data and figures is intended or inferred.*