
THE SIGNIFICANCE OF INTERNATIONAL AUDITING STANDARD GOING CONCERN DURING ECONOMIC DOWNTURN

HAYK MNATSAKANYAN

"When each of the notorious "financial crisis" institutions collapsed, were bailed out/nationalized by their governments or were acquired/rescued by "healthier" institutions, they were all carrying in their wallets non-qualified, clean opinions on their financial statements from their auditors. In none of the cases had the auditors warned shareholders and the markets that there was a substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited"¹.

The International Standard on Auditing "Going concern" deals with the auditor's responsibilities in the audit of financial statements relating to management's use of the going concern assumption in the preparation of the financial statements. The going concern assumption is a fundamental principle in the preparation of financial statements. Under the going concern assumption an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation. Accordingly, unless the going concern assumption is inappropriate in the circumstances of the entity, assets and liabilities are recorded on the basis that the entity will be able to realize its assets, discharge its liabilities and obtain refinancing in the normal course of business. The assessment of an entity's ability to continue as a going concern is the responsibility of the entity's management. The appropriateness of management's use of the going concern assumption is a matter for the auditor to consider on every audit engagement. Some financial reporting frameworks contain an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. For example, the International Accounting Standard (IAS1) "Presentation of Financial Statements" requires management to make an assessment of an entity's ability to continue as a going concern: "When preparing financial statements management shall make an assessment of an entity's ability to continue as a going concern. Financial statements shall be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties shall be disclosed. When financial statements are not prepared on a going concern basis that fact shall be disclosed, together with the basis on which the financial statements are prepared and the reasons why the entity is not regarded as a going concern. In assessing whether the going concern

¹ From the speech of Tom Ray, PCOAB Chief Auditor and Director of Professional Standards, AICPA Conference, December 2008.

assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the balance sheet date. The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate may be reached without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate"².

The consideration of an entity's ability to continue as a going concern is required in every audit performed under accepted auditing standards and is an especially important consideration in the current state of the economy. In the case of entities whose operations are substantially budget-funded, going concern issues generally only arise if the government announces its intention to cease funding the entity. An entity's ability to continue as a going concern is affected by many factors related to the current uncertain economy. The factors can be current and expected performance of the entity, any announced and potential restructuring of organizational units, the likelihood of continued government funding and potential sources of replacement funding, the industry and geographic area in which it operates, the financial health of its customers, suppliers and financing sources. Accordingly, it is critical to perform an individual analysis of going concern issues related to each entity. The consideration of an entity's ability to continue as a going concern may be discussed during client retention procedures and also in the earliest stages of the audit. The auditor is responsible for evaluating whether there is a substantial doubt about the entity's ability to continue as a going concern for a reasonable period. Some examples of indications that there could be substantial doubt about the ability of the entity to continue as a going concern include, but are not limited to the following:

- Negative cash flows from operating activities, recurring operating losses, working capital deficiencies or lack of the ability to obtain additional financing.
- Other indications of financial difficulties such as defaults on debt, debt covenants, the need to seek new sources of financing or the disposal of substantial assets.
- Inadequate capitalization.
- Internal matters such as turnover in key management positions or substantial dependence on the success of a particular investment or project.
- Entrance into a new market for which the entity might not have the required expertise to successfully compete.
- External matters such as market conditions.

Audit teams may find it useful to have preliminary discussions about going concern considerations during engagement planning meetings. However, it is not necessary to design audit procedures around specifically identifying the possibility of a going concern since results of typical audit procedures should illuminate any indicators. These procedures may consist of analytical procedures, review of subsequent events, review of compliance with financing agreements and confirmation with related third parties of the details of arrangements to provide financial support.

² IAS 1, 1 January 2007, paragraphs 23-24, www.iasb.org

In current economic situation risks related to the entity's ability to continue as a going concern should be minimized. Such activities include the following:

- Discuss with management their relationship with the lender and review loan agreements.
- Determine the viability of the related party to provide financial support.
- Obtain a strong understanding of the entity's customers and suppliers and for any major customer or supplier consider reviewing data supporting their financial health.
- Review the projections in detail and consider their reasonableness based upon current economic conditions.

If the auditor believes that substantial doubt on the entity's ability to continue as a going concern exists, the next steps are to obtain management's plans. These plans need to mitigate the effect of such conditions and then assess the likelihood that can be effectively implemented.

As it was mentioned above, if an auditor determines there is a substantial doubt about an entity's ability to continue as a going concern, the auditor should communicate with those charged with governance of the entity. The auditor should also consider the effects on the entity's financial statements and the adequacy of the related disclosure. The disclosure might include such information as the condition which gave rise to the doubt about the entity's ability to continue as a going concern, management's evaluation of the significance of conditions and factors and management's plans going forward. Alternatively, if management's plan mitigates the risk of the entity's ability to continue as a going concern, the auditor should consider disclosing the primary conditions that gave rise to the initial doubt and management's plans. These disclosures are especially important for financial statement users to fully comprehend the entity's financial strength and ability to continue as a going concern.

The auditor's consideration of the going concern assumption applies irrespective of the accounting framework that has been used in the preparation of the financial statements. The auditor cannot predict future events or conditions which may cause an entity to cease to continue as a going concern. Accordingly, the absence of any reference to going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern. Management's assessment of the entity's ability to continue as a going concern is a key part of the auditor's consideration of the going concern assumption.

The detailed requirements regarding management's responsibility to assess the entity's ability to continue as a going concern and related financial statement disclosures may also be set out in law or regulation. Going concern establishes the relevant requirements and guidance. Management's assessment of the entity's ability to continue as a going concern is a key part of the auditor's consideration of the going concern assumption. The auditor considers the appropriateness of management's use of the going concern assumption even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. The standard requires the auditor to consider going concern in the early stages of the audit by considering whether there are events or conditions and related business risks which may cast doubt on the

entity's ability to continue as a going concern, and to remain alert during the audit for audit evidence to this effect³. Management's assessment of the going concern assumption involves making a judgment, at a particular point in time, about the future outcome of events or conditions which are inherently uncertain. Where management has made a preliminary assessment, it may be more likely in the current economic conditions that it will be necessary to update it at year-end taking into account which conditions may be changing. The economic downturn is likely to result in events or conditions being identified that will give rise to the auditor performing the audit procedures described in standard. On the basis of the evidence obtained, the standard requires the auditor to determine if in the auditor's judgment a material uncertainty exists related to events or conditions that alone or in aggregate 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 is such that in the auditor's judgment clear disclosure of the nature and implications of the uncertainty are necessary for the presentation of the financial statements not to be misleading. It is important that auditors communicate with management and those charged with governance early in the audit to obtain an understanding of how management intends to assess the entity's ability to continue as a going concern and to enable the auditor to communicate any events or conditions relating to the going concern assumption that have already been identified during the audit. In some cases management may have already made a preliminary assessment that the auditor would review when performing risk assessment procedures to determine whether events or conditions relating to the going concern assumption have been identified and whether management has plans to address them.

Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern are recognized in the standard as audit matters of governance interest that the auditor should communicate to those charged with governance. However, it is likely in the current economic situation that matters relevant to the assessment of the entity's ability to continue as a going concern are already being considered by those charged with governance. A failure to have considered relevant issues may represent a weakness in governance or risk management procedures and may lead to inadequately prepared financial statements.

As noted above the assessment of an entity's ability to continue as a going concern depends on the facts and circumstances. In times like the present, making this assessment may become increasingly difficult, as the landscape in which entities are operating is rapidly changing. In particular, it relates to availability of credit and the impact on forecasts and budgets, as the recession bites and the cost of borrowing rises. The standard acknowledges that entities with a history of profitable operations and ready access to financial resources may not need a detailed analysis to support the going concern assumptions. However, the effect of the economic downturn is likely to be that such an approach will no longer be appropriate for many entities. In particular, the implicit assumptions behind such an approach may no longer be valid in the current environment. Issues surrounding

³ ISA 570, "Going Concern", Handbook of International Standards on Auditing and Quality Control, International Federation of Accountants.

liquidity and credit risk may create new uncertainties or may exacerbate those already existing. Even many well-respected entities with a long-standing history of profits and availability of credit may find it difficult to obtain or renew financing. Entities that have typically relied on extensions of debt payments or waivers of debt covenants at year-end may find that this relief is no longer available from their lenders. The economic crisis may also undermine the previous assumptions about profitability. Consequently, entities that have not previously found the need to prepare a detailed analysis in support of the going concern assumption may need to give the matter further consideration. In many cases, the management of smaller entities may not have historically prepared a detailed assessment of the entity's ability to continue as a going concern but instead may have relied on in-depth knowledge of the business and anticipated future prospects. Matters such as owner-manager support may become even more pertinent in the current economic environment. The auditor also inquires of management as to its knowledge of events or conditions and related business risks beyond the period of assessment used by management that may cast significant doubt on the entity's ability to continue as a going concern.

Neither management nor the auditor can predict future events or conditions that may cause an entity to cease to continue as a going concern. The unexpected speed and consequences of the crisis illustrate that fact only too well. It is for these reasons that the standard states that the absence of any reference to going concern uncertainty in the financial statements or the auditor's report cannot be viewed as a guarantee that future events or conditions will not result in the entity ceasing to continue as a going concern. The current economic conditions do not change either management's or the auditor's responsibility relating to the going concern assumption. There is no doubt that the events of the past year and the outlook for the future present challenges that will need to be considered by management and auditors alike in meeting those responsibilities.

The existence of one or more events or conditions mentioned in the standard does not always signify that a material uncertainty exists. When identified, these events or conditions prompt the auditor to perform further audit procedures to gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists. One major effect of the economic downturn is the lack of available credit to entities of all sizes. Turmoil in the banking sector has led to a general tightening of credit, which may have a pervasive effect on an entity's ability to continue as a going concern. In addition, as an entity's financial health changes, contractual terms in loans and other obligations, including debt covenants and guarantees and an entity's compliance with such terms, are likely to be under greater scrutiny from lenders and also from management and auditors. An important component of the going concern assessment relates to an entity's ongoing forecasts and budgeting. In evaluating management's assessment, the auditor considers the process management followed to make its assessment, the assumptions on which the assessment is based and management's plans for future actions. In considering alternative strategies that management may have to overcome any adverse factors, considerations include their effectiveness and the ability of management to execute them. Analysis of cash flow may be a significant factor in considering the future outcome of events or conditions in the evaluation of man-

agement's plans for future action. Assumptions that have been used in prior years may no longer be relevant and may need to be adjusted to account for the pressures of the current environment. For those entities that are significantly affected by the current economic conditions management needs to consider how to address the risks arising from the current economic conditions in their financial statements under the applicable financial reporting framework. Many financial reporting frameworks require that the financial statements provide sufficient disclosures to enable users to understand the effects of material transactions and events on the information conveyed in the financial statements. Many also require entities to disclose the nature and extent of risks arising from financial instruments. A combination of qualitative and quantitative disclosures of liquidity risk and credit risk will be helpful to investors as the economic landscape and future outlook unfold.

Historically, when management has concluded that the entity is a going concern without related material uncertainty, this conclusion has not usually been expressly stated in the financial statements. Even in such cases management may consider it appropriate to make disclosures in the current year's financial statements. Also it is necessary to set out the challenges that management is facing in the current economic environment and how this affects the outlook for the entity. The current economic conditions are likely to increase the level of uncertainty existing when management makes their judgment about the outcome of future events or conditions. However, while the effect of the current market conditions on individual entities requires careful evaluation, it should not necessarily be assumed that the general economic situation at the present time in itself means that a material uncertainty exists. Not all extensive disclosures necessarily indicate the existence of a significant doubt about the entity's ability to continue as a going concern. In fact, an objective of the disclosures may be to explain why the going concern issues that affect the entity do not give rise to a significant doubt.

Based on the audit evidence obtained, the auditor concludes whether management's use of the going concern assumption in the preparation of the financial statements is appropriate and determines what type of opinion is to be issued in the circumstances. If the auditor concurs with management's assessment, an unqualified opinion would be issued. Forming an opinion on the financial statements includes consideration of disclosures, certain of which assume more significance in times of uncertainty. The auditor should determine if in the auditor's judgment, a material uncertainty exists related to events or conditions that, alone or in the aggregate, may cast significant doubt on the entity's ability to continue as a going concern. If in management's conclusion the use of the going concern assumption is appropriate, the standard requires the auditor to consider the adequacy of disclosure in the financial statements and to modify the auditor's report by including an appropriate emphasis of matter paragraph if the disclosure in the financial statements is adequate. Management may consider it appropriate to make disclosures in order to reassure users of the financial statements about the entity's financial position in the light of the general uncertainty. Such disclosures may reflect only the existence of general or systemic risk. Such disclosures may be considered important and appropriate in the circumstances to ensure that the financial position of the entity is placed in appropriate context given the general economic conditions and how those conditions may affect the entity. However, the fact that

management has included such disclosures in the financial statements does not necessarily mean that there is a material uncertainty that warrants an emphasis of matter paragraph in the financial statements. If the uncertainty arises not only as a result of the systemic position but also because of circumstances specific to the entity or economic downturn, it is more likely that the auditor will judge it to be material. An entity should not prepare its financial statements on a going concern basis if those responsible for the preparation of the financial statements or the governing body determine after the reporting date either that there is an intention to liquidate the entity or to cease operating or that there is no realistic alternative but to do so.

ՀԱՅԿ ՄԱՑԱԿԱՆՅԱՆ - «Գործունեության անընդհատություն». աուդիտի միջազգային ստանդարտի կարևորությունը տնտեսական ճգնաժամի պարագայում - Աուդիտորական եզրակացությունն օգնում է հաստատելու ֆինանսական հաշվետվությունների հուսալիությունը: Ֆինանսական հաշվետվություններ պատրաստելիս ենթադրվում է, որ տեսանելի ապագայում կազմակերպությունն անընդհատ գործելու է, եթե բացակայում են հակառակը հաստատող տեղեկություններ: Նշված միջազգային ստանդարտի նպատակը ֆինանսական հաշվետվությունների աուդիտի ընթացքում ֆինանսական հաշվետվությունների պատրաստման համար կազմակերպության գործունեության անընդհատությունը որպես հիմք ընդունելու համապատասխան որոշումն է: Հոդվածում վերլուծվել է ստանդարտը և ներկայացվել են տնտեսական անկման պարագայում ստանդարտի կիրառման խոչընդոտները և դրանց հաղթահարման ուղիները:

АЙК МНАЦАКАНЯН – Значимость международного стандарта аудита «Принцип непрерывности» в условиях экономического кризиса. – Аудиторское заключение помогает установить надёжную финансовую отчётность. При её подготовке предполагается существование экономического агента как непрерывно действующего в обозримом будущем предприятия, если отсутствует информация о противоположном. Цель стандарта – установить при аудите финансовой отчётности нормы ответственности аудитора в том, что касается соответствия данной отчётности принципу непрерывности как основополагающему принципу подготовки финансовой отчётности. В статье проанализирован стандарт и представлены проблемы его применения в условиях экономического спада.