

Question 3

DIY Hardware Ltd (DIY), a private company that runs a chain of stores selling a wide range of do-it-yourself materials and hardware is wholly owned by its managing director John Adams. John had, over the last two years, expanded DIY substantially by acquiring several small hardware stores in various districts.

With no integrated or centralized computer system, let alone any form of a centralized system for stock controls, sales and purchases, John has to rely on his local managers to:-

- make decisions regarding the purchase, sale and control of stock
- set the pricing on a cost-plus basis

All the above are done locally without any consultation with head office or other stores. Furthermore there was no regular system of stock count carried out by head office. Of late too, John has also noticed that the quality of staff has fallen.

Monthly accounts are prepared by each store using their stand-alone computer system and subsequently mailed to head office on a quarterly basis. Management accounts are produced twice a year by the head office.

Realizing that there are flaws in the present set up, John has ordered his management team to look into investing in more up-to-date systems and controls. As DIY are not sure what the best course of action might be, they have requested assistance from your firm since you have recently been appointed as their auditor.

Required

- (a) Describe the problems that you might expect to find at DIY resulting from poor internal controls. (8 marks)
- (b) Make FOUR recommendations to John and his management team for the improvement of internal controls, and explain the advantages and disadvantages of each recommendation. (12 marks)

Total - 20 marks

Question 3

- (a) Describe the problems that you might expect to find at DIY resulting from poor internal controls.

(8 marks)

- (b) Make FOUR recommendations to John and his management team for the improvement of internal controls, and explain the advantages and disadvantages of each recommendation.

(12 marks)

Total: 20 marks

(a) Problems expected at DIY: poor internal control

- (i) I would expect the company to experience some level of over-ordering, leading to reduced profitability as a result of wastage
- (ii) I would expect there to be stock-outs leading to the potential loss of business to other stores.
- (iii) With no control on pricing there will be differences in the prices from store to store within the group and this could lead to dissatisfaction among the customers who expect the prices to be the same. It may even lead to a price war within the group.
- (iv) I would expect there to be inefficiencies as a result of a lack of central ordering system resulting from quantity discounts not being obtained.
- (v) All of the problems noted above are likely to be exacerbated where local managers or staffs are either inexperienced or possibly dishonest – the question states that poorer quality staffs have been recruited recently.
- (vi) Stores stock is very easily pilfered either by staff or customers even where it is well-controlled. The lack of regular stock counts in particular means that pilferage is very easy to hide.
- (vii) Management accounts are only produced twice a year, therefore budgetary control will be difficult to apply. Also it will not be possible to identify poorly performing stores.
- (viii) I would expect there to be a lack of understanding in the business as a whole as to the availability of new products, products with high margins or other areas in which profitability might be improved.

1 mark for each reasonable point

**(b) Four recommendations, explanation of advantages and disadvantages:
improvements to internal control**

Recommendation 1: that an integrated system be introduced across all stores that links sales, purchases and stock records.

Advantages

This would provide the company with an overall view of what stock is held at any particular time, enable it to order centrally and reduce the scope for pilferage. It would result in reduced stock-outs and reduced stock obsolescence.

Disadvantages

This would require considerable capital investment in hardware, software and training. It would also take control away from local managers which would almost certainly cause resentment.

Recommendation 2: the imposition of regular, or continuous stock counting procedures together with the prompt update of stock records for discrepancies found and investigation of the reason for the discrepancies.

Advantages

This would further reduce the possibility of stock-outs and provide evidence of over-ordering, which would enable purchasing patterns to be refined.

Disadvantages

There are costs in terms of staff time and, again, a certain level of resentment among staff who may feel that they are being 'spied on', or that they are no longer trusted. Training would also be required and additional administrative work would need to be undertaken by local managers.

Recommendation 3: that management accounts are produced on at least a quarterly basis, that figures relating to each store are provided to head office on a monthly basis, and that an analysis is undertaken by head office on the performance of individual stores and stock lines.

Advantages

This would enable the company to determine which stores are performing better than others. It would also enable the company to identify those stock lines that sell well and those that are profitable.

Disadvantages

The production of more regular and detailed information will be time-consuming. Local managers may feel that they are unable to service the particular needs of their customers if decisions are made on a global basis; customers may feel the same way.

Recommendation 4: that sales price decisions are made by head office.

Advantages

This would enable the company to experiment with the use of 'loss leaders', for example, and to impose a degree of consistency across stores to prevent inappropriate pricing decisions being taken by local managers.

Disadvantages

Again, loss of control at a local level is likely to result in resentment and the possible loss of good staff. What sells well in one store may not do so in another. To the extent that head office have less experience of local conditions than local staff, it is possible that inappropriate pricing decisions may be made by head office.

Up to 4 marks for each recommendation/adv/disadv