

## **BUSINESS CONTINUITY, A CONSTANT ISSUE FOR MANAGERS AND AUDITORS**

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### ***Abstract***

*The crisis of credits and its effects upon all companies, make the assumption of activity continuity be not anymore a pre-established conclusion. The major cash issues, affecting the banks, insurance companies, retailers, car manufacturers and all companies regardless of their activity, prove that keeping the business continuity, i.e. having enough funds for compliance with an obligation to be able to reach maturity at least twelve months after the balance sheet date is now a real problem for many companies.*

*Likewise, we are paying attention to the topic and to the increasing number of insolvencies at the national, European and international levels.*

**Key-words:** *insolvency, principle of business continuity, financial statements, auditor, manager*

**JEL Classification:** E16, M41, M42

### **Introduction**

The article herein presents the increase of the number of the insolvencies as derived from the economic crisis, for the 2007-2009 interval of time, for various fields. Similarly, we have considered that this crisis effect called 'insolvency' makes questionable the most important principle of assessing the assets, liabilities and equity in the financial statements and the principles of business continuity. Therefore, it seemed necessary to synthetically present the current regulations relating to the continuity principle in both the accounting and financial auditing. The bottom line is that the evaluation of the continuity hypothesis is a responsibility of the managers.

### **Literature review**

The literature includes many debates focused on the business continuity, mainly on the role that an auditor plays here. Instruments held by the companies to evaluate to what extent their activity may continue have been examined. The same was done for the effects of the financial situations that might occur in case of violating the fundamental principle of the business continuity. And if the existent regulations provide enough clues for the financial auditor in looking at the business continuity issue. Academia and others (CKK Lam, RELaSalle and M. Miller) have

thought about, among other things, whether the financial, non-financial factors or a combination of the two should prevail in the issuing an auditing report that highlights business continuity issues.

We have also questioned whether the auditor should have an active or passive role in testing the principle of continuity or examining the financial auditor liability. Moreover, the process of thinking about the business continuity was reviewed by various authors from different perspectives, in order to identify the key factors in the auditor's decision-making process.

### **The evolution of the number of insolvencies for 2007-2009**

The information published on the National Trade Register Office website has been used in drafting table 1, the evolution of the bankruptcies number per sphere of activity.

By the generic name of 'bankruptcies', it is understood all registered cases of insolvency, namely: companies that have initiated the bankruptcy procedure, in the judiciary reorganization and companies for which the bankruptcy proceedings were closed due to lack of assets.

Table 1

### **Distribution of the insolvency cases, per activity sectors, for 2007-2009**

Activity sector	2007		2008		2009	
	Total insolvencies	% total insolvencies	Total insolvencies	% total insolvencies	Total insolvencies	% total insolvencies
Retail trade	2,371	16.81	3,553	24.53	3,684	20.00
Wholesale trade and distribution	3,431	24.33	2,932	20.24	3,501	19.01
Construction	1,066	7.56	1,666	11.50	2,497	13.56
Transport	723	5.13	811	5.60	1,237	6.72
Hotels and restaurants	520	3.69	782	5.40	1,022	5.55
Other services meant for companies	625	4.43	718	4.96	979	5.31
Manufacture of wood and wood products	810	5.74	793	5.48	927	5.03
Manufacture of textiles, clothing and footwear	731	5.18	705	4.87	762	4.14
Agriculture, forestry, hunting and fishing	1,093	7.75	575	3.97	934	5.07
Industry of food and beverages	1,064	7.54	627	4.33	573	3.11
Metallurgical industry	338	2.40	38	0.26	496	2.69

Manufacture of chemicals and chemical products	302	2.14	158	1.09	223	1.21
Estate transactions	121	0.86	159	1.10	281	1.53
Drainage, garbage removal, sanitation	185	1.31	163	1.13	206	1.12
Other personal service activities	86	0.61	114	0.79	204	1.11
Recreational, cultural and sports activities	115	0.82	111	0.77	157	0.85
Industry of machinery and equipment	136	0.96	94	0.65	166	0.90
IT	96	0.68	132	0.91	172	0.93
Financial intermediation	83	0.59	78	0.54	139	0.75
Postal and telecommunications	92	0.65	97	0.67	129	0.70
Extractive industry	45	0.32	131	0.90	54	0.29
Health and social assistance	26	0.18	19	0.13	47	0.26
Production and supply of electricity and heat, water and gas	45	0.32	27	0.19	31	0.17
<b>TOTAL</b>	<b>14,104</b>	<b>100.00</b>	<b>14,483</b>	<b>100.00</b>	<b>18,421</b>	<b>100</b>

*Source:* The National Trade Register Office

It is noticed that the number of insolvency cases increased from 14.104 in 2007 to 14.483 in 2008 and, in 2009, reached 18.421.

The economic crisis deepening in Romania, the lack of effective measures for economic recovery to be promoted by the government authorities and the funding resources tightening will lead to a more severe payment behaviour of companies.

Towards the end of 2007, a number of 14,104 companies, as recorded, were found in various stages of insolvency proceedings, of which 188 were in the judiciary reorganization, 513 closed for reorganization or bankruptcy proceedings due to lack of assets and the remaining 13,403 already in bankruptcy.

As seen above, for 2007, the first positions among all bankruptcies are occupied by the commercial companies. The commercial sector including retail, wholesale trade and distribution has 41.4% of all cases of bankruptcy at the end of 2007, higher than 2006, when they accounted for 36.8% of all bankruptcies. This demonstrates that the small retailers manage harder and harder to compete with the major retail officers, who extend their networks each year, in smaller and the smallest towns.

In 2007 only, the big national and international retailer have opened 152 stores.

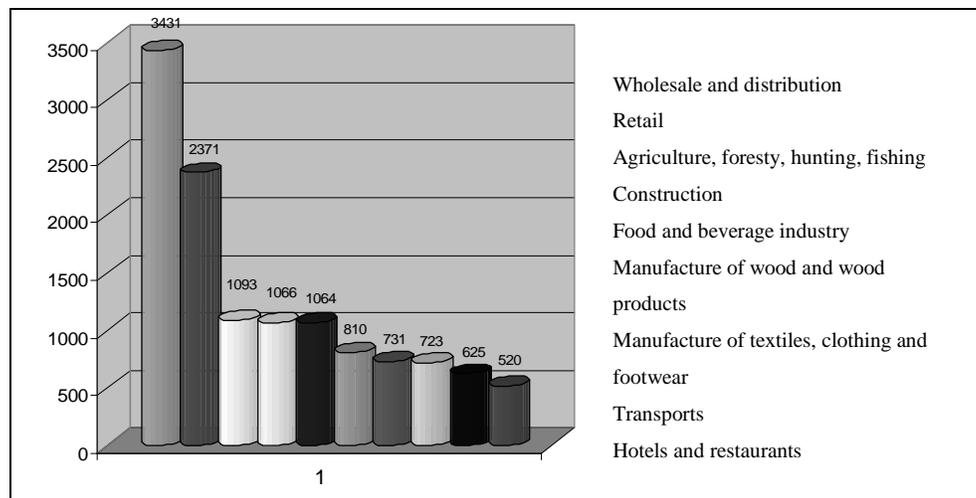
For example, the number of hipermarkets increase with 29 stores, as a consequence of the fact that Carrefour, Real, Auchan, Kaufland and the national

network PiC opened new units. In 2007 Carrefour bought a new supermarket chain, Artima, having a number of 21 new units, which will allow it to bring on the Romanian retail market a new form of stores retail.

The number of supermarket rose by 36 units, but the discount type stores developed the most, opening other 63 units.

The third and the fourth positions are occupied by agriculture and food industry, which are closely connected. The low capacity in agriculture, the lack of resources, the lack of a clear strategy in agriculture, and the delay of the reforms in this domain turn a favorable sector into an insolvent one. Although this sector rose spectacularly, is still one of the most critical. The constructions sector in Romania had the most rapid increase among all the European Countries, 35% and continues to grow in 2008.

Compared with 2006, the highest increase in bankruptcies share is recorded by the wholesale and distribution, with 6% more in 2007. An increasing number of bankruptcies is seen in construction (2%) or transportation (1.5%). A significant share of total bankruptcies with total insolvency is in agriculture, with a decline of 5.5% and industry food, with 3.3%.



Source: Own processing based on the data published by ONRC

Fig. 1. Top 10 industries in terms of number of bankruptcies recorded in 2007

At the end of 2008, a total of 14,483 companies were in various stages of insolvency proceedings. Among them, 6,022 companies were in general insolvency procedure, 4,771 in the simplified insolvency procedure, 3,672 in bankruptcy and 18 in judiciary reorganization. The total insolvencies then shows only a slight increase (+2.7%) compared to the situation at the end of 2007 (14,104 companies in insolvency).

For 2008, the distribution of the bankruptcies per activity field, shows a change in the Top 5, which showed sectors that felt for the first time the “shock wave” of the financial crisis, leading to the 2009 bankruptcy.

Although the first two positions are held by trade companies, as previously, it is noteworthy noticing the reversal between wholesale and retail trade (located in the second position in 2007). Also, the third position of the construction sector and location in Top 5 of the transport and furniture industry, the number of insolvencies of these areas exceeds the one in agriculture and food industry, these sectors were among the first five at the end of 2007, as total bankruptcies.

Another important development is represented by the spacing in the ranking of the first three sectors generating insolvencies (retail trade, distribution and construction), where these have together a share for over 56% of the total bankruptcy in 2008, compared to 49% in 2007.

The analysis of the sector evolution in the total number of the bankruptcies in 2008 over the previous year shows significant increases in the extractive industry (+191%), retail trade (+49%), construction (+56%), hotels and restaurants (+50%), IT (+37%) and real estate transactions (+31%).



Source: Personal processing, based on the ONRC published data

Fig. 2. Top 10 of the industries in terms of number of bankruptcies in 2008

The economic crisis effects are still strongly felt by most companies, as seen in the sales decline, a limited access to finance and, consequently, a considerable decrease of liquidity reflected in a surging number of bankruptcies during the last months. As a matter of fact, the first six months of 2009 feature a 7.6% economic decline, 25% a decrease in payments by debit instruments (promissory notes, checks, etc.), over 50% increase in unemployment; hence, the insolvency procedure, regulated by Law 85/2006, has become more and more known and used by the economic agencies in Romania, where the number of bankruptcies recorded in the first half of 2009 exceeded 10,000 cases.

In 2009, a total of 18,421 companies were in various stages of insolvency proceedings. Among them, 8,950 companies were in general insolvency procedure,

4,890 in simplified procedure of insolvency, 4,543 in bankruptcy and 38 in judiciary reorganization.

Out of these, most of insolvencies were for SRL's (95%), followed by SA's (3%), the remaining 2% go to others (SCS, AF, NAS, RA, etc.).

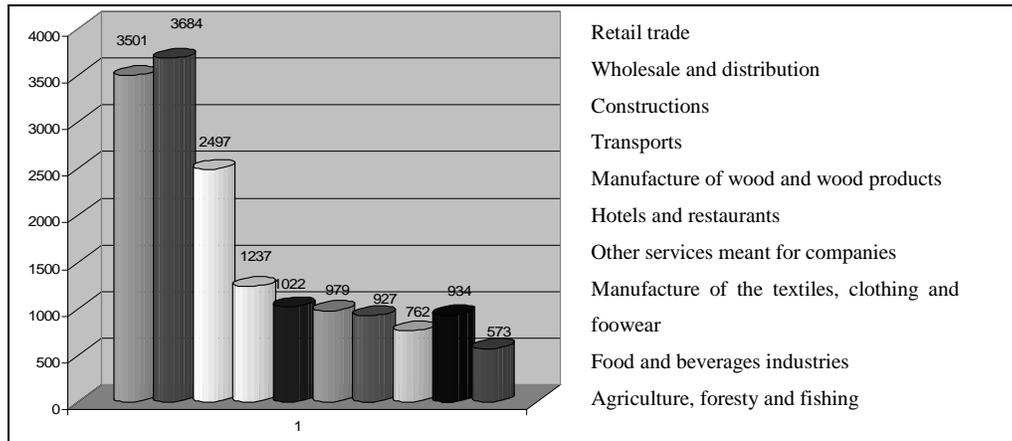
The ailing of the economic activity towards the end of 2008 continued in 2009 and made the top of four ranking positions keep their seats, while the trade (retail or wholesale and distribution), construction and transportation remain the most affected.

However, it should be mentioned the rising in the rankings by one position of the hotels and restaurants sector and the business services activities, while the wood industry fell two positions, ending on the seventh at the end of June.

At the end of 2008, there is a strong concentration of the number of insolvencies in the first three sectors (retail trade, distribution and construction), which is over 50% of the total number of bankruptcies for early 2009.

According to the data published by the National Institute of Statistics in 2009, the volume of turnover for retail trade (except for motor vehicles and motorcycles trade), decreased by 9.7%, compared to the same period of the last year, making this area to remain the hardest touched by insolvencies.

Analysis of this field evolution shares changes in the total bankruptcies in 2009 versus the end of 2008 and reveals no significant changes, as expected; on the contrary, it maintained a relatively stable situation, with small increases in the most affected industries: construction (+1.22%), metallurgy (+2.26%). In these circumstances, the retail trade recorded the largest decrease of the total bankruptcies (-4%), followed by food and beverage industry, agriculture, extractive industry, etc. but with insignificant reductions.



Source: Personal processing based on ONRC data published

Fig. 3. Top 10 of the industries in terms of number of bankruptcies in 2009

### Regulations about the activity continuity

It can be noticed that the number of bankruptcies has increased and will likely increase, therefore we will focus on the continuity principle in preparing the financial statements as the manager and the auditor's responsibilities.

Table 2

### Current regulations regarding the continuity activity principle

Regulatory Framework	Regulation for financial reporting	Regulation for audit
International	- Conceptual framework for preparing and presenting the financial statements (IASB), paragraph 23 - IAS 1; Presentation of Financial Statements; paragraph 25 to 26	ISA 570 'The principle of the activity continuity' (IAASB)
European	The fourth Directive of the Council no. 78/660/EEC Section 7 'Assessment Rules', Art. 31	ISA 570 'The principle of the activity continuity' Regulations/guidelines issued by the professional bodies in the Member States
National	Order of the Ministry of the Public Finance no. 3055/2009 for the approval of accounting regulations with European directives, Section 7 'General Accounting Principles', Article 38	Chamber of the Financial Auditors of Romania, The minimum standards of auditing, Section B2, 'Review of the principle of continuity', Section F' Audit approach'

Source: Țurlea Eugene, Mihaela Mocanu, *Considerations on the responsibility of the directors and auditors in assessing the principle of continuity*, 'Financial Audit Magazine', no. 3/2010.

According to the **Conceptual framework**, the financial statements are prepared; they usually begin to **presume** that a company will also continue its work in the future. Thus, it is assumed that the company has no intention or need to eliminate or significantly reduce its activity, whether such intention or need exists; hence, the financial statements have to be prepared on a different basis of evaluation, which basis will be presented below.

In IAS 1 **Presentation of the Financial Statements** in the subsection **Accounting policies**; in the paragraphs 23 to 24 there is a reference to the activity continuity as:

– In preparing the financial statements, the **management** must evaluate the company's ability to continue the activity. The financial statements are prepared on a continuity activity basis, unless management either intends to liquidate the company or to stop the activity, or has no realistic alternative then proceeding so. While doing the assessment, the management is aware of **significant uncertainties** related to events or conditions that may cause the significant doubt on the ability of the company to continue the activity, then those uncertainties should be pointed out.

When the financial statements are not prepared on a continuity of activity, this should be mentioned, together with the financial statements being drafted and the reason why the company was not able to continue its activity.

– When the management believes that the activity continuity basis is appropriate, all the information available for the foreseeable future will be taken into account; the interval must be at least twelve months from the balance sheet date, without being limited to this time. The importance depends on each case. When the company had a history of profitable activity and easy access to the financial resources it could be concluded that the 'going concern' basis was appropriate, without a detailed analysis. For other cases, the management may need to consider a range of factors that affect the current and expected profitability, the debt repayment schedules and the potential sources of refinancing, before being sure that the activity continuity basis is appropriate.

At the European level, this basic accounting principle is regulated by the Fourth Directive of the Council 78/660/EEC (with subsequent amendments). In the section 7 'Valuation rules' in Article 31, line 1, paragraph a), states that the Member States **will ensure** that the financial statements are evaluated according to six general principles, where the first one is that the entity must and will continue its activity.

The national accounting rules specifying that the evidence presented in the annual financial statements are assessed in accordance with the general accounting principles. These regulations were formulated and adopted the following principles: the principle of the activity continuity, the precautionary principle, the principle of the separate assessment of assets and liabilities, inviolable principle, the principle of the permanent methods, the principle of the independence of the accounting exercise, principle of netting, the principle of the economic prevalence, besides the judiciary, the principle of the significance threshold.

Upon applying the principle of the activity continuity, it turn many accounting practices legit, such as cutting the life of the company in the financial and accounting exercises, in order to determine the financial position, the financial changes and the results, via the historical cost and the fair value (of using) in the valuation of assets and liabilities, expenditures and incomes, demarcation of expenditures and income in time, separation of assets and the fixed assets, each structure with a different substitution regime, the long-term depreciation of assets, differentiation of the debts in the long-term and short-term debts, awareness of the accounting at the inflationary factor.

The financial audit regulations about the principle of the continuity activity are wider than the accounting provisions mentioned and contain **details** about the objectives and audit procedures in assessing the principle of the continuity activity.

Internationally, the International Auditing and Assurance (IAASB) has issued the International Standard on Auditing ISA 570 'The principle of the continuity activity', which, after a brief overview of this principle, describes its responsibilities in its testing and establishes requirements upon the financial auditor request.

In Europe, some Member States have acceded to the International Standards on Auditing as the principle of the continuity activity testing by the financial auditor; ISA 570 is the standard in use today.

At the national level, the Chamber of the Financial Auditors of Romania set out in Section **B2**, 'Review of the principle of continuity' and in section **F** 'Audit approach' of the Minimum standards for the audit, so the auditor will be able to test whether the principle of the continuity activity is an appropriate basis for the financial statements of the audited company.

The Standard of the Audit ISA 570 'The principle of the continuity activity' stresses that the principle of the continuity activity is a fundamental principle in preparing the financial statements, the management has the responsibility to evaluate the entity's ability to continue its activity even if it does not provide an explicit responsibility in the financial reporting.

The Standard of the Audit ISA 570 'The principle of the continuity activity' refers to the auditor's responsibility, saying that it must gather sufficient appropriate evidence regarding the appropriateness of management using the principle of continuity, in preparing and presenting the financial statements. In addition, the auditor should conclude whether there is a significant uncertainty regarding to the entity's ability to continue the activity. 'The auditor cannot predict the future events or conditions that may cause the termination of an entity activity.'<sup>1</sup>

Any judgment about the future is based on the information available at the time when the judgment is expressed. The subsequent events can contradict a judgment, which was reasonable at the time it was expressed.

The size and the complexity of the entity, nature and status of its activity and the degree to which it is affected by the external factors influence the development of the events or conditions evolution.

## Conclusion

The deepening of the economic crisis in Romania, the lack of the real economic recovery measures promoted by governments and funding resources restriction led to a severe deterioration of the payment behaviour of the companies; hence, from 14,104 bankrupt units in 2007 went up to 18,421 in 2009.

The bankruptcies analysis per activity sector, we notice that the first three positions are taken by: wholesale trade, retail trade and construction, which means a lower consumption and consumer liquidity.

The assumption of the activity continuity is found both in the national and international rules, as well as the fundamental principles for drafting the financial statements.

Upon analyzing the international, European and national standards that refer to the principle of continuity, we see the **requirement** and **responsibility of the management** in assessing the company's ability to continue the work for a

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<sup>1</sup> The International Standard of Audit ISA 570 „The principle of the activity continuity” paragraph no. 10

12-month period starting from the balance sheet date, in order to reflect the significant uncertainties related to continuity, to present the information the financial statements are based on, and why the company cannot continue its activity.

After analysing the international, European and national audit standards besides the principle of continuity, we see that **the auditor should gather sufficient appropriate** evidence regarding the appropriateness of management via the principle of continuity, in preparing and presenting the financial statements. In addition, the auditor should conclude whether there is a significant uncertainty regarding the entity's ability to continue the activity.

Therefore, the absence of any reference to the uncertainty of the activity continuity in the audit report can be viewed as a guarantee of the entity's ability to do so.

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