Reviewing the Theoretical Contradiction of Going Concern (Auditing Standard No. 57) with Views of Independent Auditors

Ali Rouhi¹, Amir Reza Keighobadi², Fatemeh Hatami Touski³

1-Assistant Professor, Islamic Azad University, Central Tehran Branch
2-Lecturer Ph.D Scholarship, Islamic Azad University, Central Tehran Branch
3-M.A. in Accounting, Islamic Azad University, Central Tehran Branch

*Corresponding Author Email: fatemeh.hatami88@yahoo.com

Abstract

Given that the auditing standards in Iran are the translated versions of international auditing standards entirely, and their mismatch with the business context in our country because each country's laws cannot be fully compatible with business context of other countries, and also due to lack of auditing culture, lack of attention to the raison d'être of auditing, and other problems and challenges, there has been a gap between theatrical level and views of the independent auditors with regard to full implementation of auditing standards. Hence, finding the origins of and bridging the gaps between theoretical level and views of independent auditors, and providing solutions for implementation of auditing standards for the purpose of improving the quality of auditing and auditing organizations seem to be necessary. Among these, Auditing Standard No. 57 (going concern) can be pointed to which has been studied here.

Generally, going concern means that the audited entity will continue to exist in the foreseeable future - usually for a period of one year after the end of the fiscal period, i.e. no intention or obligation for liquidation of the business entity or significant reduction in its amount of operations is assumed for preparation and presentation of financial statements. In this study, 6 major criteria affecting going concern were derived from Auditing Standard No. 57 including: unfavorable key financial ratios, greater total debts than total assets, failure to pay accounts payable in a timely manner, higher cash outflows than cash inflows from operating activities and major operating losses were considered as 6 hypotheses of contradiction of going concern (Auditing Standard No. 57) with the views of independent auditors and were subsequently tested. Each hypothesis was tested using some questions from a questionnaire for Likert scale, and finally the questionnaires were collected and tested using chi-square test which is a nonparametric test, by means of SPSS software programs. All hypotheses regarding the relationship between the factors influencing the going concern were not rejected and thus were accepted in this study. And finally it can be concluded that there is no theoretical contradiction between Auditing Standard No. 57 (going concern) and the views of independent auditors.

Keywords: Auditing Standard No. 57 (going concern); Independent auditors; Unfavorable key financial ratios; Greater total debts than total assets; Major operating losses.

Introduction

Generally, for preparation and presentation of financial statements, it is assumed that the audited entity will continue to exist in the foreseeable future - usually for a period of one year after the end of the fiscal period, unless stipulated otherwise. Therefore, in terms of assets and liabilities, the audited entity – on the basis of its ability in asset recovery and debt settlement in the normal flow of its activities – may not be able to recover the assets as the recorded amounts of and some changes may become necessary in the amounts and repayment of debts in financial statements (Bahramfar et al., 2005).
From accounting perspective, there are various definitions for going concern. The International Accounting Standards Committee (IASC) considers going concern as one of the fundamental accounting assumptions and defines it as follows: "It is assumed that each business entity has "going concern", i.e. its operations will continue for the foreseeable future" (International Standards Committee (IASC)).

According to regulatory ratifications (Clause 4, Note 2 of the Act of Formation of Audit Organization and Article 6 of the Act of Statute of Audit Organization), compiling auditing standards in Iran has been delegated to the Audit Organization. The committee, first published auditing guidelines based on international standards, and after final revision, published them as auditing standards. So all independent auditors are required to design and implement their audit plans in accordance with these standards which are recognized as a benchmark to assess the quality of auditing works.

Iranian Standard No. 57 deals with the going concern. After the industrial revolution, introduction of industry into society and the growth of sciences and technologies, auditing also progressed along with advances in science. Since accounting and auditing standards in our country have been adopted from other countries like America, Britain and Canada etc, and keeping in mind that such accounting and auditing standards are not fully compatible with the business context of our country, so there is a contradiction between theory and practice in implementing these standards. Among these, Auditing Standard No. 57, which deals with going concern, can be pointed to. In Auditing Standard No. 57 (going concern) some indications and signs have been proposed for auditors, and these are deemed as the indications of continuation of the activities of the audited entity. Among such indications and signs that should be considered for "going concern", greater total debts than total assets, higher cash outflows than cash inflows, unfavorable key financial ratios, major reductions in asset value, and failure to pay accounts payable in a timely manner can be referred to (American Standards on Auditing No.59). Considering the above issues and lack of attention of auditing institutions to the aforesaid indications, lack of auditing culture, lack of attention to the raison d’être of auditing, and other problems and challenges it can be concluded that Standard No. 57 is not implemented fully and accurately by auditing institutions. This thesis titled "Reasons for Theoretical Contradiction of Going Concern (Auditing Standard No. 57) with the Views of Independent Auditors" is trying to provide some of the reasons for the gap between the theoretical level and views of independent auditors for this standard.

Review of Literature

A) Conducted research in Iran

No research has been conducted in Iran for reviewing the contradiction of going concern in theory and practice; however, there are some researches regarding hypotheses of this research and some of which will be discussed here:

Conducted researches in our country are as follows:

1. "Review of Criteria Used by Independent Auditors in Connection with Going Concern for Firms in Iran" by the Dr. Vida Mojtahedzadeh and Leila Esmaeili is one of the researches conducted at Tehran University in the year 2002. In this study, research hypotheses were divided into two groups, i.e. "A" and "B". The hypotheses of Group A were designed regarding 16 criteria effective in going concern for firms. The following three hypotheses of this paper are among 16 hypotheses of that study:
   - Greater total debts than total assets are effective in going concern.
   - Unfavorable key financial ratios are effective in going concern.
   - Major operating losses are effective in going concern.

   The hypotheses of Group B were designed for comparison of Iranian Standard No. 57 with International Auditing Standard No. 570, American Auditing Standard No. 59 and British Auditing Standard No. 130. The results suggest that Auditing Standard of Iran is consistent with International and British Accounting Standards in all important aspects except one of them, which is related to the disclosure criteria. The investigation showed that Auditing Standard No. 57 is a summary of International Auditing Standard No. 570 (Esmaeili, 2004).

2. Another study conducted by Alireza Safari, MA student at Allameh University reviews the financial ratios and going concern of entities. Results of the research suggest that there is a significant relationship between financial ratios and going concern (Safari, 2002).

3. The MA thesis of Mehdi Faghani Narm at Allameh Tabatabai University in Tehran in 2002 titled "The Relationship between Financial Ratios and Bankruptcy Prediction of Listed Companies in the Stock Exchange" has come to the conclusion that there is a significant relationship between key financial ratios and bankruptcy prediction (Faghani Narm, 2002).
4. The MA thesis of Ali Davoudi at Islamic Azad University, Central Tehran Branch titled “Review of Effectiveness of Cash Flows from Operating Activities for Evaluating the Going Concern of the Listed Companies in Tehran Stock Exchange” conducted in 2007 has concluded that the most important financial ratio of significant relationship with going concern of the firms is the cash flows from operating activities to average assets ratio (Davoudi, 2007).

B) Conducted research in other countries

1. Ann Vanstraelen conducted a research in the year 1999 titled “The Auditor's Going Concern Opinion Decision: A Pilot Study”. This research studies the ratio of bankrupt companies with uncertainty in going concern in the auditor's report in America, Britain and Belgium and shows this ratio is much higher in America than Britain and Belgium; this is more due to the fact that the order and the legal environment governing America helps auditors to have more independence (Vanstraelen, 1999).

2. K. Raghunandan and P.V. Rama conducted a research titled “Audit report for Companies in Financial Distress: before and after SAS NO. 59” in 1995. In their research, the influence of Statements on Auditing Standards No. 59 on audit reports of companies in financial crisis was studied. Results show that after enforcing SAS No. 59, auditors are more willing to include going concern for the companies in crisis or bankruptcy (Raghunandan and Rama, 1995).

3. Another study with regard to the criteria used by auditors to comment about going concern is the study by Kevin C. W. Chen and Bryan K. Church titled “Default on Debt Obligations and the Issuance of Going-Concern Opinions”. The objective of this study has been the issue that how auditors uses the status of default of debts and debt re-scheduling in Statements Auditing Standard (SAS) No. 59 as a potential indicator for making going concern unstable (ChenKevin and Church, 1992).

4. In a study in 1985 by Machler titled "Auditor’s perception of going-concern opinion precision", it was concluded that there is a direct relationship between financial ratios and going concern. Most of previous researches have used financial ratios as the criteria for inclusion of going concern issue (Machler, 1984).

5. Raft Elias has conducted a research in 2003 titled: “Is there incremental information content in the going concern explanatory paragraph?” He chose a sample of 285 commercial lenders and studied the loan interest rate and the percentage of potential bankruptcy of each company. The results suggest that there is no an important difference between the explanatory paragraph of a firm and auditor's report for the same company (Elias Raft, 2001).

Hypotheses of Research

In this research, 6 main hypotheses have been prepared with regard to the research questions and objectives:

1) Unfavorable key financial ratios are effective in going concern.
2) Greater total debts than total assets are effective in going concern.
3) Failure to pay accounts payable in a timely manner is effective in going concern.
4) Higher cash outflows than cash inflows from operating activities are effective in going concern.
5) Major operating losses are effective for going concern.
6) The level of usage of Going Concern Auditing Standard (No. 57) by auditors is effective in evaluating the going concern.

Conceptual and Operational Definitions

A) Financial ratios

Ratio is a means to express the relationship between two numbers which is shown as an absolute number or percentage. By financial ratio, it means the ratio of these two numbers, where these two numbers have been derived from financial statements and provide a ratio (Novo Raymond, 2009).

B) Going concern

Generally, going concern means that the audited entity will continue to exist in the foreseeable future - usually for a period of one year after the end of the fiscal period, i.e. no intention or obligation for liquidation of the business entity or significant reduction in amount of its operations is assumed for preparation and presentation of financial statements (Toews).

Scope of Research

Scope of subject: review of theoretical contradiction of going concern with views of independent auditors
Geographic scope: Audit institutions in Tehran
Research Methodology

The research methodology is survey-descriptive in terms of nature and content, and applied in terms of objective, while the research is conducted within the framework of deductive-inductive reasoning. This means that theoretical foundations and review of literature have been provided by library-based studies, visiting websites, reading articles in a deductive manner and data collection for confirming or rejecting hypotheses have been conducted in an inductive manner. Data collection has been done based on a 5-choice questionnaire of Likert scale type.

To test the hypotheses, chi-square test (chi-square) has been employed using SPSS software program. Chi-square test is a statistical test normally used to compare the observed and expected data. Chi-square is the sum of the squared difference between observed and expected data divided by the expected data.

Test of Research Hypotheses

For testing the following 6 hypotheses, chi-square test has been used.

The chi-square test for the first hypothesis

For identifying the impact of unfavorable key financial ratios on "going concern" (choices of the questionnaire were regarded as values of considered answer in ranking manner), the nonparametric chi-square test was used. The null hypothesis and the alternative hypothesis are formulated as follows:

\[
\begin{align*}
H_0 : & \quad \text{Unfavorable key financial ratios are not effective in going concern.} \\
H_1 : & \quad \text{not} H_0 \quad \text{Unfavorable key financial ratios are effective in going concern.}
\end{align*}
\]

Rejection and non-rejection areas of null hypothesis with regard to statistical distribution of test statistic are as the following figure.

![Figure 1. Rejection and non-rejection areas of null hypothesis for test of effectiveness of independent variable on dependent variable for the first hypothesis](image)

The null hypothesis is rejected for the first hypothesis because the chi-square value is equal to 63.7, which is higher than the critical values, i.e. \( \chi^2_{4,95} = 9/49 \). The ratio of "high" and "very high" choices is 32% and the ratio of "low" and "very low" choices is only 22% of the observed ratios. This means that the
skewness of distribution of answers is towards the area which shows that unfavorable key financial ratios are effective in going concern.

The chi-square test for the second hypothesis
Like the previous hypothesis, the null hypothesis and the alternative hypothesis are formulated as follows:

\[ H_0 : \text{greater total debts than total assets are not effective in going concern.} \]
\[ H_1 : \text{not} H_0 \text{ greater total debts than total assets are effective in going concern.} \]

<table>
<thead>
<tr>
<th>Greater total debts than total assets</th>
<th>Observed</th>
<th>Observed ratio</th>
<th>Expected</th>
<th>Difference</th>
<th>Chi-square value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very low</td>
<td>3</td>
<td>3.8%</td>
<td>15.6</td>
<td>12.6-</td>
<td>10.2</td>
</tr>
<tr>
<td>Low</td>
<td>16</td>
<td>20.6%</td>
<td>15.6</td>
<td>0.4</td>
<td>0.0</td>
</tr>
<tr>
<td>Average</td>
<td>42</td>
<td>53.8%</td>
<td>15.6</td>
<td>26.4</td>
<td>44.7</td>
</tr>
<tr>
<td>High</td>
<td>17</td>
<td>21.8%</td>
<td>15.6</td>
<td>1.4</td>
<td>0.1</td>
</tr>
<tr>
<td>Very high</td>
<td>0</td>
<td>0.0%</td>
<td>15.6</td>
<td>15.6-</td>
<td>15.6</td>
</tr>
<tr>
<td>Sum</td>
<td>78</td>
<td>100%</td>
<td></td>
<td></td>
<td>70.6</td>
</tr>
</tbody>
</table>

The null hypothesis is rejected for the second hypothesis because the chi-square value is equal to 70.6, which is higher than the critical values, i.e. \( \chi^2_{4,0.95} = 9/49 \). The ratio of "high" and "very high" choices is 22% and the ratio of "low" and "very low" choices is approximately 24% of the observed ratios. This means that the distribution of answers is balanced and concentrated around the "average" choice which indicates that greater total debts than total assets are effective in going concern.

The chi-square test for the third hypothesis
Like the previous hypothesis, the null hypothesis and the alternative hypothesis are formulated as follows:

\[ H_0 : \text{failure to pay accounts payable in a timely manner is not effective in going concern.} \]
\[ H_1 : \text{not} H_0 \text{ failure to pay accounts payable in a timely manner is effective in going concern.} \]

<table>
<thead>
<tr>
<th>Failure to pay accounts payable in a timely manner</th>
<th>Observed</th>
<th>Observed ratio</th>
<th>Expected</th>
<th>Difference</th>
<th>Chi-square value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very low</td>
<td>0</td>
<td>0.0%</td>
<td>15.6%</td>
<td>15.6-</td>
<td>15.6</td>
</tr>
<tr>
<td>Low</td>
<td>3</td>
<td>3.8%</td>
<td>15.6%</td>
<td>12.6-</td>
<td>10.2</td>
</tr>
<tr>
<td>Average</td>
<td>11</td>
<td>14.2%</td>
<td>15.6%</td>
<td>4.6-</td>
<td>1.4</td>
</tr>
<tr>
<td>High</td>
<td>32</td>
<td>41%</td>
<td>15.6%</td>
<td>16.4</td>
<td>17.2</td>
</tr>
<tr>
<td>Very high</td>
<td>32</td>
<td>41%</td>
<td>15.6%</td>
<td>16.4</td>
<td>17.2</td>
</tr>
<tr>
<td>Sum</td>
<td>78</td>
<td>100%</td>
<td></td>
<td></td>
<td>61.6</td>
</tr>
</tbody>
</table>

The null hypothesis is rejected for the third hypothesis because the chi-square value is equal to 61.6, which is higher than the critical values, i.e. \( \chi^2_{4,0.95} = 9/49 \). The ratio of "high" and "very high" choices is 82% and the ratio of "low" and "very low" choices is only 4% of the observed ratios. This means that the skewness of distribution of answers is towards the area which shows that failure to pay accounts payable in a timely manner is effective in going concern.

The chi-square test for the fourth hypothesis
Like the previous hypothesis, the null hypothesis and the alternative hypothesis are formulated as follows:

\[ H_0 : \text{higher cash outflows than cash inflows are not effective in going concern.} \]
\[ H_1 : \text{not} H_0 \text{ higher cash outflows than cash inflows are effective in going concern.} \]
Table 4. Chi-square test for the fourth hypothesis

<table>
<thead>
<tr>
<th>Higher cash outflows than cash inflows from operating activities</th>
<th>Observed</th>
<th>Observed ratio</th>
<th>Expected</th>
<th>Difference</th>
<th>Chi-square value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very low</td>
<td>5</td>
<td>6.4%</td>
<td>15.6</td>
<td>10.6-</td>
<td>7.2</td>
</tr>
<tr>
<td>Low</td>
<td>6</td>
<td>7.7%</td>
<td>15.6</td>
<td>9.6-</td>
<td>5.9</td>
</tr>
<tr>
<td>Average</td>
<td>29</td>
<td>37.2%</td>
<td>15.6</td>
<td>13.4</td>
<td>11.5</td>
</tr>
<tr>
<td>High</td>
<td>32</td>
<td>41%</td>
<td>15.6</td>
<td>16.4</td>
<td>17.2</td>
</tr>
<tr>
<td>Very high</td>
<td>6</td>
<td>7.7%</td>
<td>15.6</td>
<td>9.6-</td>
<td>5.9</td>
</tr>
<tr>
<td>Sum</td>
<td>78</td>
<td>100%</td>
<td></td>
<td></td>
<td>47.8</td>
</tr>
</tbody>
</table>

The null hypothesis is rejected for the fourth hypothesis because the chi-square value is equal to 47.8, which is higher than the critical values, i.e. $\chi^2_{4.95} = 9/49$. The ratio of "high" and "very high" choices is 49% and the ratio of "low" and "very low" choices is only 14% of the observed ratios. This means that the skewness of distribution of answers is towards the area which shows that higher cash outflows than cash inflows from operating activities are effective in going concern.

The chi-square test for the fifth hypothesis
Like the previous hypothesis, the null hypothesis and the alternative hypothesis are formulated as follows:

\[
\begin{align*}
H_0: & \quad \text{major operating losses are not effective in going concern.} \\
H_1: & \quad \text{major operating losses are effective in going concern.}
\end{align*}
\]

Table 5. Chi-square test for the fifth hypothesis

<table>
<thead>
<tr>
<th>Major operating losses</th>
<th>Observed</th>
<th>Observed ratio</th>
<th>Expected</th>
<th>Difference</th>
<th>Chi-square value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very low</td>
<td>0</td>
<td>0.0%</td>
<td>15.6</td>
<td>15.6-</td>
<td>15.6</td>
</tr>
<tr>
<td>Low</td>
<td>2</td>
<td>2.6%</td>
<td>15.6</td>
<td>13.6-</td>
<td>11.9</td>
</tr>
<tr>
<td>Average</td>
<td>31</td>
<td>39.7%</td>
<td>15.6</td>
<td>15.4</td>
<td>15.2</td>
</tr>
<tr>
<td>High</td>
<td>32</td>
<td>41.0%</td>
<td>15.6</td>
<td>16.4</td>
<td>17.2</td>
</tr>
<tr>
<td>Very high</td>
<td>13</td>
<td>16.7%</td>
<td>15.6</td>
<td>2.6-</td>
<td>0.4</td>
</tr>
<tr>
<td>Sum</td>
<td>78</td>
<td>100%</td>
<td></td>
<td></td>
<td>60.3</td>
</tr>
</tbody>
</table>

The null hypothesis is rejected for the fifth hypothesis because the chi-square value is equal to 60.3, which is higher than the critical values, i.e. $\chi^2_{4.95} = 9/49$. The ratio of "high" and "very high" choices is 58% and the ratio of "low" and "very low" choices is only 3% of the observed ratios. This means that the skewness of distribution of answers is towards the area which shows that major operational losses are effective in going concern.

The chi-square test for the sixth hypothesis
Like the previous hypothesis, the null hypothesis and the alternative hypothesis are formulated as follows:

\[
\begin{align*}
H_0: & \quad \text{the level of usage of Standard No. 57 by auditors is not effective in going concern.} \\
H_1: & \quad \text{the level of usage of Standard No. 57 by auditors is effective in going concern.}
\end{align*}
\]

Table 6. Chi-square test for the sixth hypothesis

<table>
<thead>
<tr>
<th>Level of usage of going concern standard by auditors</th>
<th>Observed</th>
<th>Observed ratio</th>
<th>Expected</th>
<th>Difference</th>
<th>Chi-square value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very low</td>
<td>0</td>
<td>0.0%</td>
<td>15.6</td>
<td>15.6-</td>
<td>15.6</td>
</tr>
<tr>
<td>Low</td>
<td>2</td>
<td>2.6%</td>
<td>15.6</td>
<td>13.6-</td>
<td>11.9</td>
</tr>
<tr>
<td>Average</td>
<td>31</td>
<td>39.7%</td>
<td>15.6</td>
<td>15.4</td>
<td>15.2</td>
</tr>
<tr>
<td>High</td>
<td>32</td>
<td>41.0%</td>
<td>15.6</td>
<td>16.4</td>
<td>17.2</td>
</tr>
<tr>
<td>Very high</td>
<td>13</td>
<td>16.7%</td>
<td>15.6</td>
<td>2.6-</td>
<td>0.4</td>
</tr>
<tr>
<td>Sum</td>
<td>78</td>
<td>100%</td>
<td></td>
<td></td>
<td>60.3</td>
</tr>
</tbody>
</table>
Very low 0 0.0% 15.6 15.6- 15.6
Low 14 17.9% 15.6 1.6- 0.2
Average 23 29.5% 15.6 7.4 3.5
High 33 42.3% 15.6 17.4 19.4
Very high 8 10.3% 15.6 7.6- 3.7
Sum 78 100% 42.4

The null hypothesis is rejected for the fifth hypothesis because the chi-square value is equal to 42.4, which is higher than the critical values, i.e. $\chi^2_{0.05} = 9/49$. The ratio of "high" and "very high" choices is 53% and the ratio of "low" and "very low" choices is only 18% of the observed ratios. This means that the skewness of distribution of answers is towards the area which shows that the level of usage of going Concern Auditing Standard (No. 57) by auditors is effective in evaluating the going concern.

**Ranking the Factors Associated with Going Concern**

In the previous sections, each of the hypotheses was analyzed individually. Now, the question is that which factor is more effective on going concern from the respondents’ point of view? In other words, here the factors are ranked in terms of their impact on going concern. Given the dependency of the answers, nonparametric Friedman test is the most appropriate one for comparing the impacts.

Null hypothesis is rejected at confidence level of 99%, because the value of chi-square statistic is 68.22, which is in the range for rejection of null hypothesis. This means that effectiveness level of factors is different for going concern.

Failure to pay accounts payable in a timely manner has the highest impact on going concern. The second place goes to major operating losses and the level of usage of Auditing Standard by auditors; meanwhile, higher cash outflows than cash inflows from operating activities, unfavorable key financial ratios and greater total debts than total assets are the last factors with lowest impact on going concern respectively.

**Final Conclusion with Regard to the Hypotheses**

By further review of the research results it can be concluded that:

1. All hypotheses regarding the relationship between the factors influencing the going concern were not rejected and thus were accepted in this study. It should be noted that the hypothesis of "greater total debts than total assets" has the lowest impact on going concern.
2. The results clearly showed that the certified public accountants (CPAs) of the research population are well informed about the effective and warning factors of going concern. With regard to the point that whether there is a contradiction in terms of going concern at theoretical level with the views of independent auditors, one can conclude that almost all subjects were moderately to highly familiar with the theoretical bases of such factors.
3. To give a final answer to the question of existence of contradiction in terms of going concern at theoretical level with the views of independent auditors, with regard to results, it can certainly be concluded that there is no such theoretical contradiction with the views of independent auditors. This is because the results suggest there is no contradiction.
4. It should be noted that refuting or proving the existence of such contradiction entirely requires further investigation, especially measuring compliance with this standard in practice.

**Suggestion for Further Research**

1. Reviewing the contradictions of going concern in theory and practice in the audit reports of listed companies in the stock exchange.
2. Comparative study of views of auditors and financial managers with regard to the compliance with the Auditing Standard No. 57.
3. Assessing the business risks affecting the non-compliance with the Auditing Standard No. 57 for companies listed in the stock exchange.

**References**

American Standers on Auditing No.59


International Standards Committee (IASC)


