

FROM THE ASSUMPTION OF CONTINUING THE ACTIVITY TO INSOLVENCY – DEBATES AND REFLECTIONS

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ABSTRACT: *After 1994, the Romania accounting regulation faced many important changes. Accounting regulation was issued in Romania before 1990, but nobody spoke about accounting principles. The presentation of accounting principles in the Romanian accounting regulation has been made recently. The accounting profession tried, first of all, to understand these new concepts, and after that it started to use them in its activity. The going concern principle represents a fundamental concept used in order to prepare the financial statements of an entity. At national level, the Romanian economy faces an increased number of entities with financial difficulties and often with insolvency. The present paper aims to present some reflections upon the role of accounting practitioner in going concern analysis and accordingly the presentation of some issues that could prevent the financial difficulties and even the insolvency of an entity.*

KEYWORDS: *going concern assumption, responsibility, accounting professional, accounting regulation, insolvency*

JEL CLASSIFICATION: *K 22, K 42, M 41*

1. INTRODUCTION

Statistics on the increasing number of entities facing insolvency arouse interest and at the same time create controversies. Controversies are determined, on the one hand by the reasons that lead to the entity's insolvency, and on the other hand by the fact that, during the life of an economic entity, a lot of people who have a role in preventing such a state intervene.

The analysis of an economic entity starts, most of the times, from the perspective of the entity's ability to continue as a going concern.

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For the different categories of external users of the financial-accounting information (present or potential investors, employees, creditors, suppliers, clients, state's institutions, general public), the most important source of information on an entity's going concern and cease of an entity's activity should be, in our opinion, the annual financial statements and, maybe, the auditing report, where the legislation requires the auditing of the financial statements or if there is interest on behalf of the entity's proprietors for such an action.

The current accounting regulation (Order 3055/2009 of the Ministry of Public Finance, with the subsequent changes and adjustments) presents the size criteria according to which companies in Romania are classified in order to present the financial accounting information through the written financial statements and correspondingly the obligation of auditing or not the financial statements presented.

The responsibility of publishing information on the going concern assumption in the annual financial statements should be equally shared by the entity's management, professional accountants and financial auditors.

An entity's ability to continue as a going concern is not an assumption that we can silently accept, on the contrary it needs to be analysed. The accounting regulation in Romania (Order 3055/2009 of the Ministry of the Public Finance) specifies at point 38 (1) "there is need to assume that the entity develops its activity based on the going concern assumption. This principle implies that the entity normally continues its activity, without facing insolvency or the significant reduction of activity". Thus, the question regarding the criteria that should be taken into consideration in evaluating an entity's ability or inability to continue as a going concern arises. Once identified and known, who will analyse these criteria, who will be responsible for analysing them, and finally who will express a responsible and pertinent point of view? If the people in charge of this evaluation do not treat it with maximum attention, can the entity's insolvency be imputed to them? This is a question we would like to give an answer to, without aiming to cover all implications of such a question.

2. THE ENTITY'S ABILITY TO CONTINUE AS A GOING CONCERN – WAYS OF ANALYSIS

A relative clue to an entity's inability to continue as a going concern may be the continuous recording of losses over a certain number of years, having an impact on the size of its own funds. Moreover, art. 153²⁴, paragraph (1) of Law no. 31/1990 on companies, republished, stipulates that "if the board of directors, the management respectively, notices that, after some losses established by the annual financial statements approved according to the law, the net asset of the company, determined as difference between the total assets and total liabilities, diminished by half the value of the share capital, they will immediately convene the extraordinary general meeting in order to decide if the company needs to be dissolved".

In the specialist literature¹, three possibilities are presented that can define the entity's ability to continue as a going concern:

- the going concern assumption is tacitly accepted if no other fact managed to demonstrate the opposite; however it is indicated, in the explanatory notes of the annual financial statements, that the basis for preparing the financial statements should be mentioned;

- the going concern assumption is questioned, but not compromised – in this case mandatory specifications are necessary in the explanatory notes of the financial statements, the impact on the balance sheet and the profit and loss account being mentioned;

- the going concern assumption is compromised, in this case the financial statements need to be prepared and presented on different bases.

The criteria based on which an assessment can be made on an entity's ability to continue as a going concern are structured within the *International Standard on Auditing no. 570 (ISA 570)* as follows²:

1) *Financial clues* refer to:

- ✓ net liability or net current liability position.
- ✓ fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- ✓ indications of withdrawal of financial support by creditors.
- ✓ negative operating cash flows indicated by historical or prospective financial statements.
- ✓ adverse key financial ratios.
- ✓ substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- ✓ arrears or discontinuance of dividends.
- ✓ inability to pay creditors on due dates.
- ✓ inability to comply with the terms of loan agreements.
- ✓ change from credit to cash-on-delivery transactions with suppliers.
- ✓ inability to obtain financing for essential new product development or other essential investments.

2) *Operating clues* consist in:

- ✓ loss of key management without replacement;
- ✓ loss of a major market, key franchise, license, or principal supplier;
- ✓ labour difficulties or important shortages in the supply activity

3) *Other clues* refer to:

- ✓ non-compliance with capital or other statutory requirements;
- ✓ pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy;

¹ Idem, pag. 110.

² International Auditing and Assurance Standards Board, ISA 570 Going concern, 2009, available online at <http://web.ifac.org/clarity-center/isa-570>.

✓ changes in law or regulation or government policy expected to adversely affect the entity;

The presented clues represent a series of analyses that financial auditors should carry out in their activity in order to advance an auditing opinion. Their presentation here aims to clarify the course of action of those called to express an opinion on an entity's going concern. It can be noticed that there are clues that offer sufficient arguments in favour or not of an entity's ability to continue as a going concern. However, we should see whose responsibility this course of action is.

3. THE RESPONSIBILITY IN ASSESSING THE GOING CONCERN ASSUMPTION

Our course of action aims to identify the entities (people) responsible for the analysis of the going concern possibility of an activity and for the publication of useful information in order to assess the going concern assumption.

The responsibility of the entity's management

The accounting regulation applicable in Romania stipulates the obligation of the entity's management to analyse possible material uncertainties related to events that can lead to its inability of continuing as a going concern and to present these events in the explanatory notes of the annual financial statements.

"If the entity's managers are aware of any material uncertainties related to certain events that can lead to the entity's inability to continue as a going concern, these elements have to be presented in the explanatory notes. In case the annual financial statements are not prepared on the going concern basis, this information has to be presented, together with explanations on the way of preparing them and the reasons that were the basis of the decision according to which the entity cannot continue as a going concern³".

In other words, the entity's management is responsible for assessing the adequacy of the going concern assumption, so that the financial-accounting information presented in the annual financial statements give a true and fair view of the activity within that entity.

International auditing standard ISA 570 mentions that the going concern assumption is fundamental for preparing the annual financial statements. In this context, the management is responsible for assessing the adequacy of the going concern assumption, even if the reporting framework does not stipulate an explicit responsibility⁴.

Beside the responsibility to check the adequacy of this assumption, the management is obligated to present the material uncertainties regarding events and situations that question the entity's ability to continue as a going concern. The

³ Order MPF 3055/2009 "Reglementări contabile conforme cu Directiva a IV-a a Comunităților Economice Europene", point 38, paragraph (3)

⁴ Eugeniu Țurlea, Mihaela Mocanu – *Considerații privind responsabilitatea administratorilor și auditorilor în evaluarea principiului continuității activității*, Financial Auditing Journal, year VIII, no. 19/2010, pp. 24-31.

management needs to provide sufficient information that enables the users of the financial statements to understand⁵:

- ✓ pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern;
- ✓ the possible effects of those conditions and events;
- ✓ management's evaluation of the significance of those conditions and events, as well as any mitigating factors;
- ✓ possible discontinuance of operations;
- ✓ management's plans to mitigate the effect of the uncertainties etc.

The accounting profession's responsibility

Preparing annual financial statements is the responsibility of each entity. As far as the accounting organization is concerned, art. 10 of the republished Accounting Law stipulates "(1) The manager, the authorising officer or any other person in charge of managing assets shall bear responsibility for organizing and keeping the accounts

(2) The entities set out in Article 1 shall, as a rule, organise and keep the books in separate departments, headed by the financial-accounting director, the accounting officer or any other person empowered to fill this position. Such persons shall have a university degree in economics.

(3) Accounting activities may also be organised and carried out by authorised legal persons based on agreements for providing services in the accounting field, signed with natural or legal persons, authorized by law, who are members of the Body of Expert and Licensed Accountants of Romania.

(4) The chief financial officer, the chief accountant or any other person empowered to hold this position, together with the staff accountable to them, are accountable for the improper following of the accounting regulation. In case the accounting activity is carried out based on an agreement for providing services, signed with natural or legal persons, authorized by law, who are members of the Body of Expert and Licensed Accountants of Romania, the accountability for carrying out the accounting activity is theirs, according to law and the provisions in the contract."

No matter the way in which the accounting activity is organized the accounting professional has a huge responsibility, clearly stipulated in art 10, paragraph 4 of the Accounting Law 82/1990, republished. Making clear reference to the accounting regulation, it explicitly results that the application of this regulation is imperative and it has clear implications referring to accountability.

Section 7 of the MPF Order 3055/2009 refers to the general accounting principles and to the fact that the elements presented in the balance sheet, the profit and loss account, the explanatory notes are based on the assumption that the entity will normally continue its operations, without facing liquidity or significant reduction of activity. In order for the accounting professional to prepare the financial statements, he/she will evaluate the compliance with the accounting principles and with the going concern assumption implicitly.

⁵ Financial Accounting Standards Board (FASB) – Exposure Draft „Proposed Statement of Financial Accounting Standards. Going Concern”, October 2008, available online at http://www.fasb.org/ed_going_concern.pdf.

The question that arises, quite often, refers to the situations that have appeared over the last years, when a series of entities faced insolvency, although no element in the way of presenting the financial statements foresaw this state. Can this state also be imputed to the accounting professional? Could the accounting professional have anticipated through a pertinent analysis the entities' inability to continue as a going concern? Even if these are difficult questions to be asked, they are equally necessary!

In our opinion, generalizing the reasons for which so many entities have faced insolvency is an inadequate and maybe even irrelevant point of view. After 1990, for many years, we have not focused on the analysis of the accounting principles at the level of the Romanian entities, and now we are really starting to be aware of the importance of the general accounting principles in presenting the annual financial statements. Unfortunately, our awareness has cost and it still costs too much. Still, if the accounting professional had had clear clues that questioned the entity's ability to continue as a going concern, would he/she have presented them?

If he had, who would have been interested in them, taking into account that most of the Romanian entities are small and medium sized, and the financial statements presented by them have a relatively small number of users of the financial-accounting information? According to some studies carried out [Neag et al, 2009; Bunea et al 2011] the most important users of the financial-accounting information for these entities are creditors, especially banks, and the state through its bodies.

Maybe these users, through rigour and requests for relevant information could impose a professional conduct in the business environment, with a direct impact on the way of presenting information in annual financial statements.

The responsibility of the accounting profession exists and we need to be aware of it. Maybe through a better collaboration between the entity's management and the accounting profession, insolvency could have been avoided in some of the cases.

The present time proves that current problems make us reconsider the relationship between manager and chief accountant or another accounting professional (in case of outsourcing the accounting services).

The auditors' responsibility

The auditor's responsibility is that of analysing the adequate character of using the going concern assumption by the management in preparing financial statements and examining if there are material uncertainties regarding the entity's ability to continue as a going concern, which needs to be presented in the financial statements.

We do not wish to go deeply into the auditor's responsibility, but rather to draw the attention to the fact that there is a third party that could have a standpoint in analysing an entity's ability to continue as a going concern. And because this party intervenes only in a limited number of entities, at least in our country (not all entities are obligated to audit their financial statements), we will stick to this specification. However we draw the attention to the fact that, also in the case of big companies, unpleasant surprises existed even after obtaining an opinion without reserves from the auditor, those companies going bankrupt.

4. CONCLUSIONS

The path from the going concern assumption to insolvency is a reality of present days. This situation is not one which determines us to witness passively what is going on. Since we, the authors, are university professors and practitioners in accounting, we would like to pinpoint the fact that the responsibility related to the true and fair presentation of the financial situation and the performance achieved by an entity needs to be a desideratum of each accounting professional's work.

The permanent collaboration with the entity's management does not have to be treated residually, but it needs to be a permanent conduct. It is said that we learn from our mistakes, but sometimes these mistakes have huge implications, sometimes difficult to be quantified. Accounting principles and the going concern assumption implicitly need to be analysed thoroughly.

“What do you want me to tell you: enjoyable lies or harsh truths? Choose!”⁶

In our opinion, an entity's manager should not have to choose, and the accounting professional should not ask such a question or think like this. He/she should know the spirit and letter of the accounting regulation applicable and contribute through his/her professional reasoning to the entity's activity and signal, when it is necessary, the noticed problems.

The presentation of applying the going concern assumption in preparing the financial statements is mainly designed for the external users of financial-accounting information. An analysis not carried out or one carried out wrongly in terms of the basic criteria based on which assessments can be made regarding an entity's ability to continue as a going concern leads to the aggravation of the entity's financial situation and to the creation of a “work field” for practitioners in insolvency.

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