AUDIT OF THE ADEQUACY DEGREE FOR THE PRINCIPLE OF ACTIVITY CONTINUITY Cicilia IONESCU

“Spiru Haret” University, Bucharest, Romania,
cicilia.ionescu@yahoo.com

Abstract: *Our entire research concerning audit of the adequacy degree for the principle of continuity in the activity of an entity is based on the personal experience in auditing the financial statements and mainly on looking for a plausible answer to the following question: „Does the auditor opinion expressed in an Audit Report totally support the credibility assessment of financial statements?” The answer for this question is that „the Auditor report supports the assessment of financial statements but is not a warranty regarding the future viability of the economic agent”. This warranty, if the timing is not too optimistic, is insured by the action undertaken by the auditor in the direction of auditing of the degree of adequacy of the principle of activity continuity.*

Keywords: financial statement audit, the auditor's opinion, audit report, activity going concern, the auditor's responsibility.

Introduction

In order to find the answer at the above mentioned question, we want to remind that lately the financial statements of the economic agents which are subject to accountancy regulations complying with international and European directives on accountancy have been audited by financial auditors, natural or legal persons. The auditing is fully performed in conformity with the specific requirements of the EU directives, with the Development Programs of the Accountancy System in Romania and with the audit legislation in force.

In order to perform financial audit activities, the auditor, natural or legal person passes through important stages/phases, such as: understanding of accountancy and internal control systems, setting of general objectives of financial statements audit, expressing of an opinion regarding the image offered by the audited financial statements, audit of conformity according to the laws and requirements in force, auditing regarding the adequacy

degree of the principle of activity continuity as basis for the preparation of financial statements, sectional auditing of the financial statements, drafting of audit report of the financial statements. Each of these stages has its individual and corroborate role, all being of use, finally, at shaping a reasonable opinion regarding those financial statements, which can be formulated within an audit report. Thus:

- *During the stage on understanding the accountancy and internal control systems* – an efficient approach requires that the auditor has sufficient understanding of the way the accountancy and internal control systems are conceived and of their operation method. The auditor assesses the recording and processing system of transactions performed by the audited agent and whether it can be used as a basis for establishing the financial statements. If the auditor decides he can rely on the internal controls, he will assess these controls and will perform conformity tests upon them.

- *During the stage which involves the setting of the general objectives of an audit* – the auditor will consider the fact that the auditing of the financial statements has to comply with the provisions of the Accountancy Law, the enforcement norms of the law and harmonized accountancy norms regarding the economic agent's accountancy, the financial exercise, the financial statements of the economic agent, accountancy principles and rules, approval and signature of the economic agent financial statements, approval of profit distribution, the administrators' report, approval and submission of the economic agent yearly report, publishing of the yearly economic agent report, the general accounts plan, the balance format and the profit and loss account, situation of the treasury flows, situations of the own capital changes.

- *During the stage when the auditor expresses an opinion regarding the image of the financial statements* – he is in charge with creating and expressing of an opinion on the audited financial statements. The opinion can be: **without reserves (unqualified)** and it is expressed when the auditor thinks that the situations provide an accurate image or that they are correctly presented, in all its significant aspects, according to the identified financial reporting type (standards); **with reserves (qualified)** and it is expressed when the auditor thinks that an opinion without reserves cannot be expressed, but the effect of any misunderstanding with the management or which leads to a limited applicability field is not so significant and comprehensive, so that it could create a contrary opinion or the situation when an opinion cannot be expressed; **contrary opinion** which is expressed when the result of a misunderstanding is so significant and comprehensive for the financial statements, that the auditor comes to the conclusion that a qualified report is not adequate in order to provide information regarding the incomplete or erroneous nature of the financial statements; **the impossibility of expressing an opinion** which occurs when

the potential effect of the activity limitation is so significant and comprehensive, that the auditor was not able to obtain sufficient audit results and therefore, he cannot have an opinion regarding the financial statements.

- *During the stage which deals with the conformity with laws and regulations in force* – the auditor has the responsibility of taking into account the legislation and regulations in force, when he audits the financial statements. Therefore, he implements auditing measures and procedures which should provide the finding of errors, deviations and legalities with direct consequences upon the amounts from financial statements or upon the audit results.

- *Audit report* – it is drafted as an audit result performed by an independent auditor upon the financial statements of an entity after the audit evidence obtained as a basis for an opinion regarding the financial statement is reviewed and assessed. This review and assessment implies taking into account of the fact whether the financial statements were drafted observing the accepted general reporting type, such as the International Accountancy Standards, or relevant national practices or standards. It may also be necessary to analyze whether the financial statements comply with the statutory requirements. The report must comprise in a written form a clearly stated opinion on the financial statement, taken as a whole.

The problem which occurs is: “*Does the auditor's opinion expressed in an Audit Report represent the guarantee of credibility for the financial statements?*” The answer at this situation is that “*The auditor's report supports the assessment of financial statements, but it is not a warranty regarding the future viability of the economic agent*”. This guarantee, provided that the term is not too optimistic, is assured by the action performed by the auditor, with the purpose of auditing the adequacy degree of the principle of activity continuity, which will be analyzed later.

A. The audit of the adequacy degree of the principle of activity continuity

When auditing the financial statements, in order to guarantee their credibility from the perspective of the future viability of the entity, the auditor takes into consideration the adequacy degree of principle of activity continuity which is at the basis of financial statements drafting, as well as the risk that the principle of activity continuity might not be proper.

From such a perspective, the auditor has the obligation of gathering sufficient and proper audit evidence in order to satisfactorily remove the doubt on the capacity of the economic agent to go on existing in the foreseeable future. He also, decides and reports whether the problem related to the principle of activity continuity was suitably solved.

A1. The auditor's responsibility regarding the adequacy degree of the principle of activity continuity

The continuity of activity of an entity (within the foreseeable future, generally for a period of time which does not exceed a year after the completion of the period) is stipulated when financial statements are drafted, provided that information about a contrary activity is absent. Accordingly, assets and liabilities are recorded on the basis that the economic agent will be able to collect its assets at recorded values and to pay its debts during ordinary course of business. If the presumption is unjustified, the economic agent may be able to collect the assets at the recorded values and there can be changes regarding the debts values and due dates. Therefore, the values and classification of assets and debts in financial statements may require adjustments.

A2. The risk of non-declaring the principle of activity continuity

The auditor takes into consideration the risk that the principle of continuity might not be adequate any more. Indices that suggest the non-observance of principle of activity continuity can originate from financial statements, but as well as from other

sources. These indices can have a financial nature, operational ones or others.

a) Financial indices that can be taken into consideration by the auditor:

- Fixed term loans near maturity, without realistic renewal prospects of renewal, reimbursement or excessive reliance upon short term loans to finance long term financial assets;
- Unfavorable key financial indicators;
- Substantial operating losses;
- Arrears or failures to pay dividends;
- Inability of paying the creditors at due date;
- Difficulty in confirming the terms of the loan agreements;
- Change of credit transactions in transactions with payment on delivery for suppliers;
- Inability of obtaining funding for development of essential products or other essential investments.

b) *Operational indices:*

- Loss of management key members, with no possibility of replacement;
- Loss of key markets, of the franchise, license or of the main supplier;
- Labor difficulties, or lack of important suppliers.

c) *Other indices:*

- Non-compliance with capital requirements or other statutory requirements;
- Pending legal action against the economic agent which, if successful, may result in legal decisions that could not be met;
- Changes in legislation or of the government policy.

A3. Adequate audit evidence regarding the foreseeable future of the economic agent

When there is a question about the adequacy degree of the principle of activity continuity, the auditor is obliged to collect sufficient adequate audit evidence in order to satisfactorily try to remove the doubt on the economic agent capacity of keep on working within the foreseeable future. The

auditor performs the planned audit procedures (including additional ones or he analyses the previously obtained information) in order to obtain the audit evidence as basis for expressing an opinion on the financial statement.

The relevant procedures in such situations may include:

- ✓ Analysis and discussion with management regarding the monetary flow, profit and other relevant proceedings;
- ✓ Verification of events after the end of the period for the elements which affect the economic agent ability to continue the principle of continuity;
- ✓ Analysis and discussion of the latest available interim financial statements of the economic agent;
- ✓ Verification of mandatory lending terms and loan agreements and determination whether any term was unobserved;
- ✓ Reading of minutes of general meetings of shareholders, of the board and key committee meetings for any reference to financial difficulties;
- ✓ Economic agent lawyer investigation into disputes and complaints;
- ✓ The confirmation of existence, legality and requirement of contracts by which the financial support of third parties and affiliated parties is offered or obtained and estimation of the financial capacity of such parties to offer additional funds;
- ✓ Consideration of the economic agent position concerning the clients' non-fulfilled orders.

The auditor:

a) *Considers* the economic agent capacity of generating information regarding the monetary flow, profit and other relevant forecasts; whether the hypothesis on which the relevant forecast seem appropriate in the given circumstances;

b) *Compares* the forecasted data for the recent periods with the real historical data; the forecasted data for the current period with the results obtained until that date;

c) *Considers and discusses with the management its plans for future actions* and, namely the liquidation plans for assets, cash loans or debits restructuration, expenses reduction or delay, capital increase. A special attention shall be given to the projects that may have a significant effect upon the economic agent solvability and the foreseeable future.

The principle of activity continuity refers not only to the current solvability of the economic agents, but also to its capacity of continuing its activity. The situation of liquidities and future funding sources must be analyzed, if the activity generates liquidities or if these have to be brought by the shareholders or obtained by the creditors.

In order to establish the principle of activity continuity, the audit activity and the obtained evidence might be extended in order to perform a proper assessment whether the economic agent complies with the principle of activity continuity.

The auditor assesses the means by which the administrators ensured that the principle of activity continuity is observed when the financial statements were drawn out and that the financial statement are presented in such a way that they offer an accurate image from the perspective of the principle of activity continuity observance.

Therefore, the auditor discusses with the administrators, examines the proper financial information, and performs special proceedings in order to identify the significant problems concerning the economic agent capacity of having a continuous activity.

The auditor may need to take into consideration and document the following problems:

- ✓ Whether the period envisaged by the administrators for evaluation of activity continuity is reasonable, taken into account the client's (economic agent) circumstances and the administrators' need to analyze its capacity of continuing the operational activity within the foreseeable future;

- ✓ The systems or other means (conventional or unconventional) for timely identification of the signals regarding future risks and uncertainties the economic agent might confront;
- ✓ The budget and/or the forecasted information (especially information regarding the cash flow) produced by the audited economic agent (auditor's client) and the quality of the informational systems used for producing of these information and for their actualization;
- ✓ Whether the basic hypothesis on which the budgets and/or forecasts are realistic given the respective circumstances.

The auditor determines and documents the preoccupation degree regarding the economic agent capacity of continuing its activity. In order to assess the adequacy degree, the auditor takes into consideration all relevant information he acknowledged during the audit.

The auditor performs a preliminary assessment of the principle of activity continuity. The audit approach greatly depends whether this basis (principle) is suitable or not. If the activity continuity is an essential problem, the auditor considers all the fields that could be affected.

In order to determine the credibility and adequacy degree of the principle of activity continuity, the Review Program of Activity Continuity is applied. The following procedures shall be applied, in order to identify the possible problems related to the principle of activity continuity:

- a) Prognoses of the cash flows, profit and loss account and of the balance (provided it exists) shall be obtained. The cash flow efficiency and evolution shall be analyzed and documented.
- b) The managers are consulted and the information already obtained during the audit shall be reviewed.
- c) The below factors shall be analyzed and documented:
 - Selling orders/loss of important clients;

- The probability that the personnel likely to remain available to the economic agent, as well as the possibility that the economic agent might continue to have access to goods and services necessary to conduct its business;
- The economic agent capacity to adapt itself to new circumstances;
- Financial problems;
- The period for which the economic agent has obtained access to financial-banking capacities etc.

After the above factors are analyzed, it shall be determined whether the accountancy principle of activity continuity represents a proper basis for drafting of the financial statements:

- If not, it shall be considered whether the statements still offer an accurate image of the economic agent and whether additional information is required for the audit report;
- If so, additions to the audit report shall be prepared.

The auditor prepares a synthesis of the analyzed factors and presents the expressed assessments and opinion regarding the economic agent classification in the principle of continuity and the impact upon the financial situations.

As a conclusion, the auditor states whether he has obtained a reasonable regarding the correct application of the principle of activity continuity during the preparation of the financial statements.

A4. The conclusion of the audit and reporting

- a) The auditor decides whether the problem aroused related to the principle of activity continuity has been properly solved.

The principle of activity continuity can be used for management decisions regarding the future actions, due to its mitigation factors and in such a case, the auditor shall consider whether such plans or other factors need to be presented in the financial situations. If a proper presentation is not performed, the auditor expresses a qualified or contrary opinion, as appropriate.

b) The problem of activity continuity is not solved.

If, according to the auditor reasoning, the problem of activity continuity is not properly solved, he shall consider whether the financial situation adequately describe the main conditions that generate substantial doubts regarding the economic agent capacity to continue to operate in the foreseeable future; he may say that there is a significant uncertainty, if the economic agent will be able to continue its activity and, therefore, it is unable to collect its assets and to reduce its debts during the normal course of activity; he may say that the financial statements do not include adjustments regarding to the retrievability and classification of the values of registered assets or regarding to the classification of debts that may be necessary in case the economic agent is unable to continue its activity.

If the presentation is considered as adequate, the auditor does not express a qualified opinion or a contrary one.

If a proper presentation is performed in the financial statements, the auditor can express an unqualified opinion and he can modify the audit report, by adding a paragraph

with the purpose of emphasizing the problem related to the principle of activity continuity, by focusing on one aspect that has the above mentioned aspects; he is not prevented from expressing an opinion in case of an uncertainty regarding the activity continuity.

If no adequate presentation is performed in the financial situations, the auditor expresses a qualified opinion or a contrary opinion, as appropriate.

c) The principle of activity continuity, considered as inadequate

If based upon the additional proceedings and of the obtained information, including the effect of mitigation circumstances, the auditor's reasoning is that the economic agent is unable to continue its activity in the foreseeable future, the auditor decides that the principle of activity continuity used for preparation of financial statements is not adequate.

If the result of the inadequate hypothesis used for the preparation of the financial statement is so significant and comprehensive, so that it has erroneous results, the auditor expresses a contrary opinion.

Bibliography

Boulescu, Mircea – *Audit and Financial Control*, Second Edition, Publishing House of România de Mâine Foundation, Bucharest, 2007.

Law no. 26/2010 for modification and completion of Government Emergency Ordinance no. 75/1999 regarding the financial audit activity, the Official Gazette, Part I, no. 145 of 5 March 2007.

Government Decree no. 983/2004 for the approval of Organization and Operation Regulation of the Romanian Financial Auditors Chamber, the Official Gazette, no. 634 of 13 July 2004.

Order of the Ministry of Finances no. 1802/30.12.2014 for the approval of accounting regulations on the annual and consolidated financial statements, the Official Gazette, no. 963 of 20 december 2014.

Decision no. 20/2004 of the Council of Romanian Financial Auditors Chamber for the approval of the Code regarding the Ethic and Professional Conduct in the Field of Financial Audit, drafted by the International Federation of Accountants (IFAC, Edition 2003, the Official Gazette no. 966 of 21 October 2004).

Government Emergency Ordinance no. 90/2008 on statutory audits of annual accounts and the consolidated annual financial statements, the Official Gazette no 963 of 30 December 2014.