DOES THE ANALYSIS OF THE SUPPLIERS' FINANCIAL STATEMENTS ALLOW TO MANAGE RISKS IN TERMS OF ENSURING OF SUPPLIES CONTINUITY?

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Abstract

The main aim of the disclosure of the companies' financial statements is to ensure information to external users of accounting information. Companies registered in the Business Register have the duty to disclose their financial statements in the Collection of documents until the end of the following accounting period after the reporting date. This obligation is based on the European Union regulation with the main aim to protect the third parties (mainly business partners) during concluding of contracts. Although the disclosure of the financial statements is common in the European Union, companies located in the Czech Republic do not comply with this requirement. The paper deals with the research of 392 companies operating in automotive industry in the Czech Republic and answers two main questions. Do these entities meet their legal obligation to disclose their financial statements? Is it possible to find out the violations of going concern assumption earlier than the company is in insolvency?

Key words: financial statements, going concern assumption, negative equity, prudence principle, bankruptcy of the company

Code: G31, M41, M48

Introduction

When selecting a new business partner it is essential to gather the greater amount of financial information related to the company or group of companies under the consideration. Some companies publish basic information regarding their business activities on their websites, for instance, they provide information about their trading turnover or their profit and loss. However, for an appropriate assessment of the company that is under consideration of becoming a new business partner this information is largely insufficient. Comprehensive information, along with explanatory notes and commentaries, is to be found in the financial statements which are, in accordance with the law, all business companies obliged to provide in Business Register. (Bokšová, 2010) Financial statements represent standardized documents which are by the current legislation clearly defined. Consequently, everyone is aware of the type and extent of information which should the financial statements provide. Nevertheless, do business companies truly fulfil this obligation and publish their financial statements on the website www.or.justice.cz? Furthermore, how to deal with all information provided in the financial statements? Is it possible to assume all provided information are true and correct or is it necessary to approach such information with reservations?

In case that financial statements of a business company have been checked by the financial audit then the auditor's report represents a certain guarantee. (Strouhal, 2012) Thus, users of such financial statements can be to some degree assured that they will not make, based on the information provided within it, wrong business decision. (Strouhal, 2012) As a result, when using the financial statements in order to assess risks of potentially new business partner the financial audit will play an essential role.

When selecting new business partners do companies have their own possibilities to assess information in the financial statements or do they have to depend solely on the statement of the financial audit? Indeed, all users of the financial statements have a possibility of establishing their own assessment of provided information and thus pre-select areas with potentially increased risks. (Strouhal, 2014)

According to § 21a of Act on Accounting individuals/legal entities listed in the Business Register are obliged to publish their financial statements. (Act on Accounting, 1991) The financial statements consist of balance sheet, profit and loss account and notes to the financial statements which further clarifies and expands on information provided within balance sheet and profit and loss statement. (Decree 500/2002) To what extent have been business companies fulfilling their obligation to publish these statements in recent years? It can be inferred, based on the analysis conducted by the CRIF - Czech Credit Bureau in 2015, that when it comes to publishing the financial statements the situation is slightly improving. However, currently, it is still the case that 52% of local companies do not regularly publish their financial statements. (CRIF, 2017) Although businesses, as a result, could be financially penalized in reality the obligation to publish aforementioned statements is virtually unchecked, thus, allowing businesses to violate this obligation.

With one year delay, one tenth of companies hands its financial statements to the Collection of the Documents. Publishing of financial statements without a doubt increases the transparency of entrepreneurship and business activity. As a result, companies can assess risks and reliability of their business partners. This does not apply only to the potentially new business partners but also to the current ones as their business activities can, for instance, rapidly deteriorate. Risks related to the business activity does not necessarily have to increase only during the period of recession, but also during the period of economic growth as some entrepreneurs might overestimate their abilities, exhaust their potential or alternatively the business conditions can be altered significantly.

To provide the Collection of Documents with financial statements is, based on the current accounting legislation, mandatory business practice. Yet, significant number of companies does so with a delay or does not do it at all. For not fulfilling this obligation companies can face two types of penalties. In the first case, the registration court can demand a penalty of up to 20,000 CZK along with the tax authority which is allowed to demand a payment worth up to 3% of the value of all company's assets. In the second case, the penalty can reach the value of thousands and hundred thousands of CZK. Nevertheless, it needs to be stated that in reality, the aforementioned obligation remains virtually unchecked. (Maršíková, 2014)

Publishing of the financial statements that is providing information regarding the company's financial situation, its ability to generate incomes, and the changes in its equity are essential for the potentially new business partner or investor as this information clearly demonstrates company's ability to function correctly and to prosper.

The going concern is, therefore, essential when establishing the financial statements. It is an assumption that the company will be able to carry on with its economic activity even in the following accounting period. (Demirkan & Zhou, 2016) For assessing this assumption the key financial indicator is the amount of company's equity. In case, that financial unit expects to breach this assumption it is obliged to implement accounting methods accordingly to its situation. Information regarding the method that was implemented is required to be declared by the company in the notes to the financial statements.

Reasons that might lead to the breach of an assumption of company's continuation:

- The company has become insolvent (meaning that the company is unable to fulfil its financial liabilities for a period longer than three months after the payment deadline while creditor is unable to satisfy its claims via other means or methods - enforcement of ruling or execution); or
- The company is over-indebted (the initial insolvency means that the total amount of liabilities exceeds the total amount of assets). (Insolvency Act, 2006), (Čámská, 2014)

The going concern assumption could be therefore linked with the company's cash flow that is *with its ability to cover its future financial liabilities*. Negative equity thus indicates that company's liabilities exceed company's assets. In such a scenario the company should in its financial statements clarify, how it plans to cover its future liabilities and therefore confirm the going concern assumption. (Jáčová, 2011) The user of the financial statements should have sufficient amount of materials and evidence in order to establish his/her own opinion on whether will be the company able to uphold this assumption. It is a common practice that within the financial statements (of a company with an insufficient ability to cover its liabilities) the parent company would confirm that it is ready to provide required financial assistance in the following accounting period. (Čámská, 2013) However, this confirmation should be re-checked in the consolidated financial statements of the parent company itself (Does a parent company truly have a sufficient amount of financial means to provide financial assistance? Alternatively, it needs to be checked whether parent company has not published an information related to reducing its support or even closing-down its subsidiary company under consideration). (Krabec, 2014)

1 Methodology of the research

The main aim of the research was focused on the identification of violation of going concern assumption in the financial statements on the sample of 200 companies operating in the automotive industry in the years 2011, 2012, 2013 and 2014. The total research is based on the analysis of 397 financial statements. In one of the research phases, we analyzed 200 companies (as it was presented in Tab. 1). Unfortunately, during the time of preparation of the analysis, it was possible to examine regular financial statements for the years 2011 – 2014 because the financial statements for the year 2015 had to be published until the end of the year 2016.

The main identifiers are:

- The company has the negative equity.
- The registered capital of the company is higher than its equity.

2 Results

During the first part of the research 733 published financial statements were analyzed of which 1 financial statements were totally unreadable. The data were ascertained from the following financial statements. A number of other statements were less readable, data had to be gathered from comparative data from previous accounting periods in the financial statements of subsequent years. Unfortunately, the financial statements are published in the pdf format in the Business Register in the Czech Republic and that is why it is sometimes very difficult to gather the relevant data because of the low quality of the files. The following parameters were set before the analysis:

- The equity is lower than the registered capital of the company.
- The annual decrease of the equity was more than 10 %.

The financial statements that did not meet these criteria were excluded from the analysis. It is possible to say that there is not violated going concern in the case of the companies with no decrease in equity of at least 10 % year-on-year. The results are presented in the Tab. 1 and the Tab 2.

Tab. 1: Analysed sample of the financial statements

Published financial statements in years	Always published	Published in 3 years	Published in 2 years	Published in 1 year	Entities founded in 2012	Entities founded in 2013	Unpublished financial statements
2011	164	15	9	0	-	-	0
2012	164	18	7	0	1	-	0
2013	164	13	0		1	1	0
2014	164	8	2	0	0	1	0
Unpublished financial statements	0	18	18	3	1	0	24
The total amount of financial statements	656	72	40		3	2	24
The total amount - 200 analysed companies	164	18	9	1	1	1	6

Source: own elaboration

164 of 200 analyzed companies in the first phase of the research met their legal obligation and published their financial statements in the years 2012 -2014. 18 accounting entities published their financial statements in 3 of 4 analyzed years, 9 companies did not publish their financial statements in 2 of 4 analyzed time periods and 6 companies never disclosed their financial statements.

Tab. 2: Analysis of going concern violation

Financial statements	Going concern identifiers			Financial statements with reported violation of going concern	Financial statements with no reported violation of going concern
	Decrease of equity more than 10 % year-on-year	Registered capital is higher than equity	Negative equity		
2011	-	27	8	27	161
2012	24	27	9	42	148
2013	35	31	11	47	133
2014	22	25	10	40	135
Total amount of financial statements				156	577

Source: own elaboration

The Tab. 2 presents the companies that reported e.g. negative equity and at the same time had their registered capital higher than equity. But the decrease in the equity had not to be more than 10 %. Based on the analyzed sample, 27 companies show signs of violated going concern assumption in 2011, 42 companies in 2012, 47 firms in 2013 and 40 accounting entities in 2014.

74 companies (156 financial statements) of the analyzed sample 733 financial statements reported basic parameters of violation of going concern assumption. These financial statements will be analyzed in the next phase of the research. 8 companies of those 74 companies reported negative equity in all analyzed years. These companies are threats to their business partners. Their year-on-year decrease of equity more than 10 % or more than 30 % or more than 50 % is presented in Tab. 3, Tab. 4 and Tab. 5. The companies that reported the decrease of their equity more than 10 %, reported the decrease more than 30 % or 50 % of their total amount of equity in the next accounting period.

Tab. 3: Decrease of equity more than 10 % year-on-year

Decrease of equity more than 10 % year-on-year	From the total amount of 156 financial statements
In 3 accounting periods	4
In 2 accounting periods	9
In 1 accounting period	52

Source: own elaboration

Tab. 4: Decrease of equity more than 30 % year-on-year

Decrease of equity more than 30 % year-on-year	From the total amount of 156 financial statements
In 3 accounting periods	2
In 2 accounting periods	3
In 1 accounting period	26

Source: own elaboration

Tab. 5: Decrease of equity more than 50 % year-on-year

Decrease of equity more than 50 % year-on-year	From the total amount of 156 financial statements
In 3 accounting periods	0
In 2 accounting periods	4
In 1 accounting period	11

Source: own elaboration

Based on the analysis of the trends of these 74 companies it is possible to say that 27 companies did not save the substance of the enterprise in the year 2011, and even 31 companies in the years 2012 and 2013. The negative equity reported 8 companies in 2011, 9 firms in 2012, 11 enterprises in 2013 and 10 in 2014 from these companies. At least 8 companies were in the real insolvency due to their over-indebtedness.

Conclusion

The financial statements are the most important source of information about the accounting entity and no matter if it is the prosperous company or the firm in the bankruptcy. As it was presented in Tab. 2, many companies do not comply with the legal obligation of publishing their financial statements in the Collection of Documents. The main aim of the research was to identify the violation of going concern assumption in the financial statements. The research showed the most of the companies delayed their entry into liquidation. They waited for the worse and worse situation and tried to continue in business until the time when the creditors submitted the company into insolvency.

The entity is in insolvency at the moment when the equity is negative (the debts can no longer be satisfied with the total assets of the company) and this company is the problematic partner in business relationships. The paper presented that it is possible to identify the symptoms that showed the problems of the company with the going concern assumption. 74 companies from analysed sample were the most problematic. We think that it is the question of time when these companies will be in the insolvency if they are not in it now.

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