

# IMPLICATIONS OF GOING CONCERN PRINCIPLE ON COMPANY BANKRUPTCY

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*In an attempt to select and comprise what has been said so far on the subject of accounting principles, we have chosen to address the going concern principle, explaining its reflection in a particular situation that a company could find itself into – bankruptcy. Therefore, we have reviewed the existing literature on the going concern principle for the purpose of linking it to the bankruptcy of companies. What we are showing here is that there is a pulsing relationship between bankruptcy and the going concern assumption. In other words, both the going concern principle and the state of being bankrupt send signals back and forth, helping managers to plan, predict, and foresee the course of life for their company.*

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## 1. Introduction

Some very recent research combining accounting and neurology shows that there is a connection between the way in which the human brain is designed and accounting principles such as going concern, consistency, conservatism, periodicity.<sup>398</sup> Perhaps future research in this direction will clarify why it is that accounting principles are somehow taken for granted and insufficiently tackled.<sup>399</sup> In an attempt to select and comprise what has been said so far on the subject of accounting principles, we have chosen to address the going concern principle, explaining its reflection in a particular situation that a company could find itself into - bankruptcy.

In order to do this, the remainder of our paper is organized as follows. Part one is a literature review on the going concern principle. We try to go beyond the definition given in the legal norms by reviewing what various authors wrote on the matter. Further on, we explain how bankruptcy manifests and some of the changes that the Romanian insolvency law brought in 2006. Even though there has been much written and talked about Law no 85/2006 – the new insolvency law in Romania -, we consider that the subject is not exhausted for at least two reasons. First is that the issuance date of this law is still quite recent and its full effects are just beginning to show. And second, since every researcher approaches it from a different angle, the outcomes are bound to offer different views on the matter. Finally, the third part is meant to tackle the relationship between bankruptcy and the going concern principle and the accounting consequences that arise.

## 2. Going concern principle

Stemming from true and fair view principle, which governs financial reporting throughout the world (Achim, 2009) be it based on US GAAP, IAS/IFRS or any other national general accepted accounting principles, the going concern principle is the one that has the greatest influence on most of the other general accounting principles - like consistency principle, substance over form principle, conservatism principle, cut off principle (Imbrescu, 2005).

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398 For a detailed view on this see “NeuroAccounting – Consilience Between Accounting Principles and the Primate Brain”, Dikhaut, J., Basu, S., McCabe, K., Waymire, G., 2009, available online at <http://ssrn.com/abstract=1336517>.

399 For example, up until recently, the US GAAP did not contain a definition of the going concern assumption – one of the four major assumptions (or principles) of US GAAP (Venuti, 2004; Afterman, 2008; Wendell, 2008).

In the revised literature, the going concern principle is defined as the assumption that in the foreseeable future the company will continue operating its business naturally (Matis, 2003) without finding itself in impossibility of continuing the activity or having to reduce it dramatically. IAS 1 “Presentation of financial statements” provisions require that management assess the entity’s ability to continue as a going concern upon each preparation of financial statements. As emphasized in the accounting literature, IAS 1 defines the going concern principle *per a contrario*: “unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so” which actually means that management assesses events and uncertainties looking for hints of discontinuing operations, rather than specifically testing or verifying the going concern assumption.

According to the same accounting standard, the going concern is the default basis when preparing financial statements, and any event or uncertainty identified by the management that comes in contradiction with the default assumption must be presented in the notes to financial statements. This is, in fact, an aspect on which there is total agreement since worldwide this view is a common one. To prove this, we will add to the provisions of IAS 1 the EU’s Fourth Council Directive article no 31 which states that “items shown in annual accounts are valued [...] presuming the company to be carrying on its business as a going concern”, and mention that one of the four assumptions on which US GAAP is based on is the going concern assumption (Venuti, 2004).

Basically, the going concern principle expresses the belief that the company remains in existence for and beyond the foreseeable future, having the balance sheet to reflect its value considering this assumption. Because the financial statements are prepared once a year, the common time horizon considered is twelve months. (Afterman, 2008) The opposite is to say that the company will fold within one year from the date of the financial statement. IAS 1 specifically states that “the foreseeable future [...] should be at least, but not limited to, twelve months from the balance sheet date”. A timeline is required because, as the International Standards of Audit (ISA 570) underline, the further into the future a judgment is made, the more the degree of uncertainty increases. And continuity is a concept of the future, that is continuity is impossible in the absence of future. (Salvary, 1996)

In essence, the going concern principle is meant to offer a resolution to the problem that financial statements pose: offering information periodically about continuing operations. The company is perceived as a continuous process of transforming factors of production into value. The audit standard ISA 570 effectively explains this by saying that “the entity will be able to realize its assets and discharge its liabilities in the normal course of business”. By expecting to perform continuously, that is contracts under execution will proceed normally (Achim, 2009), assets will be used adequately and so on, using historic costs and utility values are the only pertinent options. Fair value considered from a liquidating point of view is dismissed.

The financial statements are scrutinized through the magnifying glass that the general accounting principles provide, thus leading to certain expectations and interpretations. With regard to the going concern assumption, for most businesses it is considered implicit and the “uncertainty related to it is at low enough levels not to warrant abnormal consideration by preparers, auditors or users of financial statements. Only as the level of uncertainty rises well above normal levels is it an issue relevant to a company’s financial statements”. (Martin, 2000)

Let us now point out shortly what this principle exactly means in accounting terms. First of all, it makes sense for companies that have no intention to liquidate to mark the distinction between long-term and current assets and liabilities in their financial statements. (Achim, 2009) Asset amortization is another consequence of applying going concern principle. It assumes that the company will outlive its assets (Malciu & Feleaga, 2005). Valuation of the assets according to their utility value presumes that the extent of the company’s activities will not be reduced dramatically in the near future. Based on the same principle, historical costs are seen as a

pertinent valuation basis (Notiuni, 2006; Malciu & Feleaga, 2005). Historical costs are considered pertinent because they are easily retrieved, easy to use and verifiable since they can be proven through the transactions that took place. (Wallace, 2008) Income and expenses that regard the future financial periods are presented in the balance sheet, and do not affect the net income of the current period. (Achim, 2009)

### **3. Bankruptcy as component of the insolvency procedure**

Throughout Europe – in both developed and developing countries –, the last years were marked by debates regarding the most suitable model for insolvency that should be adopted, probably triggered, as Franks (1996) points out, by the large number of insolvencies during the recession in Western Europe in the early 1990's. As a result, a wave of judicial reforms set out to determine “if particular provisions provide the correct incentives to liquidate or maintain an insolvent company as a going concern” (Franks, 1996) started in this field and Romania was part of it (Munteanu & Mihai, 2006 and Brower, 2006).

Law no 85/2006 regarding the insolvency procedure replaces Law no 64/1995 regarding judicial reorganization and bankruptcy in offering the legal setting for companies having financial difficulties. In short, the insolvency procedure set up by the new law consists of two components: a simplified procedure which sends the company directly into bankruptcy and a general procedure which allows the company to go either through reorganization or bankruptcy or both. Just like most of the other European insolvency models, the current Romanian one is obviously inspired by the US insolvency regulations. These became a model for the European jurisdictions because the requirements of the World Bank and the European Union asked for companies in financial distress to be reorganized and protected by the legislation (Munteanu & Mihai, 2006) that is they asked for a debtor oriented law like the one the US has. However, as recent studies have shown (LoPucki, 2005 and Jacoby, 2005), the American system is far from being perfect, but for the purpose of this paper, it is enough to say that the US insolvency regulations – good or bad –, are a model for many others.

The insolvency procedure is triggered when a company defaults on its debt. This may lead either to the firm entering bankruptcy or reorganization. Upon entering bankruptcy, the company will be liquidated and it will exit the market. The bankruptcy procedures specify the manner in which the company will be liquidated – sold as a going concern or piece by piece –, in order to repay the claimants in accordance with the absolute priority rule. Alternatively, reorganization or restructuring is aimed at finding a method of rescuing the company from financial distress and salvaging all or parts of it for the benefit of all claimants. (Hashi, 1997)

The Romanian insolvency law: Law no 85/2006 replaced law no 65/1994. While some authors consider the new law as being likely to suffer further improvements (Bufan, 2006), for others it brings a true revolution in administering bankruptcy (Sarcane, 2006). It is also seen as favourable for the Romanian business environment because it helps purify it (Achim, Pop, Achim, 2008). Unlike the old law, Law no 85/2006 has provisions regarding two forms of insolvency procedure: the general procedure and the simplified procedure. The general procedure means that, after an observation period, the debtor may enter reorganization and then bankruptcy, or separately, only reorganization or only bankruptcy. The new law increases considerably the number of cases in which the debtor cannot reorganize (Tandareanu, 2006). The simplified procedure supposes that the debtor goes straight into bankruptcy. By comparing these aspects with the US Bankruptcy Code, we are not wrong to say that the general procedure matches Chapter 11 Reorganization and that the simplified procedure is the equivalent of Chapter 7 Bankruptcy.

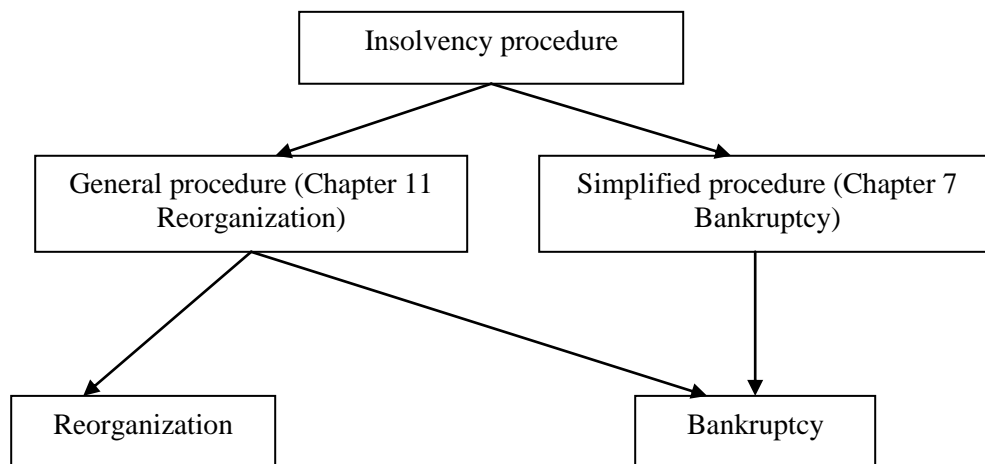


Fig. 1: Options in the Romanian insolvency procedure (created by authors)

In practice, applying the going concern principle does not differ significantly from one referential to another. What differ are the practices concerning the cases in which going concern assumption is no longer applicable (Achim).

#### 4. The going concern principle reflected in bankruptcy

The destiny of a company entering the bankruptcy procedure is quite clear. It will be liquidated, regardless of the method used (sold piece by piece or as a whole). It will no longer serve the purpose it was set up for because it exits the market. It exists until the assets have been sold and the liabilities covered. During this period, the sole reason of the activity of that company is to complete its own liquidation that is to realize its assets and pay its creditors so as to split the remaining equity (if any) between the owners (Imbrescu, 2005).

The legal personality of the company is valid only for those activities that are aimed at this purpose, the normal economic activities that it used to conduct cease. All those connected in any way with the bankrupt company no longer have future expectations from it. The company will not continue for the foreseeable future. Under these circumstances, the going concern assumption is no longer valid. A bankrupt company meets the criteria established *per a contrario* by IAS 1. Its management has no other alternative but to cease trading and liquidate the entity. Therefore, the financial statements of the company being liquidated will be prepared bearing in mind that going concern assumption no longer applies and a different basis for valuation is necessary.

Going concern assumption justifies the use of the estimated recoverable cost approach as opposed to the liquidation or exit value approach to measurement for a liquidating concern. The going concern principle is based upon inductive and deductive reasoning about the behaviour of companies. A company will be able to execute its business plans if a set of conditions are met. The ability to execute its plan makes the company a going concern. Therefore, a going concern is observed as being a firm which has committed finances to its operations, has implemented investment plans and, as a necessary condition for investment, those plans provide for recovering the money invested. There is an unbroken connection between the investment plan and the recovery plan. A liquidating concern is characterized by a disruption of the investment and recovery plan; the recovery plan is no longer operational and the investment plan is no longer valid. (Salvary, 1996)

Upon entering bankruptcy, the normal, current activity of a company is ceased, even though its legal person still exists. The main purpose for the company is no longer to obtain profit, maximize its share value and so on, but to finish liquidating. (Notiuni, 2006; Achim, 2009) In short, in accounting terms this means that all elements will be valued at liquidating values,

long-term assets such as research and development expenses or constituting expenses will be recognized in the income statement, as well as revenues or expenses concerning other financial periods.

## 5. Conclusion

In this paper, we have reviewed the existing literature on the going concern principle for the purpose of linking it to the bankruptcy of companies. What we are showing here is that there is a pulsing relationship between bankruptcy and the going concern assumption. In other words, both the going concern principle and the state of being bankrupt send signals back and forth, helping managers to plan, predict, and foresee the course of life for their company.

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