

Pre-Workshop Materials

Workshops 1 and 2

Case Background

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:

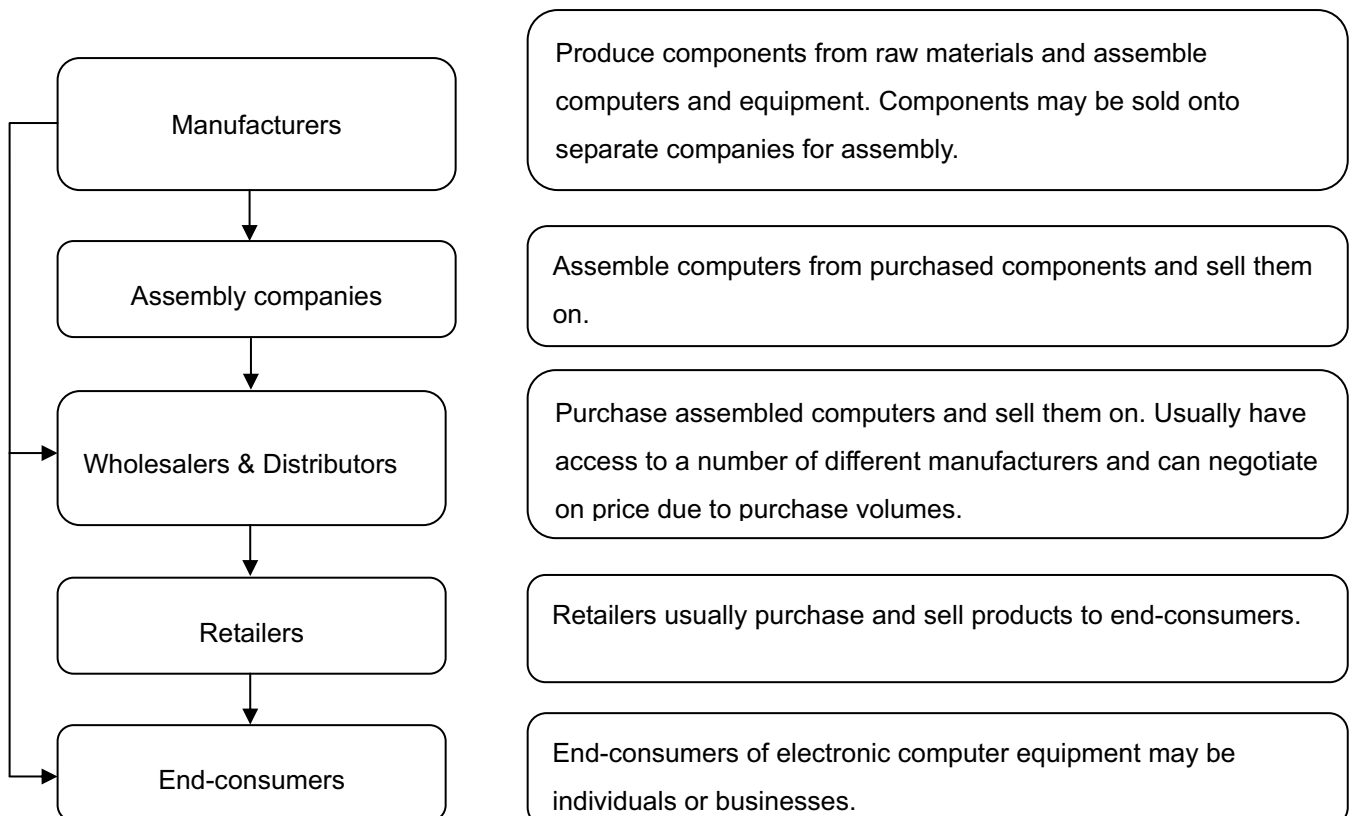
- Easybi's draft financial statements for the year ended 31 March 2011
- A trade article about the computer electronics industry
- Easybi's current internal controls and procedures manual for sales and receivables cycle
- Permanent audit file

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

Additional Information

Financial Information Extract

Draft statement of comprehensive income for the year ended 31 March 2011

	Note	Draft 2010/11 HK\$000	Actual 2009/10 HK\$000
Turnover	2	311,928	230,856
Cost of sales		<u>(275,056)</u>	<u>(198,828)</u>
Gross profit		36,872	32,028
Administrative expenses		<u>(35,940)</u>	<u>(27,720)</u>
Operating profit		932	4,308
Interest income		-	72
Interest expenses	3	<u>(170)</u>	<u>(60)</u>
Profit before taxation		762	4,320
Taxation	4	<u>(400)</u>	<u>(712)</u>
Profit for the year		<u><u>362</u></u>	<u><u>3,608</u></u>

Draft statement of financial position as at 31 March 2011

	Note	Draft 2010/11 HK\$000	Actual 2009/10 HK\$000
Non-current assets			
Property, plant and equipment	5	3,384	3,912
Current assets			
Inventories	6	30,324	25,716
Trade receivables	7	75,204	42,492
Cash and bank balances		<u>340</u>	<u>1,692</u>
		105,868	69,900
Current liabilities	8	<u>(75,616)</u>	<u>(58,728)</u>
Net current assets		<u>30,252</u>	<u>11,172</u>
Total assets less current liabilities		<u>33,636</u>	<u>15,084</u>
Non-current liabilities			
Long-term loans	9	<u>20,636</u>	<u>96</u>
Financed by			
Share capital	10	120	120
Reserves		<u>12,880</u>	<u>14,868</u>
Total equity		<u>13,000</u>	<u>14,988</u>
		<u>33,636</u>	<u>15,084</u>

Draft statement of changes in equity for the year ended 31 March 2011

	Draft 2010/11 HK\$000	Actual 2009/10 HK\$000
Balance as at 1 April	14,988	14,145
Profit for the year	362	3,608
Foreign currency exchange differences	(2,350)	-
Transactions with owners - dividends	<u>-</u>	<u>(2,765)</u>
Balance as at 31 March	<u>13,000</u>	<u>14,988</u>

Draft statement of cash flows as at 31 March 2011

	Draft 2010/11 HK\$000	Actual 2009/10 HK\$000
Profit before taxation	762	4,320
Adjustments for:		
Depreciation	1,008	998
Interest income	-	(72)
Interest expense	<u>170</u>	<u>60</u>
	1,940	5,306
Increase in inventories	(4,608)	(1,264)
(Increase)/decrease in trade receivables	(32,712)	531
Increase in trade payables and accruals	10,564	1,058
Increase in other taxation creditor	<u>6,364</u>	<u>-</u>
Cash generated from operations	(18,452)	5,631
Interest paid	(170)	(60)
Income taxes paid	<u>(712)</u>	<u>(599)</u>
Net cash from operating activities	(19,334)	4,972
Cash flows from investing activities		
Purchase of property, plant & equipment	(480)	(319)
Net cash used in investing activities	(480)	(319)
Cash flows from financing activities		
Proceeds from long term borrowings	26,928	-
Repayment of long term borrowings	<u>(6,116)</u>	<u>(5,870)</u>
Net cash received from financing activities	20,812	(5,870)
Outstanding difference (to amend)	<u>(2,350)</u>	<u>-</u>
Net decrease in cash and cash equivalents	<u>(1,352)</u>	<u>(1,217)</u>

Draft notes to the financial statements for the year ending 31 March 2011

1 ACCOUNTING POLICIES**1.1 Basis of preparation**

The financial statements have been prepared under the historical cost convention and in accordance with applicable accounting standards.

1.2 Revenue

Turnover comprises revenue recognised by the company in respect of the sale of components and assembled computers.

1.3 Non-current tangible assets and depreciation

Non-current tangible assets are stated at cost less depreciation. Depreciation is provided at rates calculated to write off the cost of non-current assets, less their estimated residual value, over their expected useful lives on the following bases:

Leasehold property	- over the term of the lease
Plant and machinery	- between 10% and 33% straight line
Motor vehicles	- 25% straight line
Office equipment	- 20% straight line

1.4 Inventories

Inventories are valued at the lower of cost and net realisable value after making allowance for obsolete and slow-moving inventory.

1.5 Foreign currencies

Transactions in foreign currencies are translated into Hong Kong Dollars at the rate ruling on the date of the transaction. Assets and liabilities in foreign currencies are translated into Hong Kong Dollars at the rates of exchange ruling at the reporting date. Exchange gains and losses are recognised in the statement of comprehensive income except on the translation of balances due from customers at the year end which are recognised in the statement of changes in equity.

2 TURNOVER

Turnover is attributable to the principal activity of the company. An analysis of turnover is given below:

	2010/11	2009/10
	HK\$000	HK\$000
China (including Hong Kong)	103,976	94,811
Rest of the world	<u>207,952</u>	<u>136,045</u>
	<u>311,928</u>	<u>230,856</u>

3 INTEREST EXPENSES

	2010/11	2009/10
	HK\$000	HK\$000
On bank loans and overdrafts	<u>170</u>	<u>60</u>

4 TAXATION

	2010/11	2009/10
	HK\$000	HK\$000
Corporation tax in respect of the year	<u>400</u>	<u>712</u>

5 PROPERTY, PLANT AND EQUIPMENT

	Land and buildings	Plant and machinery	Motor vehicles	Furniture, fittings and equipment	Total
	HK\$000	HK\$000	HK\$000	HK\$000	HK\$000
Cost					
At 1 April 2010	2,100	6,384	1,608	1,404	11,496
Additions	<u>-</u>	<u>420</u>	<u>-</u>	<u>60</u>	<u>480</u>
At 31 March 2011	<u>2,100</u>	<u>6,804</u>	<u>1,608</u>	<u>1,464</u>	<u>11,976</u>
Depreciation					
At 1 April 2010	456	5,676	696	756	7,584
Charge for the year	<u>105</u>	<u>231</u>	<u>384</u>	<u>288</u>	<u>1,008</u>
At 31 March 2011	<u>561</u>	<u>5,907</u>	<u>1,080</u>	<u>1,044</u>	<u>8,592</u>
Net book value					
At 31 March 2011	<u>1,539</u>	<u>897</u>	<u>528</u>	<u>420</u>	<u>3,384</u>
At 31 March 2010	<u>1,644</u>	<u>708</u>	<u>912</u>	<u>648</u>	<u>3,912</u>

6 INVENTORIES

	2010/11	2009/10
	HK\$000	HK\$000
Raw materials	6,007	4,985
Work in progress	8,052	5,198
Finished goods	<u>16,265</u>	<u>15,533</u>
	<u>30,324</u>	<u>25,716</u>

7 TRADE RECEIVABLES

	2010/11	2009/10
	HK\$000	HK\$000
Trade receivables	71,952	40,068
Prepayments and accrued income	<u>3,252</u>	<u>2,424</u>
	<u>75,204</u>	<u>42,492</u>

8 CURRENT LIABILITIES

	2010/11	2009/10
	HK\$000	HK\$000
Bank loans and overdrafts	6,388	6,116
Trade payables	61,404	50,876
Corporation tax	400	712
Other taxation	6,932	568
Accruals	<u>492</u>	<u>456</u>
	<u>75,616</u>	<u>58,728</u>

9 SHARE CAPITAL

	2010/11	2009/10
	HK\$000	HK\$000
Share capital called up, allotted and fully paid	<u>120</u>	<u>120</u>

10 NON-CURRENT LIABILITIES

	2010/11	2009/10
	HK\$000	HK\$000
Bank Loans	<u>20,636</u>	<u>96</u>

Appendix A



Easybi Limited

Internal controls and procedures manual

Sales and receivables

June 2010

Contents

- 1 Credit sales
 - a. Sales order acceptance procedures
 - b. Despatch procedures
 - c. Invoice processing procedures
 - d. Credit control procedures
 - e. Remittance procedures
- 2 Online sales
 - a. Integrated and automated systems
 - b. Product catalogue and price list
 - c. Online customer service
 - d. Despatch procedures

1 Credit sales

a. Sales order acceptance procedures

New customers

- All new customers must undergo a credit check through CreditSure Limited and no orders can be accepted until a satisfactory credit check has been obtained
- An internet search should be carried out on the business to ensure it is a genuine business
- Once a satisfactory credit check has been received an account for the customer should be set up in the sales ledger and a credit limit set, initially at no more than HK\$60,000
- Once customers have proved their credit worthiness the credit limit can be increased at the discretion of the senior credit controller

Existing customers

- When existing customers place orders a check should be carried out against the sales ledger system to ascertain whether the customer is within its credit limit
- The value of the current order should be taken into account to ensure that the customer does not exceed its credit limit as a result of the additional order

b. Despatch procedures

- An automated despatch note will be sent to the warehouse for each order received and processed
- Orders should be fulfilled in sequential order according to when they were received by the sales team
- Despatch notes will be printed in the warehouse and the items picked from inventory – each order will be checked against the despatch note by a second member of the team not involved in the initial picking for that order
- Items should be packed according to packing procedures and labelled using the labels produced from the sales order system
- Items ready for despatch should be marked as such in the sales ledger system

c. Invoice processing procedures

- Invoices will be produced and sent to customers on a weekly basis and all sales marked as despatched in the sales ledger system should be included in the invoice run
- All invoices should be checked for numerical accuracy
- A remittance advice slip should be included with all invoices for customers to return with payment when paying by post
- Invoices should also include details of how to make electronic payments direct to Easybi's bank account
- Prices recorded in the sales ledger system should be reviewed on a regular basis by a senior member of the sales team to ensure that the system reflects the most accurate and up-to-date pricing

d. **Credit control procedures**

- A standard period of credit of 30 days will be granted to credit customers
- Customer statements detailing each outstanding invoice on a customer's account should be prepared and sent to customers on a monthly basis
- Credit periods of greater than 30 days must be approved by the finance director
- A weekly aged sales ledger analysis will be extracted and reviewed by the senior credit controller
- Customers with invoices more than 21 days overdue will be written to requesting payment and reminding the customer of the relevant credit terms
- Customers with invoices more than 35 days overdue will be referred to Easybi's credit collection agency
- Any customers with amounts written off should be marked in the sales ledger and no further credit sales extended to them
- A monthly analysis of overdue amounts should be prepared for review by the finance director. No trade receivables should be written off out of the sales ledger without the prior approval of the finance director

e. **Remittance procedures**

- Payments received by electronic transfer direct into Easybi's bank account should be analysed on a daily basis and allocated to the correct customer account by a member of the credit control team
- Post should be opened by two members of staff, one from the credit control team, and any cheques received logged on the daily receipts schedule
- A separate member of the credit control team should allocate the payments per the daily receipts schedule to individual customer accounts
- Cheques, along with a copy of the daily receipts schedule, should be passed to the cashier clerk for recording as deposited in the bank account
- The cashier clerk should perform a weekly bank reconciliation between the cash book and the bank account and any reconciling items investigated and fully explained
- The financial controller or finance director must review the bank reconciliation for satisfactory explanation of reconciling items

2 Online sales

a. **Integrated and automated systems**

- Easybi's online sales system is run through E-link Limited. No other online sales systems are currently permitted to sell Easybi products
- Easybi's sales system has been fully integrated with the E-link online sales system meaning that transactions undertaken for Easybi products on the E-link system are automatically recorded in Easybi's sales ledger and despatch systems. No development or changes to programmes are permitted to be made without prior board approval
- An annual copy of E-link's security assurance report (WebTrust) should be obtained and reviewed by the board before deciding to renew the annual contract with E-link

- No credit sales are permitted online, all customers pay by personal credit card or through credit already deposited to their account on the E-link system

b. **Product catalogue and price list**

- It is the responsibility of the digital marketing manager to ensure that the product catalogue and price list on E-link are updated for changes on weekly basis
- A report of all changes made to the product catalogue should be run on a monthly basis and reviewed/approved by the sales and marketing director

c. **Online customer service**

- The online help desk should be available during the hours shown on the E-link website (currently 9am to 5pm, Monday to Friday)

d. **Despatch procedures**

- The same despatch procedures should be followed as for credit sales in 1b above

