

# Pre-Workshop Materials

## Workshops 1 and 2

### Case Background

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#### Easybi Limited

##### Easybi background

Easybi is a computer electronics manufacturer and trading company based in Hong Kong. The company was formed in 2004 by John Wong who invested a substantial amount of capital obtained through a personal inheritance from his aunt. John Wong continues to own 75% of the share capital and is both the CEO of the business and Chairman of the board of directors. The remaining 25% of shares are owned by the other directors and some employees. These shares were issued as part of a share incentive scheme and other remuneration packages.

The company manufactures components required in the assembly of computers and associated equipment such as keyboards, LCD monitors and printers. Easybi also assembles computers and equipment from components manufactured either by itself or imported from other manufacturers producing components in mainland China and Taiwan.

Raw materials for the production of components are imported from a number of countries around the world.

Historically, Easybi has sold both components and fully assembled computers and equipment to wholesalers and distributors in a variety of overseas markets, including North America, Europe and Asia. This market continues to form the major part of its revenue for the year ending 31 March 2011. Until 31 March 2010 all sales invoices were in Hong Kong Dollars, however, in order to match a number of competitors in the market place, on 1 April 2010 Easybi introduced the option for customers to be invoiced in their local currency.

In June 2010, Easybi also began to sell fully assembled computers and equipment direct to end-consumers (both individual consumers (b2c) and retailers (b2b)). The company has reached a wide market by launching such sales through a third party website, E-link, which provides a platform for companies to market and sell their products online. Easybi pays E-link an annual subscription fee which allows Easybi to market and promote the company's products on the E-link website. In addition, E-link takes a percentage of the revenue generated by Easybi in accordance with the contract between the two companies.

After thoroughly researching possible third party partners, the directors chose E-link because the company is well-established, has a strong reputation in many markets and is WebTrust accredited.

In addition, Easybi opted for the EDI (electronic data interchange) version of the E-link system. This means that sales made through E-link are directly recorded in Easybi's sales ledger and are also shown on Easybi's inventory system in order to avoid the need to manage sales and distribution to online customers manually.

The launch of the online sales has generally been successful. However, an error with the integration between the E-link system and Easybi's inventory system meant that in the 3 weeks after launch some customers received incorrect items or items that they did not order.

### Lee Sun & Co background

You are the audit manager for the external audit of Easybi for the year ending 31 March 2011. Lee Sun & Co has been the external auditors of Easybi since its formation, however this is your first year working on the Easybi audit and you have had no other experience in this industry sector.

In order to familiarise yourself with the company you have obtained the following information:

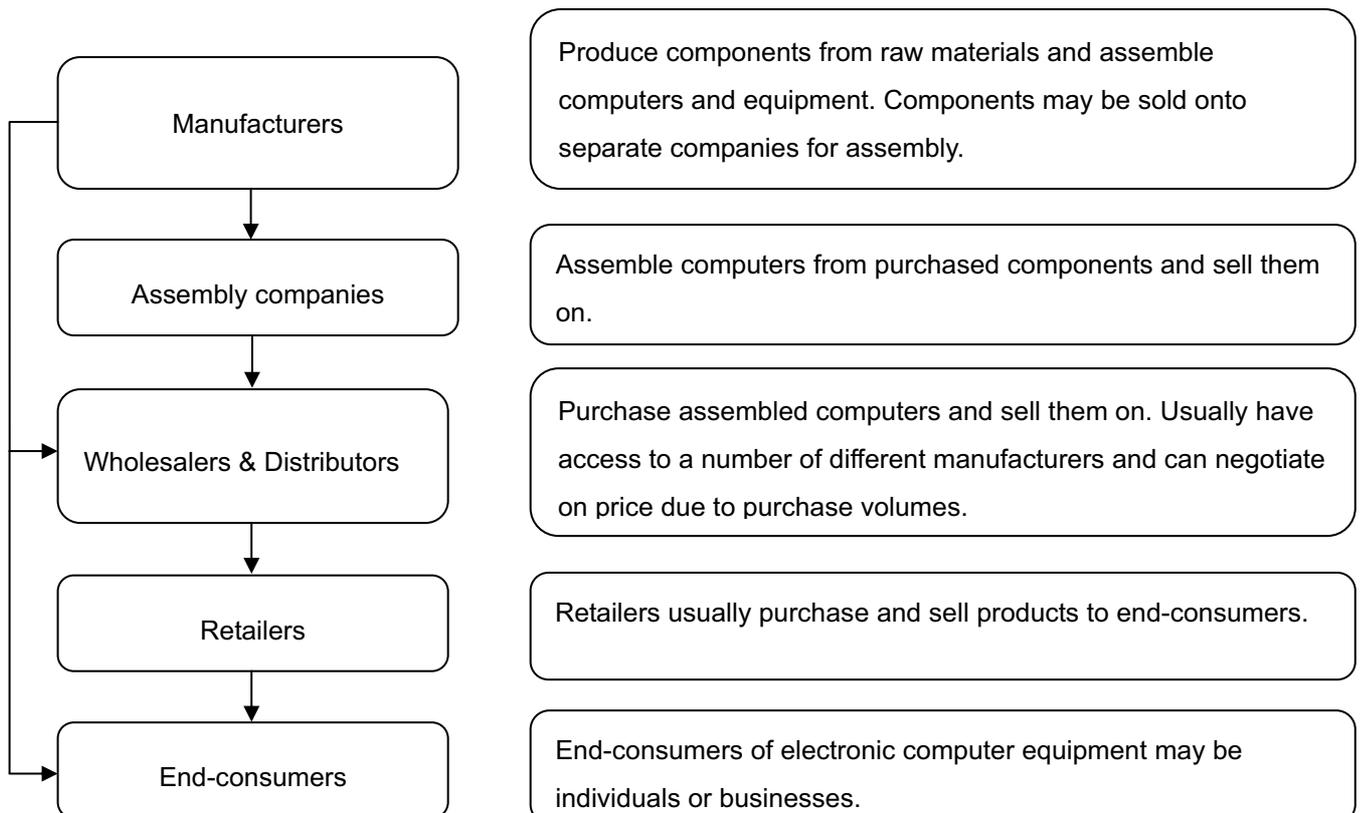
- Easybi's draft financial statements for the year ended 31 March 2011
- A trade article about the computer electronics industry
- Easybi's current internal controls and procedures manual for sales and receivables cycle
- Permanent audit file

You have also had a preliminary phone call with David Lam, finance director at Easybi who has agreed to provide you with:

- Board report for the board meeting on 10 April, 2011

### The computer electronics manufacturing and trading industry

There are a number of players in the computer electronics industry each of which are represented in the traditional sales model diagram below:



You have obtained an article from a respected trade journal which describes the current status of the computer electronics industry:



# Non-stop computer manufacturers

Tony Tong reports on the continued growth in the worldwide computer manufacturing industry

The computer and electronics industries construct an enormous range of products including computers, computer peripherals and hand held electronics. The computer electronics industry has grown rapidly; electronics and computers are in pervasive use by the public, schools, businesses and governments who all rely on computers. This extensive use and reliance creates a constant demand for computer products and computer manufacturers' order books are full.

The need for constant innovation has led to a very large number of companies making up the computer and electronics industry. A common scenario is an engineer or physicist who has a new idea for a product, and he or she creates a new company to develop it.

Even as innovations are implemented, most of the equipment and methods used for electronic manufacturing are the same for many products. After the product is developed, the new company licenses another company to manufacture it. Thus, it is possible to have one manufacturing company producing many different types of components with relatively little investment required. However, the large number of players in the manufacturing market means there is no lack of competition.

The worldwide recession has not had a major impact on the industry. Many end-consumers continue to invest in technologies to improve efficiency and productivity of their own operations. However distributors, wholesalers and retailers have become more risk averse in the current climate resulting in:

- Tighter inventory control to eliminate wastage and reduce inventory holding costs. Consequently, manufacturers have had to find ways to be able to respond more rapidly when distributors and wholesalers place orders.
- More frequent but smaller orders from distributors and wholesalers resulting in higher shipping costs for manufacturers.

“Competition manifests itself ...in terms of responsiveness and service levels of the manufacturers”

The expectations of end consumers continue to rise in terms of availability of products, speed of delivery and quality of after-sales care. Consequently, in order to meet these increasing demands, wholesalers and distributors are also raising their expectations of the service levels provided by their suppliers (i.e. the manufacturers). Competition in the industry therefore manifests itself not only in terms of price but also in terms of the responsiveness and service levels of the manufacturers.

So for manufacturers, whilst the order books are full and the production lines are working 24-7, many players are starting to feel a squeeze on their profit margins in order to achieve the right level of service.

### **Disposal of electronic waste**

Worldwide the computer electronics industry is highly regulated in relation to electronic waste. Regulation exists in relation to:

- Labelling of products with sufficient information to allow for the appropriate and safe disposal of electronic products. These rules are particularly stringent for products exported to the European market where the EU WEEE-Directive (Waste Electrical and Electronic Equipment) is in force.
- Disposal of manufacturing waste in Hong Kong where fines, and even imprisonment, may be imposed on companies breaching the waste disposal regulations.

Companies failing to comply with the regulations can face severe fines and penalties and in extreme circumstances may lose their licence to manufacture such products.

Easybi is a member of the Hong Kong Green Manufacturing Alliance and part of the role of Easybi's production manager is to monitor the company's compliance in respect of labeling requirements and waste disposal.

### **Employees at Easybi**

Employees at Easybi are all located on one site at Chai Wan, Hong Kong and work in one of the following departments:

- Sales and distribution: responsible for negotiating sales with customers, promoting products to prospective customers, meeting agreed service levels and shipping products to customers from the warehouse.
- Finance: responsible for internal and financial control, recording transactions, budgeting, monthly financial reporting and year-end financial statements.
- Production: responsible for the manufacture of components and assembly of computers and equipment and the requisition of raw materials and other components.
- Human resources and administration; responsible for the employment of staff, property and facilities management and other administrative tasks.

### **The Board**

The board consists of:

- John Wong, CEO and Chairman: oversees all operations and heads up the board of directors. Founder and majority shareholder.
- Rachel Chow, Sales & Marketing director: responsible for the sales and distribution department, including the new online sales channel.
- David Lam, Finance director: responsible for the finance and human resources and administration departments.
- Paul Ho, Production director: responsible for the production department.

The board of directors meets once a month to review the performance of the business, provide a report on the issues and risks that the business is currently facing and to share progress on any projects or programmes of work currently being undertaken.

David Lam produces a board report which is circulated before each meeting highlighting the financial performance of the business to date compared with the budgeted figures set out at the start of the year. The other directors contribute a narrative on their areas of the business to the report.

### **Restructuring and reorganisation at Easybi – sales and marketing teams**

In June 2010, Rachel Chow undertook a restructuring and reorganisation of the sales and marketing teams, to coincide with the launch of the new online sales channel. Key changes were:

- Implementation of a new online digital marketing strategy to promote the new sales channel to both b2b and b2c customer segments. The strategy was implemented by the existing sales and marketing team. A member of the existing team was promoted to the position of digital marketing manager.
- In order to take advantage of the access to new customers through the new online sales channel, Easybi also subscribed to a web-based CRM (customer relationship management) service. Customer's details are recorded directly in the CRM when they are provided by customers purchasing Easybi products on the E-link website. These details are then used by Easybi for targeted marketing campaigns.
- A new member of the sales team was recruited with the sole responsibility of cataloguing and managing Easybi's products on the E-link system. No other members of staff have yet been trained to use the system.
- A number of new staff were recruited to work in the warehouse and distribution team in order to deal with the increased volume of transactions and the fact that online orders tend to be smaller.
- Warehouse and distribution staff were previously either responsible for "picking" orders (i.e. selecting goods in the warehouse) or packing orders. From June all staff were re-trained so that they could perform both picking and packing.

### **Internal controls at Easybi**

As part of the sales and marketing teams' reorganisation and the introduction of the new online sales channel, the board of directors decided to review and amend the internal controls and procedures in respect of the sales and receivables cycle (See Appendix A) and also to update its Information and Internet Security Policy.

The permanent audit file indicates that management at Easybi undertake regular reviews of the effectiveness and internal controls in place, however they considered that the reorganisation and new online sales channel required a more thorough revision. All members of staff affected have been introduced to the new controls and procedures and have undertaken specific training where required.

In previous years the audit team has found that the internal control procedures documented in Easybi's internal controls and procedures manuals have been well adhered to and that management regularly scrutinise employees' work to ascertain that internal controls are operating effectively. For some areas of the audit the audit approach has been to rely on internal controls and reduce the level of substantive testing.

### **Permanent audit file and prior year working papers**

You have obtained the permanent audit file and prior year working papers and have ascertained the following key information regarding Easybi:

#### ***Audit approach***

In prior years the audit plan has taken a controls based approach to auditing sales and receivables and found the internal controls in this area to be effective.

### **Accounting systems**

Easybi uses an off-the shelf accounting system specifically designed for manufacturing businesses. It includes an integrated inventory system which automatically reflects the sale of finished goods and the purchase of raw materials and components when they are recorded in the sales and purchase ledgers respectively. The use of raw materials in the manufacturing process is recorded in the inventory system manually, as is the production of finished goods which are entered into the system when production is complete and the goods are transferred to the warehouse.

### **Valuation of work in progress and finished goods**

The inventory value of finished goods (i.e. assembled computers and finished components) is arrived at as follows:

|   |       |
|---|-------|
| Direct material costs (raw materials or purchased components) | x     |
| Labour costs  | x     |
| Proportion of overheads (e.g. production line electricity)    | x     |
|   | <hr/> |
| Value of item of finished inventory                           | x     |

Direct material costs and labour costs are recorded against a 'production run' or assembly of a particular line of inventory. Production employees record their time spent on each 'production run' or assembly on a time sheet which is then input manually into the inventory system.

All inventory, raw materials and finished goods, are valued on a first-in-first-out (FIFO) basis.

Paul Ho, the production director is responsible for estimating the value of work in progress for the purposes of the monthly management accounts and the year-end financial statements.

### **Trade receivables**

For the year ended 31 March 2011, Easybi had a policy of making an allowance against receivables as follows:

- 100% of amounts which have been referred to the credit collection agency
- 50% of amounts 45 days or more overdue
- 10% of remaining balances