

THE EXAMINATION OF THE GOING CONCERN IN A MISSION OF AUDITING THE ANNUAL FINANCIAL STATEMENTS

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***Abstract:** An important tool made available to the parties involved in a market economy in the era of globalization by economic practice, to provide end-users with assurance on the truthfulness and reliability of the information provided by the financial statements, is statutory audit. In addition, in order to increase the confidence of users in this information, the auditors should determine whether the audited entity complies with the principle of going concern, in which sense they must determine the bankruptcy status of the audited entity, respectively to determine the solvency level of it. In order to make this assessment, economic practice provides the necessary tools through the economic and financial analysis, using the scores method and applying the Altman model.*

***Key words:** audit, statutory audit, audit mission, going concern, Altman Model.*

***JEL Classification:** M42.*

1. Introduction

In a booming market economy, being influenced by all the changes that take place globally, politically, socially and technologically, audit is a tool made available to society by professional bodies in the field to provide the parties involved in the economic process, safety, respectively reasonable assurance regarding the consistency of the information provided by the financial statements with the requirements of a general reporting framework upon which they were drawn up.

Audit consists of a set of interrelated activities (a process) conducted by auditors or other experts who, based on their theoretical and practical knowledge, and following assignments received from certain bodies, analyzes the information and the operations of an entity or related to a certain activity to provide assurance through an opinion or to make recommendations (Oprean, 2002, p.17).

In conducting an audit of financial statements, the auditor's overall objectives are (IAASB, IFAC, CAFR, ISA 200.11, 2016, p.83):

- To obtain reasonable assurance as to the extent to which the financial statements as a whole are free from material misstatement, whether due to fraud or error, thus allowing the auditor to express an opinion on the extent to which the financial statements are prepared in all material respects, in accordance with the applicable financial reporting framework.

- To report on financial statements and communicate as required by ISAs, in accordance with the auditor's findings.

As part of the work done by auditors, an important task made by them, is to obtain audit evidence by which they determine whether the audited entity complies with the principle of going concern, respectively determines the entity's ability to continue to follow this principle or whether there is a suspicion of possible inability to continue its activity.

The audited entity's ability to observe the business going concern principle is very important to end-users of financial information, especially for investors, thus influencing their decision on the possibility to invest in the near future in the audited entity.

The purpose of the present approach is to present the importance of examining the going concern in an audit mission and to analyze, from a practical point of view, how such a procedure can be implemented through a case study.

2. Methodology

In order to achieve the proposed goal of the present scientific approach, the methodology of the scientific research used, from a theoretical point of view, is based on the study of the specialized literature and the regulations in the field regarding the going concern in an audit mission, respectively regarding the use of the score method through the implementation of the Altman model, and from a practical point of view, it is based on the presentation of a case study on the procedure of examining the going concern in an audit mission applied in the case of a listed entity.

3. Examining the going concern in the activity of auditing financial statements

An important work performed by the auditor in an audit engagement and which is of major interest to end-users, especially to investors to whom the final product is addressed from the conclusions of that activity, respectively the audit opinion issued in the auditor's report independently, is to determine the capacity of the audited entity to continue its activity.

Based on the going concern hypothesis, it is considered an entity is a going concern and will continue its business activities in the near future. General purpose financial statements are prepared on a going concern basis, unless the management either intends to liquidate the entity or stop operations or has no other realistic alternative outside of it. When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and pay its liabilities in the normal course of business (IAASB, IFAC, CAFR, ISA 570.2, 2016, p.578).

The auditor's responsibilities are to obtain sufficient and appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements, and to conclude, based on the audit evidence obtained, whether a material uncertainty exists about the entity's ability to continue as a going concern. The objectives of the auditor are (IAASB, IFAC, CAFR, ISA 570.6, ISA 570.9, 2016, pp.579-580):

- To obtain sufficient and appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statement's;
- To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern;
- To establish the consequences of the audit report.

Depending on the situation identified, the auditor will present in the audit report one of the following situations regarding the going concern of the audited entity's activity (Socol, 2017, p.163):

- The presumption of going concern of activity is appropriate;
- The presumption of going concern of activity is appropriate, but there is significant uncertainty;
- The assumption of going concern of activity is inadequate.

Often, analytical procedures are used as indicators to indicate whether the audited entity is facing significant financial difficulties. The probability of a future financial blockage should be analyzed by the diagnostician in the risk assessment procedures as well as by the way managers have applied the business going concern assumption during the preparation of the financial statements. Certain examinations can prove to be very useful in this regard, for example in the case of the finding of an over-average ratio between long-term liabilities and net assets, together with a ratio between the profit and the total assets

below average, when it can be deduced that there are financial difficulties, commercial and of other relatively large nature. Such circumstances not only affect the planning of the audit, but may also indicate the existence of a substantial doubt regarding the ability of the client entity to maintain its continuity of operation, respectively the occurrence of bankruptcy risk (Domnişoru, 2011, pp.331-332).

In practice, the risk assessment of going into business and maintaining the company's business in a competitive market also requires the use of statistical methods for predicting the risk of bankruptcy, of which, on short-term, we mention the score method or "credit-scoring". The target of this method is to determine for each company a summary indicator called "score", which would allow the estimation of the bankruptcy of the company. One of the analytical models of the bankruptcy developed in economic theory is Altman model, also called "Z" model. This model is a statistical-mathematical model for forecasting the bankruptcy of companies, being developed in the USA, in 1968, by Professor Altman. The "Z" model includes five variables considered the most representative financial understates of a company. With this model, the inspired professor was able to foresee about 75% of the bankruptcies of some companies with approximately two years before their occurrence (Domnişoru, Vînătoru and Gîrbaci, 2010, pp.7-8).

In order to be able to establish the entity's ability to continue as a going concern, auditors have at their disposal various methods established over time by economic and financial analysis specialists. Using the scores method, the Altman model can be applied to determine the Z function and determine whether the audited entity complies with the going concern principle and provide assurance to end-users, or potential investors, of whether the audited entity can continue as a going concern.

4. Examining the bankruptcy risk using the Score method

In the literature, using the Score Method, several models are available to specialists to determine the bankruptcy risk of entities. These include the Conan-Holder Model, the Altman Model, the central bank model of France, etc.

A scoring function is a combination of rates whose value for a given enterprise allows the forecast of its bankruptcy risk. The first scoring functions were conceived in the United States in 1960. The most important and already old researches in the field are undoubtedly those of E. I. Altmann; many subsequent studies, especially French, have drawn inspiration from them (Colasse, 2009, pp.173-174).

The Altman model is a predictive model of the company's bankruptcy. The decline of the enterprise occurs in several phases (Păvăloaia, et al., 2010, pp.374-375):

- Phase 1 – The early phase (decrease in profitability, decrease in turnover, debt increase, decrease in liquidity), these signs are disregarded;
- Phase 2 - clear signs of decline for which no action is taken, in the hope of their disappearance by themselves without intervening;
- Phase 3 - Strong action of declining factors, with a rather serious deterioration of the financial situation;
- Phase 4 - Collapse, managers' failure to take corrective action;
- Phase 5 - Intervention through recovery measures or by declaring bankruptcy.

The values of the Z function are (Păvăloaia, et al., 2010, p.375):

- $Z < 1,81$ – the firm is insolvent, is in Phases 4 and 5;
- $1,81 < Z \leq 2,9$ – the firm is in difficulty, phases 2 and 3;
- $Z > 2,9$ – the firm is solvent.

In order to apply the Altman model, it is necessary to determine the five specific variables and then establish the Z function. The related formulas are presented below in Table no. 1.

Table no. 1. Altman Model

Rate	Rate Name	Rate Formula
R ₁	Current assets rate	$R_1 = \frac{\text{Current assets}}{\text{Total assets}}$
R ₂	Return rate reinvested	$R_2 = \frac{\text{Reinvested profit}}{\text{Total assets}}$
R ₃	Economic profitability rate	$R_3 = \frac{\text{Gross profit}}{\text{Total assets}}$
R ₄	Financial stability rate	$R_4 = \frac{\text{Equity}}{\text{Medium and long term debt}}$
R ₅	Rotation speed of the total asset	$R_5 = \frac{\text{Turnover}}{\text{Total assets}}$
$Z = 1,2 R_1 + 1,4 R_2 + 3,3 R_3 + 0,6 R_4 + R_5$		

Source: Own interpretation after C. Burja, *Enterprise's Financial Managing*, Seria Didactică, Alba Iulia, 2017, pp.157-158.

Using the Altman model, by determining its specific rates and then the Z function, one can determine the solvency level of an entity that reflects its bankruptcy status.

5. A case study regarding the procedure of examining the going concern in a mission of auditing the annual financial statements

The entity SC AUDIT SRL carries out the audit activity of the financial statements related to the entity SC ALFA SRL, an entity listed on the Bucharest Stock Exchange, thus being a public interest entity. Among the activities carried out in order to establish the conclusions of the auditing activity on which the auditor's opinion is based, is an examination of the going concern. In order to determine the entity's ability to continue its going concern, the auditor uses the Altman Model. In the table no. 2 an extract from the balance sheet and the profit and loss account of SC ALFA SRL, which contains the indicators used to apply the Altman Model, is found.

Table no. 2. Extract from the balance sheet and the profit and loss account of the entity SC ALFA SRL

Indicators	-mil. Lei-		
	2015	2016	2017
Total assets	51398	51768	53587
Current assets	6373	7856	20195
Reinvested profit	5746	3561	3209
Equity	40555	50872	56132
Turnover	18479	15743	25742
Medium and long term debt	18385	17018	15801
Gross profit	908	1581	3930

Applying the mathematical formulas to determine the rates underlying the Altman model, through which the Z function is then determined, the auditor can determine the solvency level of the audited entity SC ALFA SRL. Within Table no. 3, the values of these

rates are determined during the period 2015-2017, and then the Z function is determined for each analyzed year.

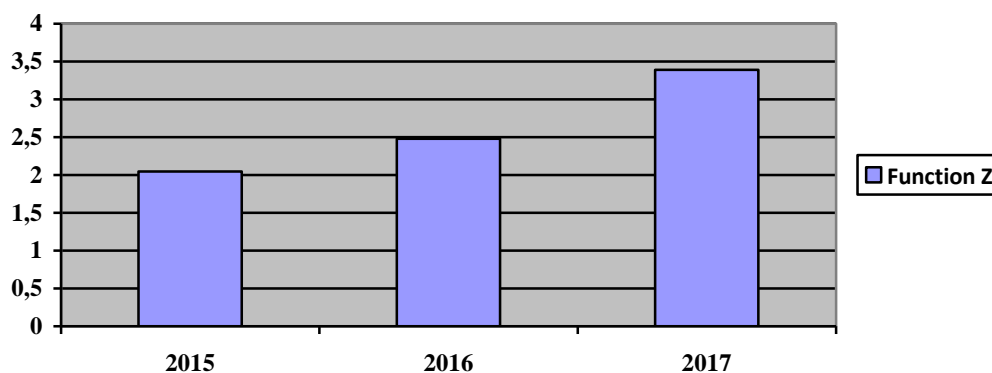
Table no. 3. Determining the Altman Model indicators in the case of entity SC ALFA SRL entity

Rate	2015	2016	2017
R ₁	0,12399	0,15175	0,37686
R ₂	0,11179	0,06879	0,05988
R ₃	0,01767	0,03054	0,07334
R ₄	2,20587	2,98931	3,55243
R ₅	0,35953	0,30411	0,48038
Function Z	2,04665	2,47688	3,38993

Source: own creation

In Figure no. 1 are represented the values of the Z function in the period 2015-2017, in order to be able to visualize the evolution of the bankruptcy risk, respectively the solvency level of the audited entity.

Figure no. 1. Evolution of Z function during the analysis period of the indicators related to the entity SC ALFA SRL



Source: own creation

We note that in 2015 and 2016, the values of the Z function are in the range of (1.81, 2.9], the audited entity thus being in difficulty, but by implementing appropriate measures, the entity has managed to overcome this situation, the Z function registering in the year 2017 a value of more than 2.9 and 3.38993, which indicates that the audited entity became solvent and the end users, respectively, the potential investors can trust the viability of this entity.

6. Conclusions

The activity of auditing financial statements is a complex process that, through the opinion issued in the independent auditor's report, seeks to increase the level of confidence of end-users in the information provided by the financial statements, respectively in the work carried out by the audited entities. In this regard, within the auditing process, an activity performed by the auditor and which has a direct impact on the decisions made by the end-users, is the examination of the audited entity's ability to continue as a going concern.

In order to examine the ability of an entity to continue as a going concern, the literature provides professionals with the necessary tools through the economic-financial analysis, respectively, in this case, using the scores method by applying the Altman model and determining the Z function. In the case study presented, we can observe that the audited entity was in difficulty for the first two years analyzed, but following the implementation of the necessary measures in the last year analyzed, the entity managed to overcome this situation and become solvable, thus allowing end-users to trust in its reliability.

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