

## ANALYSIS OF FINANCIAL POSITION IN DETERMINING THE GENERAL INHERENT RISK

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**Abstract:** *The auditing of financial statements is a complex process which besides knowledge of accounting nature, also uses other disciplines from the economic area, having the purpose of obtaining necessary samples for justifying the opinion which is to be given by the auditor. In this way it is justified that the financial statements do not contain major distortions caused by fraud or error, and thus, the users of finance accounting are provided with a higher level of trust. The economical – financial analysis represents one of these disciplines through which the auditor may obtain information concerning the audited entity's financial position. For expressing opinion concerning financial situations, the statutable auditor identifies and evaluates the risks which may point out the fact that, these may contain significant distortions, which are likely to influence the decisions taken by the users of the information. One of these risks, evaluated and determined by financial auditor, is the inherent general risk. The auditor uses worksheets for identifying the level of this risk which support him in establishing some risk factors' degree of influence upon the information given in the financial situations, factors which are not always of economical nature. These risk factors refer to aspects concerning managerial environment, accounting environment, operational environment of the audited entity. Among risk factors concerning managerial environment, financial position and the dissolution of audited entity are worth mentioning. In order to determine the level of risk for these factors, the auditor utilizes elements of economic – financial analyses such as structural analysis of balance sheet liability, analysis of financial equilibrium, analysis of financial risk, analysis of bankruptcy risk – Altman Model, solvency analysis and liquidity analysis. After accomplishing these analyses, the auditor establishes the level of general inherent risk for the financial position and dissolution of the audited entity, using a professional reasoning. Thus, the paper follows the presentation of these aspects from a theoretical point of view and then making an analysis of financial position and dissolution of the audited entity and presenting the degree of general inherent risk made by the statutable auditor.*

**Keywords:** *financial position; dissolution; solvency; general inherent risk.*

**JEL classification:** *M41; M42*

### 1. Introduction

The entities whose financial situations are certificated by the statutable auditors, offer a high trusting level to the users of financial – accounting information. The auditor has to provide an adequate audit opinion of the fact that financial statements do not present significant errors, and this aspect has to be sustained by the audit samples.

In the process of auditing the financial statements, the auditor evaluates the risks having the purpose of making an opinion concerning the situation of the audited entity and of establishing if the information provided by it are significantly distorted. "The auditor has to take into consideration if the sum of the uncorrected distortions is a significant one. If the auditor reaches the conclusion that the distortions may be significant, this has to take into consideration the abatement of audit risk by expanding the audit procedures or to ask the leadership to adjust the financial statements". (Todea and Stanciu, 2009: 43-44).

For evaluating general inherent risk, among the risk factors which have to be analyzed, according to *The guide Concerning the Audit Quality*, emitted by ICAS and IFAC (in Bucharest, 2012: 64), there are also the following: financial position and entity's dissolution. Within the study of this paper, the analysis of the main indicators has been done, in order to establish the entity's financial position, respectively the structural analysis of assets and liabilities of balance sheet, the analysis of financial equilibrium, analysis of financial risk, analysis of liquidity and solvency and analysis of bankruptcy risk determined based on the Altman model. Following this analysis, the degree of general inherent risk has been established corresponding to financial position and liquidity of the audited entity.

## **2. Methodology of the Scientific Research**

The purpose of this paper is to present the usage of economical – financial analysis in determining the general inherent risk. Thus, the quantity of audit samples is being determined based on which the auditor justifies the provided opinion and some aspects which gain the auditor's attention are identified and which may present risks of significant distortion.

The used methodology was presented from a theoretical point of view of the aspects linked of the audit risk, general inherent risk, respectively aspects concerning the analysis of financial position, met during studying the specialty literature and Audit International Standards. In the same time, the analysis of an entity's financial position was presented from a practical point of view, in order to determine the general inherent risk.

## **3. Aspects Concerning the Determination of General Inherent Risk**

"The auditor has to correctly appreciate the quantity of audit samples which must be collected in order to ensure that he / she will not express an inadequate audit opinion when the financial statements contain significantly distorted information. The key to his / her workload is a subtle but correct appreciation of the audit risk and ensuring that this is reduced up to an acceptable level." (Briciu, Socol, Rof, 2010: 29).

"Risk identifying is the most important aspect in making an audit of financial statements. Risk identifying itself has no significance at all if not accompanied by the evaluation of the way in which the risks may generate significantly wrong presentations in the financial statements. The reasoning of audit implies that risk identifying and evaluation are nothing but ways of establishing those aspects which will arouse the auditor's attention, that are believed that would contain a risk of significantly wrong presentation." (Briciu et al, 2014: 110).

Audit risk, according to ISA 200 (in Bucharest, 2016: 84), represents “the risk that the auditor expresses an improper audit opinion when the financial statements are significantly distorted. This is a significantly distortion risk and detection risk function.”

Significant distortion risk ISA 200 (in Bucharest, 2016: 87), represents “the risk that the financial statements are significantly distorted before the auditing. This is consisted of two components, inherent risk and control risk. Inherent risk represents the susceptibility of an affirmation concerning a transaction class, balance account or presenting as being significantly distorted, either individually or cumulated with other distortions, before taking into consideration any check linked to these”.

“Financial auditor has to make an evaluation of the context in which the entity operates and of the characteristics of the audited environment. Thus, the inherent risk evaluation is being made with the purpose of elaborating the audit plan, referring to professional reasoning and to the financial auditor’s experience, following the analysis of the factors which influence the inherent risk. The importance of evaluation inherent risk is worth mentioning in establishing or modifying the quantity of audit samples in the auditing segments. A generally risk evaluation and a specifically inherent risk one are made in the preliminary phase of auditing.” (Dănescu, 2007: 79).

“For estimating the inherent risk, when elaborating the action plan, the professional realizes an environment evaluation (of the context) in which he / she operates - on one hand, and on the other hand he / she realizes an evaluation of the characteristics and warrant’s requirement of the audited entity.” (Domnişoru, 2011: 229).

“The purpose of evaluating the inherent risk is to allow the financial auditor to form a preliminary opinion about the entity which is complied to be audited, opinion which is to be considered in the planning process. The profound inner checks realized by conformity tests within the audit global strategy are not to be confounded with the global check of inherent risk.” (Dănescu, 2007: 79).

From the typology point of view, the inherent risk may be a general inherent risk and specific inherent risk. In this study we follow the position of the entity’s financial analysis in evaluating general inherent risk.

The manner of evaluating general inherent risk is mentioned *in the Guide Concerning the Quality’s Audit*, delivered by ICAS and CAFR (in Bucharest, 2012: 64), where there is a worksheet destined to this evaluation, containing risk factors which have to be analysed by the auditor in order to determine the general inherent risk. Two of these risk factors are the financial position of the audited entity and its dissolution. Thus, after factors’ analysis, the auditor must appreciate if the analyzed and documented risk factor, generates a very low risk, a low risk, medium, high or very high one, identifying the grade in which the identified distortions may produce effects on the financial statements.

After analysis and documentation of all risk factors provided in the worksheet, concerning the general inherent risk evaluation, according to *Guide Concerning the Quality’s Audit*, delivered by IACS and CAFR (in Bucharest, 2012: 64), the risk with the greatest weight in the obtained results is determined, this being established as general inherent risk.

#### 4. Theoretical Aspects Concerning the Financial Position Analysis

For analysing the risk factors, financial position and dissolution, for determining the general inherent risk, the auditor has used structural analysis of the assets and liabilities of the balance sheet, financial equilibrium analysis, financial risk analysis, liquidity and dissolution analysis and bankruptcy risk analysis made by the Altman Model.

“Financial position is evaluated according to the economic resources that the enterprise controls, to the financial structure which sustains these resources, its liquidation and dissolution, as well as the capacity of adapting to the environmental changes.” (Petcu, 2009: 411).

“The analysis of patrimonial structure as a component of financial position analysis, follows the share analysis of different patrimonial elements in the sum of balance sheet, as well as the report between different asset components, respectively liabilities ones. This completes the study of absolute size indicators and allows comparisons for situating the enterprise more correctly in its competitive environment.” (Păvăloaia et al, 2010: 300).

For financial position analysis, Burja (in Cluj-Napoca, 2005: 237) points out the following aspect: “the structure of financial balance sheet allows the equilibrium analysis from the point of view of respecting some main financing principles, according to which the fixed assets will be financed from permanent equities, and the circular assets (temporary needs) have to be financed from temporary resources. Violations of these principles will determine a state of financial disequilibrium.”

In the financial position analysis, financial risk analysis is one of its components. So, Burja (in Cluj-Napoca, 2005: 278), defines financial risk “as being the variability of result indicators, under the company’s financial structure incidence. Financial risk produces when borrows do not generate financial efficiency namely when the ratio of economical profitability obtained by utilising the borrows is inferior to the ratio of borrowed capital”.

“The enterprise’s short term financial equilibrium analysis is made with the help of liquidity ratio which offer a static vision of the situation on a limited time horizon. “The enterprises which have a reduced liquidity ratio, but have a quite high cash flow may have a comfortable liquidity degree; on the other hand, the enterprises which have high liquidity rates but low cash flow, may have difficulties in honouring the obligations. Long term solvency analysis supposes correlating the total liquidity and assets with total chargeability, thus calculating the report between the total assets and the total credit. This ratio is the relative expression of the enterprise’s net asset, which represents the warranty of owner and creditors’ thrust in its management and financial health.” (Petcu, 2009: 441-442).

“Financial analysis by classical methods based on patrimonial statements, on financial performances evolution, on the working capital situation and on working capital requirement or based on table funding, offers partial information about bankruptcy risk and a general appreciation on a past situation.” (Burja, 2017: 156).

“Bankruptcy risk, the one of incapacity or liquidity is a major risk because as opposed to the risk of loss it is juridical sanctioned; an enterprise which registers losses may continue its activities as long as it is able to pay / cover its debts; instead the fact that it seizes the payments makes it enter in a juridical process which may lead to its disappearance” (Colasse, 2009, 111).

“Internationally, there have been developed certain score functions, starting with Beaver’s study (1996), who used the univariate analysis and continuing with Altman (1968), the most famous name in the field of bankruptcy prediction methods, the first author who used multiple discriminate analysis in bankruptcy prediction. The most often cited are Altman Model, Conan and Holder Model, the Model of Central Balance from the Bank of France etc.” (Vâlceanu, Robu and Georgescu, 2005: 381-382).

## 5. Study Concerning Financial Position Analysis in Determining General Inherent Risk

Based on indicators of financial statements of SC ALFA SA and respecting the worksheet for evaluating general inherent risk provided in *The Guide for Quality Control* issued by ICAS and IFAC (in Bucharest, 2012: 64), the auditor has realised the audit sample upon which he will demonstrate the level of risk factor (very low risk, low, medium, high and very high) established by this, concerning the financial position and the entity’s liquidation, as a result of these analyses.

The entity’s financial position analysis was realised starting from the structural analysis of assets and liabilities of balance sheet, from financial equilibrium analysis, financial risk analysis, liquidity and solvency analysis and bankruptcy risk analysis realised using the Altman Model.

**Table 1:** Financial position analysis of SC ALFA SA entity

Indicators	2013	2014	2015
Total assets	253.878.930	306.422.578	331.749.758
Fixed assets	157.968.523	192.664.106	196.414.800
Tangible assets	108.593.258	143.256.111	137.505.149
Financial assets	48.714.404	48.712.986	58.375.756
Current assets	95.825.754	113.487.036	135.057.068
Stock	27.281.030	23.056.938	39.627.118
Commercial claims	52.163.620	59.307.749	58.688.649
Cash and deposits	4.266.471	14.711.465	10.549.463
Total debts / liabilities	132.119.416	183.333.599	197.806.022
Current liabilities / debts	98.572.405	132.552.913	151.558.118
Bank credits	17.050.495	10.987.516	4.706.206
Personal capital	121.759.514	123.108.979	133.943.736
Permanent capital	149.568.049	168.462.544	172.364.464
Total of liabilities	253.878.930	306.422.578	331.749.758
Medium and long term liabilities	27.808.535	45.353.565	38.420.728
Financial debts	42.360.948	67.038.898	82.143.234
Net income	9.150.871	10.500.453	15.374.248
Reinvested income	545.906	605.935	444.319
Gross profit	10.918.116	12.300.030	17.857.204
Fiscal value	429.806.098	528.981.984	593.636.395
<b>Structural Analysis of Balance Sheet Asset</b>			
$R_{AI} = \frac{\text{Fixed assets}}{\text{Total asset}} \times 100$	62,22%	62,88%	59,21%
$R_{IC} = \frac{\text{Tangible assets}}{\text{Total assets}} \times 100$	42,77%	46,75%	41,45%
$R_{IF} = \frac{\text{Financial assets}}{\text{Total asset}} \times 100$	19,19%	15,90%	17,60%
$R_{AC} = \frac{\text{current assets}}{\text{Total asset}} \times 100$	37,75%	37,04%	40,71%
$R_{St} = \frac{\text{Stock}}{\text{Total asset}} \times 100$	10,75%	7,52%	11,95%
$R_{CC} = \frac{\text{Commercial claims}}{\text{Total asset}} \times 100$	20,55%	19,35%	17,69%

Indicators	2013	2014	2015
$R_{DB} = \frac{\text{Cash disponibility}}{\text{Total assest}} \times 100$	1,68%	4,80%	3,18%
<b>Structural Analysis of Balance sheet Liabilities</b>			
$R_{SF} = \frac{\text{Permanent capital}}{\text{Total liabilities}} \times 100$	58,91%	54,98%	51,96%
$R_{afg} = \frac{\text{personal capital}}{\text{Total liabilities}} \times 100$	47,96%	40,17%	40,37%
$R_{aft} = \frac{\text{Personal capital}}{\text{Permanent capital}} \times 100$	81,41%	73,08%	77,71%
$R_{sf} = \frac{\text{Personal capital}}{\text{Long term debts}} \times 100$	437,85%	271,44%	348,62%
$R_{ig} = \frac{\text{total debts}}{\text{Total liabilities}} \times 100$	52,04%	59,83%	59,63%
$R_{ig} = \frac{\text{Long term debts}}{\text{Personal capital}} \times 100$	22,84%	36,84%	28,68%
$R_{dt} = \frac{\text{Financial liabilities}}{\text{Own capital}} \times 100$	34,79%	54,45%	61,33%
$R_f = \frac{\text{Net Income}}{\text{Personal capital}} \times 100$	7,52%	8,53%	11,48%
<b>Financial Equilibrium Analysis</b>			
$\text{Net situation} = \text{Total assets} - \text{Debts}$	121.759.514	123.088.979	133.943.736
$\text{FRF} = \text{Net current assets} - \text{Short term debts}$	-2.746.651	-19.065.877	-16.501.050
$\text{NFR} = \text{Temporary necessities} - \text{Temporary Sources}$	-12.784.024	3.723.949	5.843.257
$\text{RNFR} = \frac{\text{NFR}}{\text{Fiscal value}} \times 360$	-10,70	3,16	3,59
$\text{TN} = \text{FRF} - \text{NFR}$	-15.530.675	-15.341.928	-68.314.321
<b>Financial Risk Analysis</b>			
$\text{Lever} = \frac{\text{Financial debts}}{\text{Personal capital}}$	34,79%	54,45%	61,33%
$\text{Lever effect} = (R_{EC} - R_d) \times \frac{\text{Fiancial debts}}{\text{Personal capital}}$	0,89%	0,74%	0,85%
$R_{EC} = \frac{\text{Gross income}}{\text{Total assest}} \times 100$	4,30%	4,01%	5,38%
Interest rate*	1,75%	2,75%	4,00%
<b>Liquidity Analysis</b>			
$R_{LC} = \frac{\text{Current assets}}{\text{Current debts}} \times 100$	97,21%	85,61%	89,11%
$R_{LP} = \frac{\text{Current assets} - \text{Stock}}{\text{Current debts}} \times 100$	69,54%	68,22%	62,97%
$R_{LI} = \frac{\text{Cash and bank accounts}}{\text{Current debts}} \times 100$	4,33%	11,10%	6,96%
<b>Solvency Analysis</b>			
$R_{SG} = \frac{\text{Total assets}}{\text{Total liabilities}} \times 100$	192,16%	167,14%	167,72%
$R_{SP} = \frac{\text{Personal capital}}{\text{Personal capital} + \text{Bank credits}} \times 100$	87,72%	91,81%	96,61%
<b>Bankruptcy Risk Analysis – Altman Model</b>			
$R_{AC} = \frac{\text{Current assets}}{\text{Total assets}} \times 100$	37,75%	37,04%	40,71%
$R_{PR} = \frac{\text{Reinvested profit}}{\text{Total assets}} \times 100$	0,22%	0,20%	0,13%
$R_{EC} = \frac{\text{Gross profit}}{\text{Total assets}} \times 100$	4,30%	4,01%	5,38%
$R_{sf} = \frac{\text{Personal capital}}{\text{Medium and long term debt}} \times 100$	437,85%	271,44%	348,62%
$\text{VRA} = \frac{\text{fiscal value}}{\text{Total assets}} \times 100$	162,29%	172,63%	178,94%
$Z = 1,2 \times R_{AC} + 1,4 \times R_{PR} + 3,3 \times R_{EC} + 0,6 \times R_{sf} + \text{VRA}$	4,85%	3,93%	4,55%

Source: own processing

Following the accomplished analysis, the auditor has reached the next conclusions:

- *Structural analysis of balance sheet asset*

The ratio of fixed assets ( $R_{AI}$ ) register, in the period of analysis a relatively constant value of around 60%, this being specific in industry because any evolution of fixed assets has a major influence on the assets' total value.

Tangible assets rate ( $R_{IC}$ ) suggests an increase in their value in 2014 as compared to 2013, due to the entity's investments in purchasing fixed assets. The diminishing value in 2015 at a level which is close to the one in 2013 is due to the selling of some fixed assets.

Financial assets rate ( $R_{IF}$ ) registers relatively constant values and points out the ownership of financial assets in the capital of other entities, having the purpose to expanding and developing the manufacturing capacity on the market in which the entity operates.

Current assets rate ( $R_{AC}$ ) registers approximately equal value during 2013 and 2014, and in 2015 registers an increase caused by the increased value of stock and claims. Claims' value is influenced by the value of merchandise which is at customers. Their weight in the total assets is relatively low, being specific to the entities which have the same object of activity.

According to stock rate ( $R_{St}$ ), these have registered a drop from the total assets in 2013 as compared to 2014, due to the efficiency of production management, even if the price for raw materials has increased.

Commercial claims rate ( $R_{CC}$ ) owns a greater weight in the total assets than stock, and this fact has a negative effect on the entity, namely on its liquidity being influenced by the value of merchandise that the customers have. Cash availability rate ( $R_{DB}$ ) maintains a relatively low level, pointing out the entity's lowered liquidity.

■ *Structural analysis of balance sheet liabilities*

Financial stability rate ( $R_{SF}$ ) emphasizes a drop of the entity's financial stability grade in the period of analysis, but is not of major proportion which would put the entity's stability over time under the question mark. The registered value highlights a good economic stability.

Global financial autonomy rate ( $R_{afg}$ ) registers a relative drop of the entity's financial autonomy level, its level pointing out the entity's satisfactory solvency.

Financial autonomy rate at term ( $R_{aft}$ ) highlights a drop in 2015 as compared to 2013, but during 2015 this comes back to a value closed to the one from 2013. The level of this rate, over 50%, indicates the entity's good financial position.

Financial security rate ( $R_{sf}$ ) registers a higher percentage than the minimal 100% provided value, reflecting the fact that the value of personal capital ensures the entity's financing.

Global debt rate level ( $R_{tg}$ ) registers a relatively growth during the three years period of analysing, which doesn't exceeds the maximum 66% provided level. Term debt rate ( $R_{tt}$ ) determined according to personal capital, registers a growth during 2014 as compared to 2013 and during 2015 a relatively drop, its value being under the 100% allowed level, which points out the fact that the entity's financial security is not threatened.

In the analysed period one can observe an increase of financial liabilities rate ( $R_{dt}$ ) its level being a satisfactory one, maintaining in the 30% - 70% interval.

Financial profitability rate ( $R_f$ ) highlights a constant increase on the three years period of analysis, their value is relatively low but higher than inflation rate in economy. (<http://www.insse.ro/cms/ro/content/ipc-serii-de-date>, accessed on the 17th of February 2017), thus we can sustain the fact that in the analysed period the personal capital was efficiently valued by the entity.

#### ■ *Financial equilibrium analysis*

Net situation registers a constant increase during the analysed period, pointing out the efficiency of the entity's economic management by maximising personal capitals thus leading to the financing of net assets.

Negative value of the financial working capital (*FRF*), in the analysed period proves the fact that the net current assets' value is smaller than that of short term debts, and then the liquidity of net current assets is insufficient for covering the short term debts.

Working capital requirement (*NFR*) registers a negative value during the first year, but in the following two years it registers positive values, which indicates the fact that the entity has invested in increasing the manufacturing, thus also increasing the commercial assets.

Net treasury (*TN*) presents negative values during the analysed period, which notes that the entity has to call to credits for covering and supplement the financing. This situation does not have to be considered as being an insolvency state, because the entity started a process of acceleration concerning the stock rotation and a process of identifying the modalities of recovering the assets.

#### ■ *Financial risk analysis*

The positive and approximately constant value of leverage effect indicates the fact that the value of economic profitability (*REC*) is higher than the interest rate (<http://www.bnr.ro/Raport-statistic-606.aspx>, accessed on the 15th of February 2017), denoting the beneficial effect of debts on the entity.

The entity's debt degree increases in the analysed period, but the financial debts do not overcome personal capital, thus the entity remains secure concerning its financial solvency.

#### ■ *Liquidity and solvency analysis*

During 2013 – 2015, one may observe a lowered volatility of liquidity indicators \, respectively of current liquidity rate ( $R_{LC}$ ), of partial liquidity rate ( $R_{LP}$ ) – *acid test* and immediate liquidity rate ( $R_{LI}$ ), and liquidity risk was maintained at an almost satisfactory level, also owed to the 29,30% percentage obtained during 2014 – 2015, of the stocks in the total of current assets, the rest being elements of immediate liquidity, owned mainly in assets and cash availability.

General solvency rate ( $R_{SG}$ ) registers a positive evolution, observing a percentage decreasing owed to debts increasing, but not as to affect the entity's solvency.

Through the rate of patrimonial solvency rate ( $R_{SG}$ ) it may be observed a diminishing of entity's used credits, having the purpose of financing the assets, thus in the same time reducing financial risk.

#### ■ *Altman Model*

After applying Altman model and determining the Z function, the fact that the entity is solvable resulted, thus ensuring the users' of financial – accounting information thrust in its viability.

Following the effected analyses the auditor has reached to the conclusion that the entity had to call to credits in order to supplement its financing. This situation must not be tabulated as being insolvability, because the entity accelerated stock speed rotation and identifying the modalities of recovering the assets. Bankruptcy risk analysis through Altman model proved that the entity is solvable.

Therefore the auditor, applying the professional reasoning, established that the analysed risk factors, financial position and liquidation present a general inherent risk.



## 6. Conclusions

In the actual context of market economy, the auditing of financial reports represent a necessary element in order to offer the users of financial – accounting information, an insurance of the fact that the information offered by these do not contain significant distortions due to fraud or errors and may be used in the process of taking decisions.

Risk evaluation represents a necessary step for identifying the elements which can significantly distort the information offered by financial reports, thus letting the auditor to supplement the quantity of necessary samples for efficiently documenting the opinion which is to be provided when ending the audit.

In order to determine the general inherent risk, the auditor analyses different risk factors, and calls to different methods of evaluating them, in the case of financial position of the entity's liquidation, the auditor uses indicators specific to economic-financial analysis. In the case of the present study the auditor established the fact that the analysed risk factors present a general inherent environment.

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