

You are responsible for the audit of ComSys Ltd for the year ended 30th April 2007. The principal activity of ComSys Ltd is the provision of high quality communications services for companies. The company was established 3 years ago and has significantly exceeded its growth targets in each subsequent year.

ComSys faces severe competition in the market place due to the recent entry of a new competitor from Finland. Consequently it has cut its prices in an attempt to maintain sales. The company has sought to reduce labour costs in the provision of its services. To achieve this and to improve efficiency, in January 2007 the company invested in a new commissioning system. The investment was funded by a loan repayable in monthly installments over 1 year.

The company is currently trading in excess of its overdraft limit and is due to re-negotiate its facility with the bank in October 2007. A comparison of the draft accounts for the year ended 30th April 2007 with the previous year indicates a significant increase in turnover (revenue) with a small increase in profitability. Management has prepared, in support of its negotiations, profit and cash flow forecasts based on the assumptions that the anticipated increase in efficiency and reduction in labour costs will be achieved.

The company faces a legal claim from a major customer, X Ltd, for faulty design. X Ltd alleges that this has led to a loss of £150,000 of profit. It also experiences cash flow problems each month when salaries are due to be paid. In addition it has also fallen behind with its payments to the Inland Revenue in respect of its PAYE and NIC liabilities.

Required:

- (a) **Identify and explain**, from the information provided above, the factors which indicate that ComSys Ltd may not be a going concern.

(10 marks)

- (b) List the audit work that you would carry out in the post balance sheet period in order to gather further evidence and determine whether ComSys Ltd can continue as a going concern for the foreseeable future.

(10 marks)

Total: 20 marks

Question 3

(a) Identify and explain, from the information provided above, factors which indicate that ComSys Ltd may not be a going concern.

(10 marks)

1. Exceeding growth targets/significant increase in turnover
 - overtrading - inadequate working capital to fund level of activity
2. Loan agreement with term of one year
 - may not be able to meet the instalments
 - this is a short term for an investment in a fixed asset which may not generate substantial sales in the first year
3. Trading in excess of overdraft/negotiating increase in facility
 - increase in facility may not be granted/facility may be withdrawn
4. Overdue PAYE and NIC
 - Inland Revenue may seek to recover which may lead to a winding up order
5. Struggling to pay wages
 - key employees may leave
6. Shortage of cash may struggle to pay suppliers of packaging material
 - suppliers may refuse to supply packaging material (place Speedypak Ltd on-stop)
7. Legal claim from X Ltd
 - ComSys will not only face a possible claim for £150,000 but legal fees as well
 - There may be a loss of custom from X Ltd
8. Entry of a new competitor in the market place
 - may reduce sales available to ComSys

**½ mark for each factor and 1 mark for each explanation
4 and 10 marks possible (14 max)**

(b) List the audit work that you would carry out in the post balance sheet period in order to gather further evidence and determine whether Communisys Ltd can continue as a going concern for the foreseeable future.

(10 marks)

1. Obtain the profit and cash flow forecasts
2. Consider quality of the systems in place for producing forecasts and keeping them up to date
3. Perform sensitivity analysis on key components
 - particularly in respect of anticipated efficiencies/reduced labour costs
 - also on turnover (in the face of Finnish competition) and interest rates
4. Ensure company **is** meeting debts as they fall due and **can** pay debts as they fall due
5. Check status of major debtors
6. Inspect correspondence with Inland Revenue to ascertain any payments plan
7. Ascertain whether post year end management accounts support efficiencies
8. Confirm whether the company is up to date with loan instalments
9. Ensure covenant not breached
10. Ascertain outcome of negotiations with bank
11. Consider whether directors plans for resolving the going concern issue are realistic
 - e.g. debt restructuring , share capital issue , factoring of debts
12. Obtain further information about the legal claim
 - obtain advice from solicitors as to the status and likely success of this claim
13. Obtain written confirmation from directors regarding their assessment that the company is a going concern

1 mark for each point and 0.5 for subsidiary points (possible 15 or more marks) (max 10).