

FROM THE CONTINUOUS ACIVITY PRINCIPLE TO THE DISCONTINUTY PRINCIPLE

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The principle of continuous activity starts from the presumption that a company will continue its activity into the previewed future. Therefore, we presume that the company does not intend and does not need to terminate or to reduce in a significant way its activity; if there is such an intention or a need the financial situations might be imposed based on a different valuation base and in this situation the used based must be indicated.

If the continuity is insured the traditional accounting principles will continue to be applied, and the accounting works and the financial situations will be elaborated in a usual way, as during the previous periods.

If the company enters a discontinuity state the continuity principle is to be infringed because complying with it should take to distorted financial situations.

Keywords: principle of continuous activity, discontinuity activity, intangible assets and tangible assets

The companies from around the world elaborate based on the accounting data the financial situations (the balance sheet, the profit and loss account, the situation of the treasury flows, accounting policies and explanatory notes) in order to be presented to the external users.

The basic concepts stipulated by the General frame of elaborating and presenting the financial situations, elaborated by the Committee for International Accounting Standards (IAS) are the engagement accounting and the principle of continuous activity.

The principle of continuous activity starts from the presumption that a company will continue its activity into the previewed future. Therefore, we presume that the company does not intend and does not need to terminate or to reduce in a significant way its activity; if there is such an intention or a need the financial situations might be imposed based on a different valuation base and in this situation the used based must be indicated.³⁵⁸

The Romanians mainly respect the definition given by IASB: „The company normally continues its activity in a previewed future without entering the impossibility of continuing its activity or without significantly reduce it. If the company’s administrators found out about some un-secure elements related to some events that may lead to its incapacity to continue its activity, these elements must be presented in the explanatory notes as well as the reasons that were at the base of the company’s decision not to continue its activity anymore”.³⁵⁹

It is obvious that this principle (postulate) has appeared together with the development of commerce, credit and business. Initially the companies have been created to be related to the life duration of their owners. The concept has been consolidated together with the appearance of shares companies.

³⁵⁸ *International Accounting Standards 2001, Editura Economică, 2001, p 63,*

³⁵⁹ *Order of the public Financing Ministry no 94/2001 regarding accounting regulations harmonised with the Directive 4th of the European Economic Community (C.E.E) and the International Accounting Standards, O.M.F.P. no. 306/2002 for approving the Simplified accounting regulations harmonised with the european directives.*

Mainly, continuing the exploitation does not mean that the company has an unlimited life or permanence but it supposes that it will exist a long enough period so that the targets, previewed activities to be accomplished, the agreement to be respected, the companies existence being longer than the use period of its assets. It is an expression of what A. Marschall called "a longer period" as a subdivision of the economic time, where all the production factors are variable. This determines that the goods' valuation to be done based on their utility, presuming that the company's activity will maintain without any significant reduction in a previewed future.

Applying the principle of continuous activity needs the performance of the following requests in the accounting-financial field:

- separating the companies' activity during the financial exercises depending on which the following will be established: the patrimony's situation, the financial situation, the obtained results and the elaboration of the financial situations.
- limitation in time of the expenses and income;
- using the historic cost and the actual value in valuating the assets and passive, the expenses and the income;
- separating the assets in intangible assets and tangible assets and the passive in long term and short term passive;
- adapting the accounting to the inflation.

Jacques Richard identifies the origins of the continuity principle in the practice of the American companies between 1920-1930 and he wrote that „ companies can have longer life duration than the individuals that make them, they can transfer capital and their target is to insure an operational continuous cycle.”³⁶⁰

From a juridical point of view,³⁶¹ the continuity postulate was mentioned for the first time in the Anglo-Saxon texts in 1971 (the English text SSAP no 2 and the American APB Statement no.4), and in 1974 in the IASC norm no.1, the Communitarian Europe mentioned the continuity principle in the UEE recommendation no 4 (1978) and the 4th Directive (1978).

Even if the French accounting plans from 1947 and 1957 did not mention this principle rules related to the continuous exploitation have been published, such as: immobilisation liquidation, valuation at historical costs etc., and the one in 1982 does not mention the continuity among the general principles, but it refers to it when considering the goods valuation and rules of presenting synthesis documents. Nevertheless the accounting law from 1983 and the Commercial Code mention this postulate in a distinctive article.

In the Anglo-Saxon world we talk about „going concern”, like a fundamental working hypothesis, mentioned by the commercial code: „To elaborate the annual accounts either for an individual or a moral person, the trader continues his activities”³⁶².

The pregnancy of the continuity in exploitation, mentions Professor Robert Teller, from the Institute of Administrating Companies, Sophia Antipolis University, Nice, France, justifies by:³⁶³ the hypothesis of continuity in exploitation is an implicit support, but an essential one of the accounting-financial information. The financial situations are used for obtaining a company diagnosis, by starting from the exploitation continuity presumption. IAS 1 „Presentation of the financial situations” sees the exploitation continuity presumption as a fundamental base in establishing financial situations. So in IAS 1 it is mentioned „the financial situations must be elaborated based on the activity's continuity, except the case when the management either intends to liquidate the company or to terminate its activity, or has other alternative”³⁶⁴.

The exploitation's continuity is rooted in practice and accounting doctrine, it is an implicit hypothesis of the traditional accounting model. This refers to the neo-classical model of a company that develops its

³⁶⁰ Jacques Richard, Cristine Collette, *Comptabilité générale. Une optique internationale, 4-e édition*, Dunod, Paris, 1996, p.40, quoted from N. Feleagă, L.Malciu, Șt.Bunea, *The accounting basis, European and International approach*, Editura Economică, București, 2002 p.237.

³⁶¹ Niculae Feleagă, Ion Ionașcu, *Financial accounting treaty*, vol.I., Editura Economică, București, 1998, p.314.

³⁶² N. Feleagă, *Be Beyond the the frontiers of the accounting vagrancy*. Editura Economică, București, 1997, p.45.

³⁶³ Robert Teller. *Essay on discontinuity in exploitation*. National Accounting Symposium SICON 94 „Five centuries if accountancy 1494-1994”, Timișoara 7-8 dec.1994.

³⁶⁴ ...*international Accounting Standards 2001* Editura Economică, București p.99.

activity under the conditions of a pure and perfect competition of waiting conditions. An increase is possible, but it is regulated, balanced, without interruption, and the price variation is regulated by the market.

We consider that the logical consequences of these hypotheses formulated by R. Teller for the classical accounting model can be resumed as following:

- The model is universal and does not depend on time;
- It describes the economic agents' balance conditions correctly;
- It perfectly resumes the company's reality (balance sheet);
- The administration control can be resumed to a checking of the correct data (applying the principle of transparent information);
- The environment is stable; the risk related to exploitation is covered by provisions.

Appreciating the continuity criteria in this way is difficult, because in evaluating the company's activity, there are some subjective and objective factors. Therefore the European Federation of the Accounting Experts - the European Union of the Accounting Experts (F.E.E. – U.E.C.), referring to the continuity principle recommends: „This principle cannot be used in a valid way when it is not probable in a previewed future that the company may dispose of sufficient funds to regulate the debts in their payment terms or when a company that would be solvable there are doubtful external factors to determine it to stop its activity or to significantly reduce its volume. Normally, this situation will be valued on the period after terminating the exercise and for which a previewed provision is probable to be realized, a provision to bring again into discussion the perspective of continuous activity”³⁶⁵.

Usually, the exploitation's continuity is appreciated while elaborating the financial situations. The management analyses the effects that the technical, financial, commercial, social, external difficulties have on its activity in the future. They have sufficient data for such a valuation, that is: the financial situations from the last years, the provisions for the future activity, the market study for supplying and sale, due of some important debts, attracting supplementary financial resources, etc. While analysing the annual financial situations or other sources the auditor may see some clues to suggest the infringement of the activity continuity principle:³⁶⁶

Financial clues

- The net debt or the situation of the current net debt;
- Appreciating the expiration of the debts with fix deadline without realistic perspectives of renewing or reimbursement or relying too much on short term credits for financing long term activities;
- Financial unfavourable key clues;
- Substantial exploitation losses;
- Non-payments or interruptions in paying the dividends;
- Incapacity to pay creditors on the due date;
- changing the transactions on credit for transaction suppliers with payment on delivery;
- Incapacity to obtain financing for developing new essential products or for other essential investments.

Clues from exploitation

- The loss of key management members without the possibility to replace them;
- the loss of an important market, the licence or the main supplier;
- Difficulties with the labour force or the lack of important suppliers.

³⁶⁵ Robert Obert, Eric Delesalle, Barthelemy Mercadal, Patrick Dalion, Gilles Nodel „*Law and accounting*”. (traducere) Editura Economică București 2002 p.96.

³⁶⁶ Audit 2000 Standarde. *The code of the ethic and professional condition*, Editura Economică, București, p.181 – 187. *Audit Standard No.570 The Principle of continuous activity*.

Other clues

- the non-conformance with the requests related to capital or with other statutory requests;
- Legal actions in progress against the entity that if successful may take to judicial decision that could not be respected;
- Legislation change or governmental political change.

The significance of such clues may be attenuated by a serial of factors. Such as the incapacity to reimburse debts on time can be counterbalanced by the management's plans to keep the cash flow obtained by assets transfer, rephrasing the reimbursement of debts or obtaining supplementary capital or losing a main supplier can be diminished by corresponding supplying alternative sources.

After analysing the criteria based on exploitation, financial situation and other criteria the administrators and the auditors of the financial situations can reach one of the following conclusions:

- the continuity state is obvious;
- continuity is uncertain;
- the company will enter a discontinuity state.

If the continuity is ensured, the traditional accounting principles such as: valuation of the transactions and events at historical costs, the permanence of the methods, continuity of exploitation, independence of exercises, the prudence principle etc. will continue to apply and the accounting works and financial situations will be elaborated as during the previous periods. In case of uncertainty, the situation changes, the principles of the traditional accounting cannot be applied anymore. It is obvious that the appearance of some uncertainties regarding the exploitation continuity does not justify the abandonment of the exploitation continuity, and in the explanatory notes their causes must be presented as well as the conditions that justify the maintenance of the continuity principle.

If the company enters a discontinuity state the infringement of the continuity principle is imposed, because complying with it will take to the distortion of the financial situations. Such an attitude may have the following consequences: the valuation of the patrimonial elements is done at the liquidation values (realized on the market) and not at the historical costs, by infringement of the methods permanence principle; the activity being terminated, there is no need to register the liquidation and to create provisions, the prudence principle being infringed; the stocks and debts will be devalued; expenses registrations and advance income are not justified; this will affect the principle of exercise independence; there is no distinction between assets and circulant assets, debts on short and long term; involves expenses related to liquidations, indemnities for annulling contracts in progress, for firings, etc.

In a crisis period of the world's economy mentions Professor R. Teller, a period characterised by rupture situations, uncertain events, bankruptcies, activity decrease levels or weak activity of the companies, the question is asked if it is correct to consider and implicit hypothesis of exploitation continuity? Must this hypothesis be rethought; is there no discontinuity of the company's activity?

The answer to such legitimate questions must start from the need to put an early diagnosis for each company depending on analysing the criteria based on exploitation, financial and other criteria (social, legislation, political etc.) regarding its difficulties, survival, restructure, merge, its development or liquidation. The principle of exploitation continuity is valid only when the continuity state is obvious or uncertain, difficulty repair measures can be taken. If the company enters a discontinuity state its reorganisation or liquidation is necessary.

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