

Auditor's Uncertainty About Going Concern – Predictor of Insolvency Risk

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Abstract

The primary indications of some uncertainties about the going concern of an entity can be obtained by investors and the general public in the financial statements and in the audit report. The present paper analyzes the going concern principle based on the regulations in the field of financial reporting and on the basis of the regulations in the field of international, European and national auditing. The financial statements must provide a faithful image of the performance and financial position of the entities, and the auditors must to express an opinion on compliance with all accounting principles. The study showed that in most cases the auditors had uncertainties about the going concern that led to insolvency of companies, and the main underlying factors were the reported losses, negative equity, the business history.

Key words: going concern, auditor's opinion, auditor's report, financial statements, insolvency risk, uncertainty

J.E.L. classification: M40, M42

1. Introduction

The present article deals with the analysis of the main accounting and auditing regulations in terms of going concern reporting and its implications for the legal status of the companies. The financial statements as a whole provide a true and fair view of the performance and financial position of the entities, and the auditors should express their views on the observance of all accounting principles. In order to analyze the auditors' reports on the going concern have been selected 10 companies listed on the Bucharest Stock Exchange (BSE) and suspended from trading, from 2011 until now. Data systematization revealed that the auditors had uncertainty about the going concern, which was analyzed retrospectively as predictions for the future insolvency.

The study will contribute to the development of literature as it provides an analysis of the available data on the reporting of going concern by listed Romanian companies from a perspective oriented on the importance of identifying the reasons that may lead to the going concern principle.

The paper is structured as follows: the next section contains a summary of the relevant literature on going concern, while the third section describes the methodology of the research. The fourth section presents the results of the study together with our comments. The last section includes the final conclusions, study boundaries and future research directions.

2. Literature review

In analyzing regulations regarding going concern, a distinction is made between the accounting regulations and those applicable to the auditors. Under these regulations, an entity's financial statements are prepared on the assumption that the entity will continue its business in the foreseeable future, with neither the intent nor the need to liquidate or significantly limit its activity. At an international level, auditing regulations are governed by the International Standard of

Auditing (ISA) 570 Going concern, which states that "the auditor cannot predict such future events or conditions" and the absence of references to going concern uncertainty in the auditor's report can't be regarded as a guarantee as to the entity's ability to continue the activity.

In the literature there have been many debates on the going concern, the tools available to companies to assess the extent to which the activity may or may not continue, have been investigated. It was debated whether the existing standards provide sufficient indications for the auditor to consider going concern (Masocha and Wettman, 2007). Some authors (Lam and Mensah, 2006; LaSalle 2006; Miller, 1999) questioned whether the issue of an audit report that highlights the problem of going concern should be based on financial factors, non-financial factors or their combination. At the same time, the question was whether the auditor should have a rolling or a passive in testing the principle of going concern.

Others authors (Arnold et al, 2001; Barnes, 2004) questioned the auditors' competence to issue judgments about the going concern, as well as their ability to withstand the pressures on the part of the client company and on the economic, social and political environment. Read and Yezegel (2018) analyzed a sample of US companies, if Great Recession had an effect on the issuance of opinions going concern and have found that there is a no major difference between the period after the crisis that during the crisis, that auditors preserves conservatism in issuing opinions. Caserio et al. (2014) conducted statistical models to identify the relevant financial indicators for auditors in going concern and resulted that the auditors' opinions being useful in warning the risk of bankruptcy.

For investors, the auditors' report is a source of information about their investment, so any modified opinion of the auditor may be a negative signal. Geiger and Kumas (2018) found that institutional investors were better informed related going concern, than other investors on the market.

Financial statements must be the basis for an effective dialogue between the company and its users without being distorted to prevent the risk of insolvency (Megan et al., 2009). A company's performance is measured by financial and non-financial indicators to capture the whole of the company and identify the risks associated with its business (Imbrescu and Hategan, 2011).

Uncertainty of going concern is becoming more important in the case of the new audit report that contains a special paragraph for this situation. Cordos and Fullop (2015) conducted a survey in which they asked the auditor whether the inclusion of this paragraph and half of the respondents considered it a good solution.

Gutierrez et al (2016) examined the going concern opinions can be a better predictor for default, on a sample of US companies and they found that they do not perfect overlap but the auditor's opinion can be considered information to predict the risk of insolvency. Also the same study was performed on a sample of companies from 17 major economies and have reached similar results, even if there were differences between countries (Gutierrez et al, 2015).

3. Methodology

From a methodological point of view, the topic of going concern was treated from the perspective of the concept and of the norms. The norms in the field of accounting and auditing were explained and evaluated. The paper presents the content of the main accounting and audit regulations regarding the principle of going concern, existing at international, European and national level.

In order to demonstrate the objective of the paper, a qualitative analysis was conducted of the auditor's reports in order to identify the sign for a future insolvency. For the case study, 10 companies listed on BSE, which have been suspended from trading from 2011 until 2018. Based on the annual reports published for the period prior to the suspended trading, the reasons for the suspended trading due to insolvency were identified and the extent to which the auditor identified any uncertainties as to the continuity of the business before insolvency.

The analysis carried out has identified the types of opinions issued by the auditor, the bases of opinions expressed, the size of the financial result and the equity as the main indicators indicating possible difficulties in the activity of the companies. The analysis was deepened on the basis of

reports prior to the reference period with the assessment of indications that could have foreseen the risk of insolvency of companies.

4. Results

In table no. 1 were presented the information regarding auditor's opinion in the year before insolvency, considering reference year, preceding the insolvency of companies ordered after the date of insolvency.

Table no. 1 Auditor's opinion before insolvency

Name of companies	Date of insolvency	Ref. year	Auditor category	Type of Opinion	GC paragraph
UCM RESITA S.A.	08.12.2011	2010	N/A	N/A	N/A
CONCEFA S.A.	15.03.2012	2011	Non-Big4	Unmodified	Yes
OLTCHIM S.A.	30.01.2013	2012	Big4	Disclaimer	Yes
COS TARGOVISTE S.A.	25.02.2013	2012	Non-Big4	Adverse	Yes
COMP ENERGOPETROL S.A.	25.07.2013	2012	Non-Big4	Qualified	Yes
AMONIL S.A.	05.06.2015	2014	Non-Big4	Unmodified	Yes
DAFORA SA	19.06.2015	2014	Big4	Unmodified	Yes
CONDMAG S.A.	20.07.2015	2014	Big4	Unmodified	Yes
ROMCAB SA	20.02.2017	2016	Non-Big4	Qualified	Yes
PETROLEXPORTIMPORT S.A.	19.10.2018	2017	Non-Big4	Unmodified	Yes

Source: Own projection

From the table no. 1 result that the most companies were audited by non-Big4 auditors. Most of the opinions expressed by auditors were unmodified, but all auditors highlighted in the report a paragraph on going concern. In the case of one company, UCM Resita, the appointed auditor (Big4) did not audit the financial statements, and after the insolvency, a new auditor (Non-Big4) was appointed to carry out the audit, but could not find any information, the report was no longer published on the website.

In order to highlight the justification of the auditors' opinions, table no. 2 presents the accounting indicators of the reference and the previous years, showing the indices of difficulty of the companies' activity.

Table no. 2 Indicators from financial statements

Name of companies	Reference year		Previous year		GC previous year
	Net profit	Equity	Net profit	Equity	
UCM RESITA S.A.	-88169863	37654724	-63838458	125824587	Yes
CONCEFA SA	-51905451	61029382	3728288	107059998	No
OLTCHIM S.A.	-569443477	-1522329485	-198562403	67293474	Yes
COS TARGOVISTE S.A.	-104082423	-200391355	-138341241	-97286439	Yes
COMP ENERGOPETROL	764606	12818972	56773	8770358	No
AMONIL S.A.	-2659572	63512371	1569835	66181570	No
DAFORA SA	3248788	-58159643	-146376831	-50951080	Yes
CONDMAG S.A.	-14383768	44715718	-23285323	59099486	Yes
ROMCAB SA	-179413881	-17710337	42130193	164618321	No
PETROLEXPORTIMPORT	-3656536	-108872931	-6520540	-108248123	No

Source: Own projection

In table no. 2 can be observed that the most of the companies recorded losses in the reference year, but half of the companies registered negative equity. Analyzing the situation in the year before the reference year was found that more than half of the companies had losses, and only three companies registered negative equity, which highlights that the companies' situation was worse in the reference year.

In order to detail the information, table no. 3 presents the reasons for the auditors' opinions related to the insolvency reasons of the companies.

Table no. 3 Auditor's opinion and insolvency cause

Name of companies	Basis for modified opinion and GC	Insolvency cause	Status at Oct 31, 2018
UCM RESITA S.A.	Losses, provisions, adjustments, revaluation	Demand notice, default	Suspended, insolvency procedure
CONCEFA SA	Losses, GC Uncertainty	Demand notice, default	Delisted Dec, 2017
COS TARGOVISTE S.A.	Losses, unpaid taxes, adjustments	Demand notice, default	Suspended, insolvency procedure
OLTCHIM S.A.	Losses, provisions, adjustments, revaluation	Inappropriate management, related parties, inefficient investments	Reorganization, Tradeable
COMP ENERGOPETROL S.A.	Revaluation, GC Uncertainty	Dependence on a single supplier, customers portfolio reduction	Special Watch List, Tradeable
AMONIL S.A.	Losses, GC Uncertainty	Unpaid taxes, default	Reorganization, Tradeable
DAFORA SA	GC Uncertainty, negative equity	Demand notice, default	Suspended, insolvency procedure
CONDMAG S.A.	Losses, GC Uncertainty Dadora Group	Demand notice, default	Reorganization, Tradeable
ROMCAB SA	Losses, adjustments, inventory	Demand notice, default	Suspended, insolvency procedure
PETROLEXPORTIMPORT S.A.	Losses and growing of liabilities	Enforcement of loan, assets guarantees	Bankruptcy

Source: Own projection

The reasons for insolvency were closely correlated with the deficiencies identified in the auditor's report. Most insolvency entries were made at the request of companies as a result of default. In the reference year, all companies surveyed had references in the auditor's report on going concern. The insolvency indices were identified one year before the reference period to half of the number of companies, which shows that auditors performed audit tests on going concern.

Fortunately, 4 companies have managed to apply the reorganization plan, registered profit or reduce losses and were tradeable at BSE on October 31, 2018. A single company (COMP ENERGOPETROL) that had positive indicators started insolvency because of external factors to the company, driven by competition and dependence on a single suppliers and customers portfolio reduction, but this situation was also identified by auditors.

5. Conclusions

Through this paper were presented the theoretical and practical aspects related to the going concern, from the accounting point of view and the audit, with legal implications. Going concern topic may be followed by users of financial statements for investment decisions or other strategic decisions.

Going concern is an important area of the audit engagement and it is essential that everyone involved in this process is aware of the audit evidence required by the auditor to confirm that the accounting policies and disclosures have been correctly applied in the annual financial statements.

From the accounting point of view, the implications of the going concern are reflected in the financial statements when the basis for their evaluation and presentation is established. Following the analysis of financial reporting frameworks at international, European and national level, it can be concluded that the entity's management holds the responsibility to assess the plausibility of the going concern on the basis of which the financial statements are prepared. From the point of view of the implications in the audit, it is very important for the auditor to identify all events and transactions that can influence the auditor's opinion. The auditor has the responsibility to appreciate each audit engagement is appropriate for the management's use of the going concern. But the auditor cannot be imputed to the situation in which the audited entity fails, although a report has been issued without additional the going concern principle.

An important conclusion to be drawn from the case study was that the risk of insolvency was in direct correlation with several factors, such as the profit of the company, followed by size of equity and auditor's opinion and the evolution of past activity of the company.

The paper can be a bibliographic source for researchers in the field of accounting and financial audit, for representatives of the management of entities to understand the necessity and importance of observing the principle of going concern, as well as for the practitioners of the accounting profession who find in the paper systematized indications regarding the uncertainty of going concern.

The limits of the research were that there is no certified database on insolvency companies' reports, for listed companies the level of confidence in the published information was provided by the reports issued by independent financial auditor's reports. Also, the small number of companies surveyed did not allow for empirical research to test hypotheses on the role of the auditor in preventing company insolvency, but which can be considered a future direction of research by increasing the number of companies, as well as a comparative analysis of the uncertainty situation on the continuity of the activity of companies from different countries.

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