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THE METHODS OF EVALUATION OF COMPANIES FINANCIAL CONDITION AND SOLVENCY FOR THE AUDIT PURPOSES

Abstract: This article describes the main methods of estimation of financial condition and solvency, used for finding high risk audit areas and necessary audit procedures application to obtain the necessary audit evidence. The author gives the characteristic of the Ukrainian practice indices and ratios required by Ukrainian Securities and Financial Market Commission for citing in an audit report, especially during economic crisis. The author pointed out in the article that an auditor has to modify the audit report adding an emphasis of matter paragraph which may contain information about the material uncertainty of the ability to continue business activity by the company.

Keywords: methods, financial condition, solvency evaluation, audit.

Audit evolution abroad and in our country indicates that in modern terms the role of analytical procedures in activity of auditing firms grows permanently, because enterprise managers, founders, shareholders and partners need complete and detailed information about financial independence and financial stability of an enterprise. In addition, clients are often interested not only in current financial condition of an enterprise but also in growth prospects, expected effects of decision-making, identification of probability of strategic aims achievement. For this reason, during the audit conducting financial analysis is used more often as one of types of economic analysis, which is understood in an audit as a method of cognition of enterprise financial procedure, processes of resources forming and use, for its operational and investment activity. It is a type of concomitant audit services.

Such a formulation of audit results in analytical functions predominance, but not control functions. As vice-president of world group Price&Waterhouse Nigel Bukenan said, "in the countries with the developed market relations an auditing firm is considered not as an inspector, but as independent consultant that during financial statements verification gives unbiased professional estimation of the entities condition" [2, p. 30].

Strengthening of the analytical orientation of audit is evidenced not only because of the increases in quantity of financial analysis services but also because of the growth of the role of analytical procedures during audit conducting, especially during the audit of the completed financial reports.

Thereby, financial analysis as one of the types of economic analysis is used in an audit in two aspects: as a cognition method of the enterprise's financial mechanism during audit and other auditing services, and as a separate type of the services provided by auditing firm.

The Audit Chamber of Ukraine as a higher regulatory body of audit activity in Ukraine confirmed by the Decision of ACU No 122 in 2003 the international auditing, assurance, and ethics pronouncements as national standards on auditing, assurance and ethics.

ISA 520 *Analytical Procedures* marks that "for implementation of analytical procedures different methods can be used, beginning from simple comparisons and up to the complex analysis with difficult statistical methods application" [5, p. 441].

It is reasonable to define the following analytical procedures: the comparison of current period information with the comparable information for the previous periods; current (or present) information comparison with the planned data, budgets, prospects; the comparison of indices and financial rates with the rates of the business area and indices of other enterprises; evaluation of the ratios of the current period indices from the point of view of their accordance with the correlations predicted with taking into account the terms of business activity; an analysis of interrelationships between the elements of financial information; comparison of financial information with the proper information of non-financial nature.

Analytical procedures can be conducted at all stages of financial audit. Some analytical procedures are reasonable for implementation at the stage of planning for determination of the nature volume and time of future activity. The conduction of analytical procedures at the stage of planning helps an auditor to identify important aspects which need the specific detailed investigation during the audit. Analytical procedures are used as procedures of risks estimation to obtain the understanding of the business and its environment. For example, the calculation of supplies turnover before testing their value can indicate the necessity of attention to the audit of supplies.

For analytical procedures which are performed at the planning stage it is common to use comparisons of indices, aggregated on a high level (for example, on the level of enterprises, type of business), analysis of possible fraud and procedures volume, type, period which differ depending on clients. For some clients the comparison of the prior and current period balance accounts using trial balance (which was not audited) can be sufficient. For other clients procedures must include the extended analysis of quarterly financial statements basing on the auditor's judgment.

In the US Dun and Bradstreet, Robert Morris Associates and other analysts accumulate financial information about thousands of companies and collect information about the different businessareas. Many audit firms buy this information for the use as a basis for comparisons in particular industries during the audit performance [1, p. 210].

Analytical procedures are conducted at the stage of audit providing in combination with other audit procedures. Like substantive procedures analytical procedures are used, if their application is productive or more effective than the detailed tests, for decreasing the risk of material fraud at the level of assertions in financial statements to the acceptable low level. For example, the amount of money paid to insurance company for the insurance policy can be compared with the policy of a previous year as a part of the audit of the prepaid insurance payments.

The analytical procedures application is based on the expectation of the existence of an interrelation between data, this interrelation will concern further affairs in case of absence of other evidence.

The level of confidence in the results of analytical substantive procedures depends on the auditor's estimation of a risk, that analytical procedures can identify the expected interrelations, though there actually can be substantial disclosure. As for accepted risk data, there can be applied only detailed tests, or their combinations with analytical substantive procedures.

Analytical procedures are also needed at the completion stage of audit. Such tests are useful for the final evaluation of material frauds and financial problems and help auditors to make a generic objective view of the audited financial statements.

Analytical procedures are also required to be done during the completion phase of the audit. Such tests are useful at that point as a final review for material misstatements or financial problems and to help the auditor take a final "objective look" at the final statements that have been audited. It is common for a partner to do the analytical procedures during the final review of the audit files and financial statements. Typically, a partner has a good understanding of the client and its business because of ongoing relationships. Knowledge about client's business combined with effective analytical procedures is a way to identify possible oversights in an audit [1, p. 208].

According to ISA 570 "Going Concern" the auditor has to express his opinion about the correspondence of the entity to the going concern principle as a basis of the financial reporting. During the analytical procedures performance for the evaluation of the enterprise's ability going concern (mainly, during the following year) it is possible to discover at the stage of planning that an enterprise has considerable financial problems. The results of bankruptcies study testify that the majority of bankruptcies occur at the beginning of enterprise's activity. Enterprises which set up the proper accounting and control system have fewer chances go bankrupt. The bankruptcy probability is taken into account during the evaluation of audit risk. During the final stage of audit the last evaluation of continuity is performed, which influences the expressing of the auditor's final conclusion about the financial statements' reliability. The most effective method for the achieving the final aim of audit procedures is to evaluate, among others, financial stability rates, liquidity rates, business activity rates and profitability rates. The auditor has to make an analysis of the cash flow, the income, the other information for verification of assertions which are the projection basis, and to compare prospective information for the previous periods with actual results, and also prospective information for the current period with results obtained to the audit start [3, pp. 375, 376].

Ratio analysis is perhaps the most commonly used tool in financial analysis. Financial ratios allow the analyst to assess and analyze the strengths and weaknesses of a given company with regard to such measures as liquidity, performance, profitability, leverage and growth on an absolute basis and by comparison to other companies in its industry or to an industry standard [4, p. 74].

For the enterprise's solvency estimation the assets liquidity relative indices are used which are considered as coverage of short-term liabilities.

For the enterprise's balance sheet liquidity estimation the following indices and ratios are used:

– owned working capital ("functioning capital", in the US it is a difference between current assets and current liabilities);
– coverage ratio which is calculated by dividing the enterprise's current assets by the amount of its current liabilities;
– the intermediate coverage ratio is determined by dividing the sum of cash, short-term financial investments, account receivable by the amount of current liabilities;
– the total liquidity ratio is calculated by dividing the sum of the enterprise's cash and short-term financial investments by the amount of current liabilities. It is also called a rapid liquidity ratio and characterizes urgent ability of enterprise to eliminate the debt;
– the ratio of entity's autonomy is determined by dividing the owned capital by the balance total;
– the debt-own capital ratio is calculated by dividing the enterprise's liabilities (debt capital) by the amount of own money.

Balance sheet ratios fall under the heading of liquidity ratios (measuring the company's ability to meet its short-term obligations) or solvency ratios (measuring the company's ability to meet long-term and other obligations).

Financial ratios serve the following purposes:

– they provide insights into the microeconomic relationships within a company, which helps analysts project earnings and free cash flow (which is necessary to determine entity value and creditworthiness);
– they provide insights into a company's financial flexibility which is its ability to obtain the cash required to meet financial obligations or to make asset acquisitions, even if unexpected circumstances should develop. Financial flexibility requires a company to possess financial strength (a level and trend of financial ratios that meet or exceed industry norms), lines of credit, or assets that can be easily used as a means of obtaining cash, either by their outright sale or by using them as collateral.

They provide a means of evaluating management's ability. Key performance ratios can serve as quantitative measures for ranking management's ability relative to a peer group [6, p. 208].

The audit conclusion is issued according to ISA's, in particular: ISA 700 *The independent Auditor's Report on General Purpose Financial Statements*, ISA 701 *Modifications to the Independent Auditor's Report*, ISA 720 *Other information in documents containing Audited Financial Statements*.

According to the Audit Conclusion Requirements audit conclusion is submitted to The Securities and Stock Market State Commission in Ukraine when information recording and securities issuing, and also when presenting regular information by public corporations and by the enterprises which issue bonds (except for commercial banks). That is why due to this Requirement an auditor has to perform an analysis of indices of the public company's (or of the bonds issuer's) financial state. These indices are: the coverage ratio, intermediate coverage ratio, total liquidity ratio, ratio of entity's autonomy, debt-own capital ratio.

Methodical recommendations to the preparation of audit conclusion during the audit of public companies and companies-bonds issuers put the approximate values of the ratios (total liquidity ratio – 0.25-0.5; general liquidity ratio – 1.0-2.0; the ratio of entity's autonomy – 0.25-0.5; capital structure ratio – 0.5-1.0) [3, pp. 397-399].

During the audit the analysis purpose is obtained by execution of the proper operational task, put before an auditor. The examples of analytical tasks can be: the analysis of balance sheet items dynamics and structure; analysis of balance sheet liquidity; analysis of the financial state and solvency; income factor analysis; profitability analysis; rapid analysis of the enterprise's financial state; overall analysis of business activity of enterprise, etc.

Nowadays, the substantial development of audit activity stipulates the new audit areas arising. More often auditors have orders to provide the definite procedures which include not only the financial statements audit, but also business valuation in the view of the financial policy, business strategy and tactic, professional skills and knowledge of personnel, business trends, and prospective, financial stability and solvency. Ukrainian and foreign investors are interested in such valuations, it is very important for them to obtain the information about the real condition of the business and its potential.

Audit firms may provide much more types of services than those listed before. The competition between audit firms stimulates them for permanent extension and verification of additional services (for example consulting, legal services, information-system testing, trainings for personnel). As a result there could be issued a letter with recommendations concerning the business processes by auditors. In this letter there are disclosed the management failures which could cause distortions of the financial statements.

Also there is the need for proper information about company's market position, financial potential, production capacities, contractors and partners in order to take management decisions about the investment process, mergers and acquisitions. Auditors often conduct the special audit investigation to collect such information. This complex, general investigation of a company is called "Due Diligence" and is one of the types of the operational audit. Due Diligence helps determine the actual market position and enterprise's development prospects.

Traditionally Due Diligence involves a process of discovery that is relevant in key business transactions, as well as in operational activities. As can be seen in more detail below, Due Diligence has become the norm in decision-making as regards: joint ventures; mergers and acquisitions; selecting appropriate partners; choosing the right jurisdiction or location; buying and selling assets, etc.

Essentially in all such situations there will be: the transfer of assets from one party to another or the creation of obligations; the existence of risks that may affect the future value of such assets or obligations; the need to apportion the risks between the parties [7, p. 8].

However, for research of the noted objective the auditor has to go beyond the accounting function meaning inside the company and to find out how all the sides of company's activity are represented in the final reports.

Due Diligence is the complex analysis of all relations inside the enterprise and its co-operating with an external environment, rigorous enterprise and business investigation, which is carried out with the following purposes:

- to confirm that business really fits to the information mentioned in the company's documentation;
- verifications of correctness of all documents processing and timeliness of tax, statistical and financial statements presentation;
- confirmation of accounting and financial statements reliability (real proprietors, hidden debts, hidden book-keeping);
- likelihood appraisal of the short-term and long-term market strategy realization;
- investigation of enterprise's competitive positions at the market on which it works;
- collecting of the information which will provide the possibility for real estimation of the company's situations and problems in order to avoid errors during contract signing.

There is much that can be gleaned from disclosed financial information and the accompanying financial ratios. However, there is still much that can lurk behind the figures, irrespective of the interpretation of the entries and calculations of financial ratios. The information identified from detailed investigation will be highly relevant in the ongoing negotiations for the cost of finance and its structure. At a minimum, accounts should be audited as required by best accounting practices, and should be in conformity with the local law. An important part of historical analysis is to look at any disclaimers or qualifications on the audit reports, or a frequent change of auditors. Equally, at a minimum, management accounts should adopt accounting policies and practices that are consistent with the audited accounts [7, p. 58].

The conducted complex analysis of the financial condition of the company, and its relations with the state and contractors enables to issue a report in which an investor or potential buyer of a company will find all the necessary information for the decision-making about investments. Objectiveness and reliability of the information, which the investor gets, will allow to take independent and the most adequate in this situation decision [8].

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METODY OCENY KONDYCJI FINANSOWEJ I WYPŁACALNOŚCI PRZEDSIĘBIORSTW DO CELÓW AUDYTU

Streszczenie: W artykule opisano najważniejsze metody oceny kondycji finansowej oraz wypłacalności stosowane do znajdowania obszarów wysokiego ryzyka w procedurach kontroli w celu uzyskania niezbędnych dowodów. Autorka przedstawiła specyficzne dla praktyki indeksy i wskaźniki wymagane przez ukraiński rynek papierów wartościowych. Komisja rynku finansowego wymaga ich zamieszczenia w raporcie z rewizji finansowej szczególnie podczas kryzysu gospodarczego. W artykule wskazano na konieczność przedstawienia biegłemu rewidentowi informacji na temat niepewności co do możliwości kontynuowania działalności przez przedsiębiorstwo. Wątpliwości w tym zakresie powinny być wykazywane w raporcie rewizji finansowej.