

**Geneva Group International  
World Conference  
Cape Town, South Africa  
October 16 - October 19, 2014**



**The Going Concern Assumption  
and how to deal with it as auditor in a  
company crisis**

**Friday, October 17, 2014**

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MUNKERT & PARTNER GbR, Nuremberg, Germany**



# Agenda

**1**

**Introduction**

**2**

**Risk assessment procedures and related activities**

**3**

**Additional audit procedures when events or conditions are identified**

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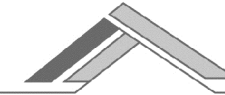
**Audit conclusions and reporting**

**5**

**Conclusion**

# 1. Introduction

## - The Going Concern Assumption -



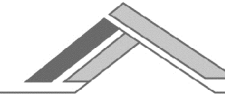
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### ▶ Definition

- ▶ An entity is viewed as continuing in business for the foreseeable future
- ▶ Financial statements are usually prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so
- ▶ When going concern is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business

# 1. Introduction

## - The Going Concern Assumption -

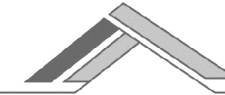


### ▶ **Going Concern in IFRS**

- ▶ Going Concern is one of the main principles of accounting as an underlying assumption (Conceptual Framework 4.1 and IAS 1 par. 25)

# 1. Introduction

## - The Going Concern Assumption -

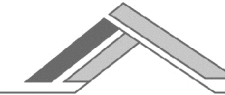


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- ▶ **Responsibility for assessing Going Concern**
  - ▶ Usually the reporting/accounting frameworks require management to make an assessment of an entity's ability to continue as a going concern (e.g. IAS 1 par. 25-26)
  - ▶ Even if there is no explicit requirement, the preparation of financial statements always requires management to assess Going Concern since the going concern is a fundamental principle in the preparation of financial statements
  - ▶ Management has to make a judgment at a particular point of time about inherently uncertain future outcomes of events or conditions

# 1. Introduction

## - The Going Concern Assumption -

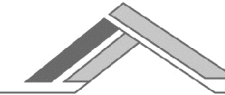


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- ▶ **Relevant factors for the Going Concern assessment**
  - ▶ The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. Most reporting frameworks specify the period for which management is required to take into account all available information. For example IFRS: Usually at least 12 months beginning from the balance sheet date (IAS 1 par. 26); maybe longer in individual cases
  - ▶ Size and complexity of the entity, nature and condition of its business and the degree to which it is affected by external factors
  - ▶ Information basis available at the time the judgment is made.

# 1. Introduction

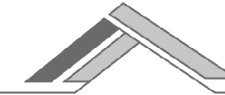
## - The Going Concern Assumption -



- ▶ **No detailed Going Concern assessment necessary, when the entity**
  - ▶ was successful in the past and created sustainable profits
  - ▶ has easy access to funds
  - ▶ has no material risk for an excess of liabilities over assets
  
- ▶ Given these facts the auditor usually does not have to obtain additional audit evidence regarding the Going Concern Assumption

# 1. Introduction

## - The Going Concern Assumption -



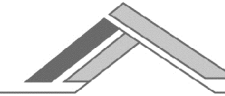
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- ▶ **Responsibilities of the auditor**
  - ▶ Obtain sufficient and appropriate audit evidence about the appropriateness of management's use of the going concern assumption
  - ▶ Conclude, based on the audit evidence obtained, whether there is material uncertainty related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern
  - ▶ Determine the implications for the auditor's report



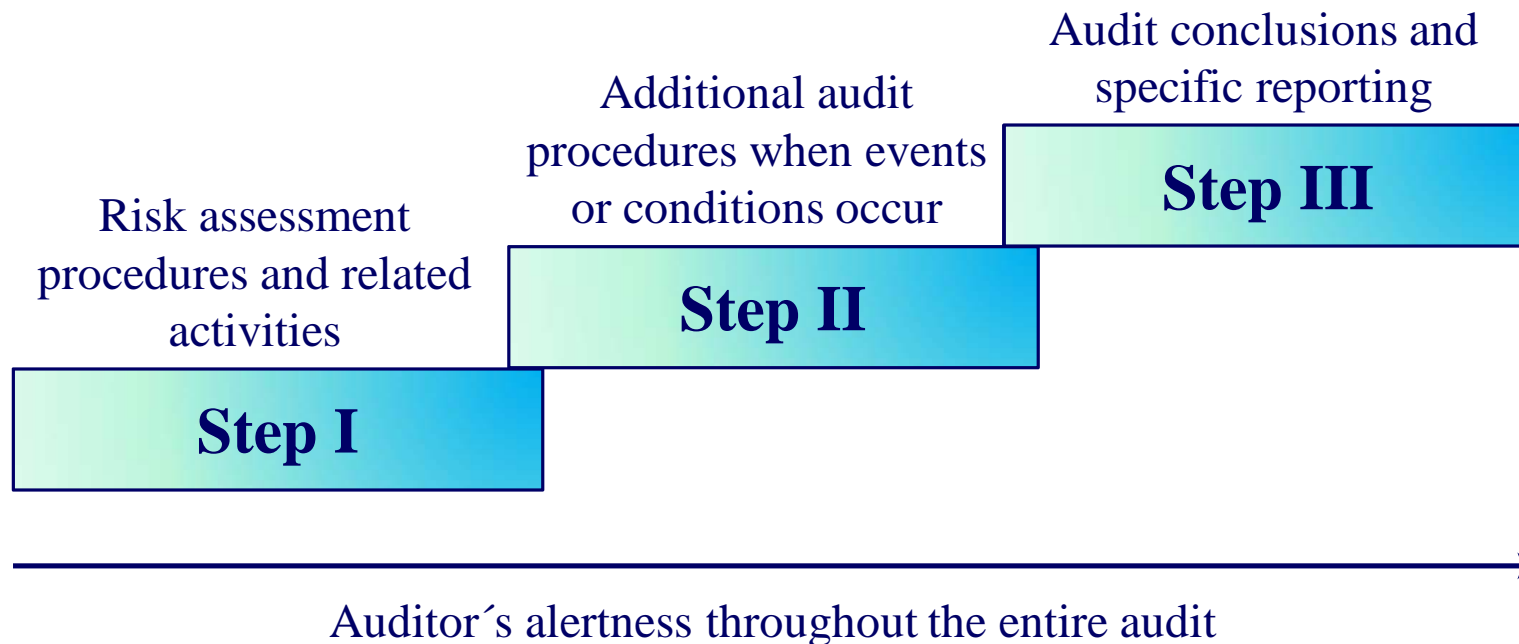
# 1. Introduction

## - The Going Concern Assumption -



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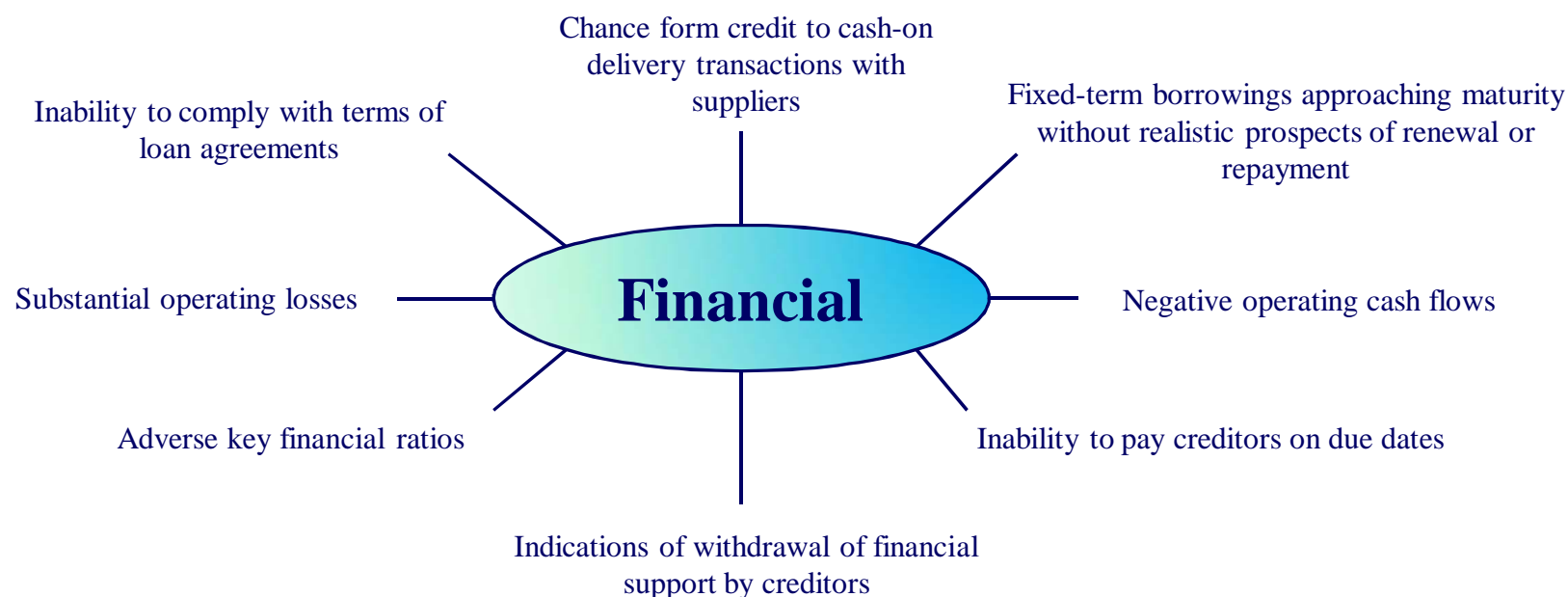
### ► Three steps for auditing the going concern assumption



## 2. Risk assessment procedures and related activities

### ► Risk assessment procedures

- Are there events or conditions that may cause significant doubt on entity's ability to continue as a going concern? Examples:



## 2. Risk assessment procedures and related activities

### ► Risk assessment procedures

- Are there events or conditions that may cause significant doubt on entity's ability to continue as a going concern? Examples:

Shortages of important suppliers

Loss of major market, key customers or key staff/management

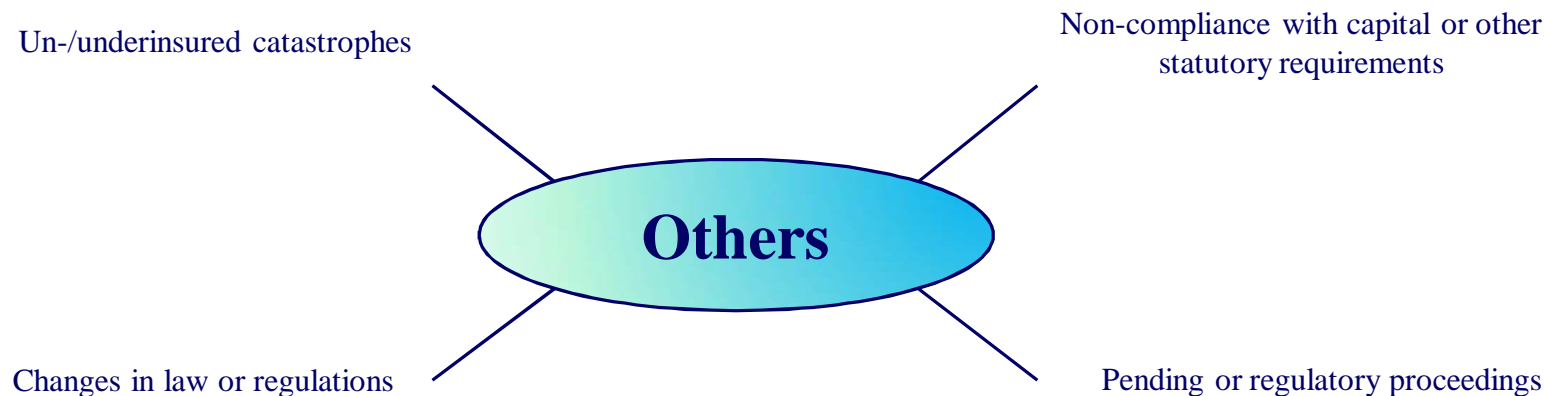


Management intentions to cease the operations or to liquidate the entity

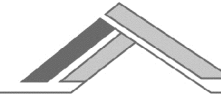
## 2. Risk assessment procedures and related activities

### ► Risk assessment procedures

- Are there events or conditions that may cause significant doubt on entity's ability to continue as a going concern? Examples:



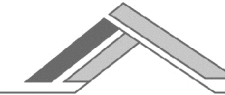
## 2. Risk assessment procedures and related activities



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- ▶ **Risk assessment procedures**
  - ▶ Has management already performed a preliminary assessment?
  - ▶ **If so,**
    - ▶ the auditor shall discuss this assessment with management,
    - ▶ ask for management's plans to address events and conditions that cause, individually or collectively, significant doubt on the entity's ability to continue as a going concern
  - ▶ **If not,**
    - ▶ the auditor shall discuss with management the intended use of the going concern assumption and
    - ▶ inquire management whether events or conditions may cast significant doubt on the ability to continue as a going concern

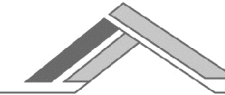
## 2. Risk assessment procedures and related activities



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- ▶ **Risk assessment procedures**
  - ▶ The auditor shall remain alert throughout the audit for audit evidence regarding significant doubt in respect of the going concern assumption → **ongoing process**
- ▶ **Evaluating Management's Assessment**
  - ▶ Covering the same period as that used by management to make its assessment according to the requirements by the applicable financial reporting framework or by law or regulation
  - ▶ If managements assessment covers less than twelve months from the balance sheet date, the auditor shall request management to extend its assessment to at least twelve months from that date
  - ▶ Consideration whether management's assessment includes all relevant information

## 2. Risk assessment procedures and related activities



### ▶ **Period beyond Management's Assessment**

- ▶ The auditor shall require management as to its knowledge of events or conditions beyond that period of assessment that may cast significant doubt on the ability to continue as a going concern

### 3. Additional audit procedures when events or conditions are identified

- ▶ **Sufficient appropriate audit evidence through additional audit procedures shall include:**
  - ▶ If not performed yet: Requesting management to make its assessment
  - ▶ Evaluation of management's plans for its future actions in relation to its going concern assessment.
    - ▶ Is the outcome of these plans likely to improve the situation?
    - ▶ Is the plan feasible under the given circumstances?
  - ▶ Evaluation of
    - ▶ the reliability of the underlying data generated to prepare the forecast
    - ▶ adequate support for the assumptions underlying the forecast



### 3. Additional audit procedures when events or conditions are identified

- ▶ **Relevant additional audit procedures may include:**
  - ▶ Analyzing and discussing of
    - ▶ cash flow, profit and other relevant forecasts with management
    - ▶ entity's latest available interim financial statement or accounting data
  - ▶ Checking terms of loan agreements (financial covenants) and determining whether any have been breached
  - ▶ Reading minutes of shareholder meetings or governance bodies
  - ▶ Inquiring entity's legal council regarding existence of litigations and claims, their potential outcome and the estimate of their financial implications

### 3. Additional audit procedures when events or conditions are identified

- ▶ **Relevant additional audit procedures may include:**
  - ▶ Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties. Appropriate audit evidence may be for example
    - ▶ Resolution to increase share capital
    - ▶ Letter of awareness/comfort letter
    - ▶ New loan agreements
  - ▶ Determining the adequacy of support for any planned disposals of assets/inventories
  - ▶ Obtaining an external expertise regarding the restructuring/recapitalization plans of the entity

### 3. Additional audit procedures when events or conditions are identified

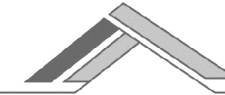
#### ▶ **Examples**

- ▶ Transportation industry: Did government grants violate European competition law? If yes, potential illiquidity of the client.
- ▶ Entertainment electronics: Impacts of tremendous market/price decrease. Assessment of new production and distribution strategy.

### 3. Additional audit procedures when events or conditions are identified

- ▶ **Sufficient appropriate audit evidence through additional audit procedures shall include:**
  - ▶ Consideration of any additional facts or information have become available since the date of management's assessment
  - ▶ Requesting written representation from management regarding their plans for future action and the feasibility of these plans

### 3. Additional audit procedures when events or conditions are identified



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► **Example for additional written representation:**

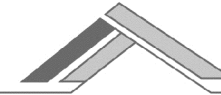
*“Provided that the measures for generating liquidity and strengthening the equity base as pointed out in the external expertise by XXX Consulting as of March 28, 2014, can be implemented successfully, it is more likely than not that the entity can continue as a going concern this and next year. At this point of time all restructuring measures stated in the external expertise are transformed as planned. We do not have knowledge of any events or conditions that may prevent our restructuring efforts.*

*Given these facts we still of the opinion that it is appropriate that the entity continues as a going concern as stated in the external expertise.*

*Management’s signature*

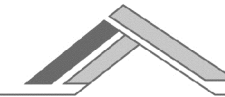
*Date of opinion/representation letter “*

## 4. Audit conclusions and reporting



- ▶ **Conclusion of the auditor based on the audit evidence obtained**
  - ▶ Does a material uncertainty exist related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern?
  - ▶ A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that appropriate disclosure of the nature and implications of the uncertainty is necessary for a fair presentation of the financial statements

# 4. Audit conclusions and reporting

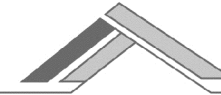


## ► Possible scenarios for audit conclusions and reporting

		Use of Going Concern Assumption in accounting	
		appropriate	not appropriate
Use of Going Concern Assumption in the notes/management report	appropriate	Unqualified opinion Matter of Emphasis paragraph	Adverse opinion
	not appropriate	Qualified opinion	Adverse opinion

In dependence on: Lilienbecker/Link/Rabenhorst, BB 2009, S. 264

## 4. Audit conclusions and reporting



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- ▶ **Use of Going Concern Assumption appropriate but material Uncertainty**
  - ▶ The auditor shall determine whether the financial statements
    - ▶ adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plan to deal with these events or conditions
    - ▶ disclose clearly that there are material uncertainty related to the going concern assumption and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business
  - ▶ If adequate disclosure is made
    - ▶ unmodified opinion
    - ▶ Auditor's report shall include an Emphasis of Matter paragraph to
      - ▶ Highlight the existence of material uncertainty
      - ▶ Draw attention to the notes of the financial statements that discloses the events and conditions that cast significant doubt regarding going concern



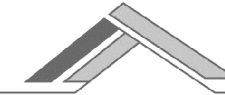
## 4. Audit conclusions and reporting

- ▶ **Use of Going Concern Assumption appropriate but material Uncertainty**

- ▶ **Illustration of an Emphasis of Matter paragraph:**

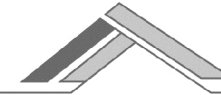
*“Without qualifying our opinion, we draw attention to the paragraph A. III and C. II. in the management report, where management points out that for continuing as going concern it will be essential, that the terms of a loan agreement are fulfilled and necessary measures of a worked out restructuring concept are implemented successfully until December 31, 2014. To ensure sufficient liquidity it will be furthermore essential that the development of sales goes according to plan.”*

## 4. Audit conclusions and reporting



- ▶ **Use of Going Concern Assumption appropriate but material Uncertainty**
  - ▶ If adequate disclosure is not made
    - ▶ qualified or adverse opinion
    - ▶ Statement of auditor in the auditor's report that there is significant doubt about the entity's ability to continue as a going concern

## 4. Audit conclusions and reporting

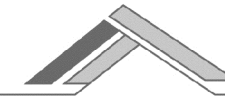


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- ▶ **Use of Going Concern Assumption inappropriate**
  - ▶ Auditor shall express an adverse opinion
  
- ▶ **Management is unwilling to make or extend its assessment**
  - ▶ Auditor shall consider the implications for auditor's report
  
- ▶ **Communication with those charged with Governance**
  - ▶ Do the events and conditions constitute a material uncertainty?
  - ▶ Is the use of the going concern assumption appropriate in the preparation of financial statements
  - ▶ Are the related disclosures in the financial statements adequate?

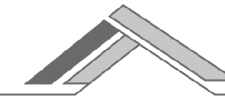
## 5. Conclusion

- ▶ Three step approach for auditing the going concern assumption
- ▶ Additional audit procedures and audit evidence necessary when events or conditions occur that cast significant doubt on the entity's ability to continue as a going concern
- ▶ In case of material uncertainty and adequate disclosures no qualified opinion required, but an additional Emphasis of Matter paragraph
- ▶ Additional audit procedures usually stresses the client relationship and clients usually fear a “self fulfilling prophecy”
- ▶ To reduce liability risks the auditor shall stand tall even if the client threatens to terminate the mandate



**Thanks for your attention!**

# Contact



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