

Hotye 2001: Accounting Policy and Financing Strategy in Emerging China

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Section 8

Dr. Di Yang

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Reporting Objective

This report develops a financial reporting strategy for Hotye as it launches its electronic payment network expansion in Guangzhou, China. Given Hotye's urgent need to secure substantial bank borrowing and new equity with its limited initial capital, a short-run income maximization strategy is utilized. This strengthens early profitability, supports a debt-oriented capital structure, and leaves the option open for share buybacks once the company realizes its high levels of projected revenue.

Macro Environment Analysis

After the dot-com bubble burst, investor confidence in technology companies declined. As a result, markets began to demand transparent business models with credible financial reporting and believable early performance metrics. In China, payment ecosystems were still developing, and most consumers remained cautious about digital transactions given weak legal protections and a preference for secure, receipt-based payment solutions. Within this environment, rising Chinese technology firms that could demonstrate rapid scaling and near-term results found greater ease in attracting capital. This reinforces the importance of Hotye to show strong short-run performance through its reporting choices and capital structure decisions.

Capital Structure

Given Hotye's projected capacity to generate strong cash flows, the company should pursue a debt-leveraged capital structure. This approach allows interest payments to reduce taxable income while limiting the dilution of ownership stakes. Since Hotye can secure only RMB10M in independent debt financing, it must pursue additional forms of financing. Hotye can do so by raising an additional RMB20M through equity by selling 10% of its ownership, based on a conservative company valuation of RMB200M. This assumption was based on expected investor hesitancy to pay large amounts of capital for stock in a brand-new growth-based company. Following these steps, Hotye will need to obtain an additional RMB20M through guarantor-backed debt financing to achieve its financing-need of RMB50M. This approach is reasonable given the limited debt that Hotye can raise independently. Incorporating the assumption of a guarantor charging a prime rate plus a 5% fee on the required debt further reinforces the conservatism of this financing scenario. This financing strategy leads to a D/E ratio of 1.5, indicating the levered capital structure that is preferred.

Hotye should IPO because it needs cash-infusion from public equity to fund its rapid rollout. An IPO structure facilitates future share repurchases more effectively than a venture capital arrangement. In public markets, trading is governed by straightforward supply and demand dynamics, whereas venture capital investors often retain their stakes for extended periods. This prolonged ownership is less desirable for Hotye, given its rapid growth trajectory following the initial cash infusion and its ownership's desire to retain control of the company. Regical has no immediate need for large external financing and can continue with its current capital structure. Hotye's accounting policies should boost short-run income while remaining compliant with domestic reporting so it can demonstrate strong early profitability that matches the expectations of a future IPO on a Chinese exchange.

Accounting Policies

When making accounting decisions, Hotye has to balance two key considerations: aligning with GAAP, and making the financial statements appear more attractive to investors and banks to secure financing. This can best be achieved by selecting policies that prioritize short-term income. To align with our ideal capital structure, we will aim to have a higher portion of debt financing and a lower portion of equity financing to retain more stake and ownership in the company. Debt financing is more attractive because while investors' expected rate of return (based on the 10-year treasury) is similar to the interest our debt would bear investors expect a market risk premium on top of the risk-free rate. Debt is effectively cheaper, which helps Hotye maintain stronger and more stable cashflows in the long term.

Depreciation Policy and Economic Life:

Given Hotye's business model and its objective of maximizing short-term income, straight-line depreciation is the most representative and advantageous policy. Under GAAP, depreciation must reflect the pattern in which the asset's economic benefits are consumed: straight-line is the default method when benefits are realized evenly over time. Hotye's terminals deliver uniform economic benefit over time because, similar to ATMs, their functionality does not decline with age, and transaction volumes depend on customer adoption rather than equipment wear and tear. Straight-line depreciation aligns with GAAP's consumption-pattern criteria but also supports more favorable early-period income reporting that is more attractive to investors.

Hotye should estimate the terminal's economic life to be 10 years. Although it is on the high end of the 3 to 10 year range, it is still reasonable because the terminals resemble durable payment infrastructure similar to ATMs, which routinely operate for a decade. Their functionality is maintained through software updates rather than hardware wear, making the longer life align with industry norms and GAAP's service-potential criteria.

Accelerated depreciation as an alternative depreciation method allowable under GAAP would front-load depreciation expense and reduce early income, lowering the attractiveness of reported results to investors. Although accelerated depreciation can generate tax shields, Hotye makes a net loss in the first year (Exhibit 1), rendering any potential tax benefit null.

Labor, Consumables and Future Accessories:

Labor and consumable costs are classified as SG&A when they support operations rather than directly producing goods or services, while only direct production inputs belong to COGS. This classification matters because it keeps Hotye's gross margin higher, shaping how investors and regulators perceive the company's profitability and positioning it as a high-margin service platform rather than a low-margin utility provider. Expenditures must be capitalized only if they extend the useful life of an asset or add significant new functionality, while routine maintenance, repairs, and consumables are expensed immediately. This means that upgrades to Hotye's terminals that enable new services would be capitalized and amortized, but replacing paper, ink, or minor parts would be treated as current expenses.

Lease Amortization:

Leasehold improvements must be capitalized and amortized over the shorter of the improvement's useful life or the lease term, unless renewal or purchase of the property is reasonably certain. Hotye signed two-year leases for offices and shops with a strong likelihood of renewal, so amortization can reasonably be spread over four years rather than the initial two-year term, which would otherwise increase annual expenses and reduce reported profitability. This is consistent with the recent renovation of the office and shops, which effectively restarts or significantly extends the useful life of the premises, making it reasonable to assume that the economic life of the improvements will exceed the original lease term while also smoothing annual expenses and supporting reported profitability.

Despite GAAP requiring a high threshold for including renewal periods in the lease term, Hotye meets this standard because the lease renewal is "very likely," and the significant renovation investment creates a strong economic incentive to remain in the same premises and lease the same office space in the future. Since the functional life of the improvements exceeds the expected four-year occupancy, the lease term is an appropriate assumption to calculate amortization: the four-year amortization period remains the most GAAP-aligned and economically-sound accounting policy.

Revenue Recognition:

Under GAAP, revenue must be recognized when a performance obligation is satisfied or when control of the promised service transfers to the customer. For Hotye, the performance obligation is fulfilled when the bill is paid, and the transaction service is processed through its terminal network. Because revenue is not recognized when payments are received, the fact that commission payments can take anywhere from one week to three months to receive is rendered immaterial. Furthermore, deferring revenue until payment is received would understate revenue performance when transaction volume is high, and would not reflect the economic reality of Hotye's service model.

A key consideration of recognizing revenue when the performance obligation is satisfied is whether or not payment collection is probable. However, this can be mitigated by the nature of Hotye's highly automated and transaction-based service model, which significantly improves the degree of certainty that we will receive payment.

Income Taxes:

Hotye should pursue high-tech venture recognition, which reduces corporate income tax from the standard 33% to a preferential rate of 15%. Hotye meets the general qualifications of the high-tech venture status, given the technology-intensive nature of the service (networked terminals, proprietary payment system) and its ties to Regical, a recognized technology company. Hotye should base its statutory accounting projections on the 33% tax rate and present the high-tech venture status as an upside scenario that, if approved, would lower the tax rate. This would keep reported policies conservative and compliant with Chinese practice, while still signaling to investors the additional room for earnings, debt capacity, and valuation in the optimal scenario.

Exhibit 1: Hotye Projected Income Statements From 2001 to 2004

Year	Income Statement			
	2001	2002	2003	2004
Revenue ¹	282	30,844	123,271	202,888
COGS	-	-	-	-
Gross Profit	282	30,844	123,271	202,888
Operating Expenses:				
Salaries and Wages	1,842	4,332	5,178	5,881
Rental Expense	681	1,482	1,482	1,482
Marketing and Promotion	4,485	8,665	9,098	9,553
System Maintenance	1,162	3,620	7,769	11,378
Property Insurance	12	66	122	237
SG&A	426	1,654	2,302	2,371
Depreciation & Amortization ²	2,355	6,970	11,230	12,295
Total Operating Expenses	10,963	26,789	37,181	43,197
EBIT (Operating Income)	(10,681)	4,055	86,090	159,691
Interest Expense ³	2,728	2,728	2,728	2,728
EBT	(13,409)	1,327	83,362	156,963
Income Tax Expense ⁴	-	438	27,510	51,798
Net Income	(13,409)	889	55,853	105,165

① Management is uncertain about income from franchised shops. Thus, shop's revenue forecast is excluded.

② Refer to Depreciation Table.

③ Refer to Interest Expense Table.

④ Calculated using 33% tax rate, however, could be lowered to 15% for 2-3 years if approved by local government as high-tech venture status.

Depreciation Table				
Year	2001	2002	2003	2004
Terminal Depreciation ①	710	5,325	9,585	10,650
Computer servers and electronics ②	1,000	1,000	1,000	1,000
Maintenance Vehicles ③	63	63	63	63
Office Equipment ③	82	82	82	82
Lease Amortization ④	500	500	500	500
Total D&A	2,355	6,970	11,230	12,295

① Terminal FV (71k) = Sale Price (68k) + Parts (3k); Useful Life of 10 Years, like ATMs.

② Economic life used for computers is 3 years, stemmed from case fact.

③ Maintenance Vehicles and Office Equipment are amortized over 5 years.

④ Under GAAP (ASC 842), leasehold improvements must be capitalized and amortized over the shorter of the useful life of the improvement or the lease term. Signed 2-year leases for offices and shops with a strong likelihood of 2-year renewal, so amortization will be spread over 4 years.

Interest Expense Table				
Year	2001	2002	2003	2004
ICBC 10-year Loan Interest ①	576	576	576	576
Guarantor Loan Interest ②	2,152	2,152	2,152	2,152
Total Interest Expense	2,728	2,728	2,728	2,728

① RMB10M * 5.76%. Source: Industrial and Commercial Bank of China (ICBC), "RMB Loan Rate," accessed December 8, 2025.

② RMB20M * 10.76%. Assumed a 5% spread as technology is perceived as risky in 2001.

Depending on the health of the B/S, Hotye can pay back the loan starting 2004 to reduce overall debt and interest expense.

Exhibit 2: Works Cited

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AI Usage Disclosure Statement

We used generative AI to complete this assignment. We used AI to help us understand the content of the case (e.g., Hoyte's business model, how Regical and Hotye are connected), extract key considerations prompted in the case, clarify accounting concepts, learn how to use financial platforms (e.g., Capital IQ), and to edit our draft for clarity and conciseness.