

Principles and Rules of Conduct in the Internal Audit Activity**Mihaela Iuliana Dumitru¹**

Abstract: The objectives of the paper are to present the basic principles governing the internal audit mission as well as the code of conduct that must be observed in exercising such a mission, because the completion of a professional audit mission implies precisely the compliance with the two category of elements. Consequently, this paper is meant to be added to the practice specific to this field as support in exercising the internal audit according to the market requirements. For this purpose, we analysed the above-mentioned elements, presenting brief examples in support of the importance of the approached topics. Thus, from the practical point of view, we can notice the mechanisms used to apply these principles and how the compliance with the audit specific audit conduct lead to a more efficient activity. For these reasons, we can say that the paper is an element of interest both for the academic field (as a starting point for the support of practical approaches) and also for the future researches in order to improve the specific audit activity.

Keywords: internal audit; conduct; audit principles.

JEL Classification: H83; M42

1 Introduction

For the smooth conduct of an internal audit mission, irrespective of the type of entity, the existence and thus compliance with certain principles, with a code of conduct, is an element that provides its quality and professionalism. According to the extent and objectives aimed, the code of conduct, both at general and at individual level, will represent the framework for the actual internal mission.

In the analysis of the problems of the principles and rules of conduct in the internal audit activity, the legal provisions in force, the regulations issued by the profession of auditor, as well as the regulations issued at internal level within the entities subject to the audit play a very important role.

On the basis of the information included in their content, an internal audit mission can be organised in compliance with the national and corresponding international

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social and economic requirements.

2 The Internal Audit Profession: Reference Framework

Internal audit is a profession whose structuring has been made over a long period as a result of the needs of organizations related to the increase in the efficiency of the activities performed. Currently, there are, in various countries, more than 80 national institutes, parts composing IIA (the Institute of Internal Auditors), with professional representation in more than 120 countries. At the level of this profession, the overall aim is to improve the systems and activities of the entities, from the point of view of the risk management, control activities and the administration of the controlled resources. More specifically, the major objectives of the internal audit activity aim the risk management assessment and the control system assessment (Boulescu & Bârnea & Ispir, 2004, p. 29).

The exercise of this profession takes into account the reference to a benchmark framework, a set of professional standards structured as follows (Țogoe, 2008):

- Defining the profession and the notions specific to the internal audit;
- The deontological code;
- The professional standards;
- Practical application methods;
- Professional development framework.

Obviously, the Deontological Code plays a very important role in the structure of the reference framework applicable in the case of the internal audit specific services. Under the provisions of IIA, in the Deontological Code we will find two components:

- The basic principles of internal auditor profession;
- The rules of conduct required in practice.

3. The Basic Principles of Internal Auditor Profession

The Code of Ethical Conduct of the internal auditor was approved by Order no. 252/2004. Based on this act, the generally accepted basic principles for the good organization and exercise of the internal auditor profession are focused on the five major objective elements:

- integrity;
- independence and objectivity;
- confidentiality;
- competence in exercising the profession;
- political neutrality.

Integrity implies the auditor's fairness, honesty and incorruptibility. If the auditor meets these requirements, then there will be trust and credibility in relation to the results obtained by the auditor. Thus, the auditor must exercise his profession in compliance with the law and with its application (legitimacy), not to perform illegal activities, to support the ethics of the audited entity.

On the other hand, the auditor should have the capacity to obtain the best professional solutions for actual situations and for the increase in the efficiency, by using the legal and professional tools available, for the entity.

Independence will be manifested in the relationship with the auditor, both with the audited entity, and with any other groups with which it interacts. No problem approached, both theoretically and practically, should be affected by personal problems or by any other external interferences. The auditor will never get involved in a mission in which he has the least interest.

“Internal auditors must fulfil their competences objectively and independently, with professionalism and integrity, in compliance with the legal provisions and the norms and procedures specific to the internal audit activity.” (Law no. 672/2002)

The objectivity manifested by the internal auditors will be reflected both in the preparation of the reports (accurate and objective), as well as in expressing conclusions and opinions that should be based only on the documents obtained and analysed in compliance with the audit standards, on the useful information coming from various sources (the point of view of the audited entity, the pertinence of the points of view expressed, the relevant circumstances).

“Internal auditors should have an impartial attitude, they should not be prejudiced and they should also avoid conflicts of interests, they should achieve their objectives objectively and independently, with professionalism and integrity, in compliance with the norms and procedures of the public internal audit activity” (General Norms for the Exercise of the Public Internal Audit Activity).

Confidentiality implies that any internal auditor should keep the professional secrecy related to the facts, information or documents used in exercising the professional competences. None of the above-mentioned elements can be used to satisfy personal interests or interests of third party stakeholders directly or indirectly interested in the activity carried out by auditors. Such information may only be disclosed under certain situations provided by the legal norms.

Competence in exercising the profession implies that internal auditors should fulfil their professional duties with professionalism, competence, impartiality, in compliance with the international standards set for this profession, applying the knowledge, skills and experience acquired.

Political neutrality, i.e. internal auditors should exercise their professional

competences mentioning their independence in relation to any political influence. The impartial exercise of their professional competences also implies expressing or manifesting their political believes.

4 The Rules of Conduct Required in Practice

The principles listed and analysed above are supported by the rules of conduct that represent the behavioural norms, which is a support for the interpretation of the principles and their application into practice, an ethical guide for internal auditors. Under such circumstances, according to the Code of Ethical Conduct of the Internal Auditor we are mentioning:

A) Integrity includes the following behavioural rules:

- a) exercising their profession honestly, in good faith, and responsibly;
- b) observing the law, acting in compliance with the requirements of the profession;
- c) observing and contributing to the legitimate ethical objectives of the entity;
- d) the interdiction of knowingly taking part into illegal activities, commitments that discredit the profession of auditor or the entity of origin.

B) Independence and objectivity:

- a) internal auditors do not get involved in activities or in relationships that could generate conflicts of interests related to the entity and could affect the objective assessment;
- b) internal auditors can only provide the audited entity with audit and consultancy services;
- c) it is forbidden to internal auditors, during the mission, to receive undue benefits from the audited party, which could potentially affect the objectivity of the assessment;
- d) internal auditors are required to present, in their reports, any document or fact they know that could affect the activity of the audited structure.

C) Confidentiality: internal auditors may not use the information obtained during the audit mission, for personal or illegal purposes, or for purposes that could jeopardize the legitimate and ethical objectives of the audited entity.

D) Competence:

- a) internal auditors must behave professionally in their activities, must apply the professional standards and norms, must be impartial in their professional duties;

- b) internal auditors will only be committed to missions for which their knowledge, skills and experience are appropriate;
- c) internal auditors will only use high-quality methods and practices in their missions, will have as a priority the basic principles and generally accepted audit standards, both in relation to the actual audit performance, as well as to the preparation of the reports;
- d) the continuous improvement of internal auditors is another necessary rule of conduct (in this respect, we are talking about new knowledge, high efficiency and quality of their activity); the audit compartment chief, or the manager of the entity, is required to provide the conditions needed for the professional training of internal auditors (at least 15 working days per year);
- e) the specialised studies, the professional training and experience, should be representative and should answer practical needs;
- f) knowing the specialised applicable legislation, increasing the training level, in compliance with international standards, represent other rules that must be observed by auditors;
- g) internal auditors may not exceed their professional competences.

5 Practical Applicability of the Principles and Rules of Conduct

From the practical point of view, the principles and rules of conduct are synthesized throughout the documentation and reports that will be prepared from the beginning of the audit mission to its end.

Thus, at the beginning of any audit mission, the auditor, in compliance with the legal provisions in force, must fill in an independence statement that could have the structure below:

Incompatibilities and conflicts of interests	YES	NO
Have you had/do you have any official financial or personal relationship with persons in the audited structure that could limit the extent to which you can intervene and ascertain deficiencies of any kind concerning the internal public audit mission?		
Do you have misconceptions in relation to persons, activities, processes, programmes, groups that are related to the audited structure and that could influence your audit mission?		
Have you held/are you holding positions or have you been involved in the past 3 years in the activity of the structure to be audited, in any other way?		
Do you have any responsibilities in carrying out programmes and projects		

fully or partially funded by the European Union?		
Have you been involved in the development and implementation of the control systems of the structure to be audited?		
Are you the spouse, a relative or an in-law up and including the 4 th degree of the manager of the entity/structure to be audited?		
Do you have any political or social connection, or a connection resulting from a former employment or from receiving benefits from any group, organization, etc., related to the audited structure?		
Have you previously approved documents, orders of payment and other payment instruments for the structure to be audited?		
Have you been/are you involved in the bookkeeping of the entity/structure to be audited?		
Have you had/Do you have any personal interest that influences or seems to influence the fulfilment of your professional duties impartially and objectively in relation to the audited structure?		
Can you assess the effectiveness of the processes and systems in relation to the requirements specified and the compliance of the objectives with the entity policy?		
If during the public internal audit mission, personal, external or organizational incompatibilities occur that could affect your objectivity in working and preparing unbiased audit reports, will you notify them to your superior?		

Integrity implies fairness in the conduct of the internal audit mission, honesty in carrying out specific actions and honesty in the dialogues with the audited persons. The relationships with your fellow-workers and the external relationships must be based on the same values (Ghiță & Popescu, 2006, p. 134). Any mistake assumed provides high respect for the profession and also the improvement of the performances of the entity by applying the recommendations made by respected professionals.

The public audit compartment/the internal audit mission operates directly under the management of the entity, exercising a function that is separate and independent from the activities of the entity. Due to his/her tasks, there should be no interference in the preparation of the specific internal control. Moreover, there should be no external involvement, starting from setting goals, performing the audit, and communicating the results. The audit activity must be able to be exercised from own initiative in all areas covered by the audited entity/structure.

According to their independence statement, auditors must be impartial, unprejudiced and must avoid conflicts of interests, they must fulfil their duties objectively and independently, with professionalism and integrity, according to specific norms and procedures.

They are also forbidden, in exercising their function:

- a) to take part in the collection of funds for any political party;
 - b) to support candidates to public positions;
 - c) to cooperate, internally or externally, with persons involved in supporting political parties;
 - d) to be part of the management of political parties.
- f) according to Order no. 252/2004 on the Code of ethics of the internal auditor, internal auditors must be politically neutral, they must remain independent from any political influence;

When objectivity or independence are affected in various ways, the affected parties shall be informed (the level of the damage caused will also be taken into account). The provision of impartiality allows the entity/structure management to request opinions, in relation to the control principles, the organization of activities with high risk, to the information and informatics system management. Hence the advisory role of the auditor that will not have implications on the implementation of the measures themselves.

In the exercise of their function, internal auditors must not use offensive language, and must not publicly disclose aspects of private life, or perform slandering actions.

During their missions, auditors have at their disposal information about various activities or persons. Confidentiality implies keeping this information for internal judgements, unless there are cases when legal or professional norms require its disclosure. Confidential information obtained during the mission must not be used for personal interest. Confidentiality has as barriers the exercise of professional activities or barriers required by the superior. All collected documents and documents with negative implications on the business must be treated very carefully.

The audit staff must not request or accept undue benefits irrespective of their form, for them, their families, persons who have various relationships with them, which can influence their impartiality or may represent a reward.

Auditors' competence is a very important element in effectively achieving the objectives of the mission. Internal auditors must have the skills required to exercise their responsibilities (the application of the audit norms, procedures and

techniques; principles and techniques on the audited direction; basic economic, legal and IT principles; identifying irregularities and fraud; high communication capacity, clarity and concision, for the preparation of the final audit report).

Professional competence can be provided by training on the job, internal and external training, staff turnover, the publication of specialised materials, etc. It was noticed that the training on the job and specialised courses represent the most effective form of training (the period dedicated to this purpose is of at least 15 days a year).

6 The Place and Role of the Principles and Rules of Conduct. Economic and Social Implications

The set of principles and rules of conduct are applicable to all internal auditors and thus to the services they provide. Any audit mission will implicitly become valuable due to the compliance with the above-mentioned elements. The strict compliance with these elements provides, in fact, the capitalization and certification of the results of the auditor's work: the audited party's confidence can only exist if these minimal requirements are observed.

Any specialised service provided by a professional (such as an internal auditor) should not have errors (voluntary or involuntary), should not generate conflicts of interests, or should not tacitly accept compromising situations both for him and for the audited entity.

All these elements provide the improvement of the organizational process, in general, and especially the improvement of the productive one. This would be translated into the value added that can be obtained through internal audit services provided at the quality level required by the international professional norms.

The above-mentioned value added which represents the benefit or benefits created by performing the internal audit, the immediate effects on the elements targeted through the respective mission, or the distal temporary effects quantifiable at the level of the economic and financial indicators.

It is intriguing and it is important to study this aspect of value added created by performing the internal audit mission, the manners and tools used to obtain the value added and to increase it, the possibility to quantify and express it.

The quick identification, if necessary, of such tools and means of increasing the efficiency of the activity, committing staff with appropriate skills highlight the importance of internal audit and specific missions.

7 Conclusions

In order to be able to assess any entity, information needs to be collected and sent to another direction, in our case, to internal auditors. Their role is to process the set of information obtained and to draw conclusions based on it, in order to assess the evolution of the entity in a pertinent manner.

However, this set of actions cannot be carried out chaotically, it should be organised based on certain guidelines. These guidelines are represented, among others by basic principles and specific rules of conduct. Thus, any audit mission provides counselling both for the entity management and for its employees, impartially and professionally.

Although, at the level of each country, there are a number of differences and peculiarities, the reporting should be made according to a rigorous normative framework, with general applicability, which allows, in fact for adjusting the peculiar to the general requirements in such a way as to provide coherence and the integration of a part into the unified whole.

The current existence of a diversified range of forms of audit highlights the major impact of this profession and the economic and social life by an active involvement in solving problems that involve the compliance with principle and conduct guidelines.

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Understanding Going Concern in Auditing: Seker Poultry, Inc.

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Abstract: Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. In this case study, we examine the recent financial problems of Seker Poultry, Inc. – one of the listed companies in Borsa Istanbul –and their impacts on the financial statement audit process. This case provides an opportunity to examine the auditor’s judgment process and responsibilities regarding the going concern assumption. This case uses information in Seker’s recent publicly available financial statements and annual reports. The case can be used in undergraduate or graduate level audit courses.

Keywords: Independent Auditing; Going Concern; Audit Risk

JEL Classification: M41; M42

1. Introduction

Assume that after graduating from Istanbul University School of Business, you started at ABC Accounting Company as a junior auditor and are assigned to the Seker Poultry, Inc. (Seker) financial statement audit team by your partner for your first task. Seker is one of the leaders in the market and, produces and sells chicken meat, chick, breeding, egg and animal feed. The audit manager in your team wants you to prepare a report regarding the financial sustainability of Seker and issues that might be faced during the audit. You have never prepared such a report before so you collected information about the poultry industry in Turkey and the history, financial position and financial performance of Seker, which are provided in the following section.

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2. History of the Company

Seker Poultry was founded in 1960. Seker invested in egg incubators due to increased demand for breeding. In 1973, Seker increased its weekly egg capacity to 14 thousand units and in 1983 imported Holland-made incubators which have a capacity of 230 thousand units per week and expanded the business quickly. With the joint cooperation of American Hy-line, the company set up breeding houses and started producing chickens for meat and eggs.

In 1990, the company scaled up and established a feed factory and new incubation facilities as well as increased the number of plantations. Shares of Seker Poultry, Inc. started to trade on the Istanbul Stock Exchange in February, 2000.

In 2008 and 2009, Seker increased its production capacity with new investments. In addition, the company allocated more resources for promoting its brand and changed its logo. In parallel with increased white meat consumption, Seker expanded its capacity gradually and in July 2010 went into production in new butchering facilities which have a capacity of 12 thousand chickens per hour. With new facilities the production capacity reached 20 thousand chickens per hour. The new butchering plant has a capacity of 75 tons per day and also includes further processing facilities that produce delicatessen food such as sausage, pepperoni, salami as well as nugget, cordon bleu, and gyros. The company planned to increase its production capacity to 100 thousand tons with new investments in the following years.

Seker primarily exports to Middle East and East Asian countries. In addition to that, the company completed the necessary infrastructure investments to export to European countries. Seker renewed its vision as "On land, in air, and everywhere" in 2009 and had increasing demand from China, Germany, Iran and Iraq. The managers thought that they could increase their export capacity in the future. Pursuing its continuous growth strategy, the company became one of the leaders in white meat production in Turkey. It was selected as one of the most successful food companies in Turkey by the Department of Agriculture in October 2010.

3. Poultry Industry

The poultry industry in Turkey has been developing since 1950. Entrepreneurships started to become corporations in the 1970s. With the foundation of incubation companies in the 1980s, the industry established capacity beyond domestic needs and therefore focused on exports. Since the 1990s, there has been a boom in production capacity. The chicken production, which was 217 thousand tons in 1990 and 752 thousand tons in 2000, reached 1.7 million tons in 2012. With 943 thousand tons of white meat production, Turkey was ranked 14th in the world in 2005.

The effect of the worldwide economic crisis in 2008 on the poultry industry was limited since chicken meat is one of the main foods consumed. Chicken meat consumption was stable in European countries and there was an increase in consumption in Turkey. Moreover, the export to Middle East countries increased with the Arab Spring. However, due to political barriers the export to Europe is limited.

With Turkish Lira (TL) 6 billion of total revenues, the poultry industry is a big job creator in Turkey. Though, chicken production has shown huge improvements in the last decade, some issues have not been resolved yet. The imbalance between production versus domestic consumption and obstacles related to export top the list. For example, the chicken meat consumption per capita is between 15kg/year to 27kg/year in developed EU countries whereas the consumption in Turkey reached 16kg/year in 2008 and 19kg/year in 2011. In addition egg consumption is lower in Turkey than in European countries as well.

As noted above, chicken plantation facilities in Turkey have a capacity above domestic demand. Therefore, oversupply needs to be exported. When export is restricted, the domestic market cannot consume the supply which can lead to crisis in the poultry sector. Diseases, and input costs are cited among the most important factors that negatively affect production and consumption. In particular, 70 per cent of total production cost arises from feed expenditure in chicken meat and egg production which are to a large extent important.

4. Financial Position and Performance of the Company

The financial statements of Seker have been prepared in accordance with International Financial Reporting Standards and have been audited according to International Standards on Auditing published by the IFAC. The capital of Seker is TL 44 million as of December 31, 2011. The balance sheet, income statement, and cash flow statements for the years 2011, 2012, and 2013 are attached in Exhibit 1, 2, and 3 respectively.

Seker reported net loss of TL 13 million in the year 2011. In December 31, 2011, after an evaluation by company management, it was determined that the net realizable value of some portion of the inventory and biological assets were below historical cost; therefore, the company recorded an expense of TL 1.3 million for impairment. In addition, TL 2.5 million worth of inventory was lost because of a fire in the further processing department and flooding in feed production facilities. These items were classified as other inventories and Seker recorded an allowance expense. (Seker Poultry and Feed Industry Incorporation, Financial Statements for the year 2012, Footnote 13, Inventories, Footnote 14, Biological Assets.)

In 2012, the revenue of Seker increased 19 per cent compared to 2011 and reached TL 401 million. In spite of the increase in revenues, the company suffered a loss of TL 49.5 million, and the total debt of Seker exceeded its assets by TL 29.8 million.

In December 31, 2012 the company management determined that the net realizable value of some portion of inventories and biological assets were again below historical cost value, and, therefore, recorded an expense of TL 6.6 million for impairment. After the balance sheet date, all of the production operations were stopped, and the value of the inventories and biological assets significantly dropped. (Seker Poultry and Feed Industry Incorporation, Financial Statements for the year 2012, Footnote 13: Inventories, Footnote 14: Biological Assets.)

Seker reported a net loss of TL 83 million in the year 2013. The company could not make payments to suppliers because of liquidity problems, and some suppliers started to seize Seker's assets in January 2013. Demands by and payments to led to a total stoppage of production (except for some breeding ranches). In order to keep control of its assets, maintain day-to-day business operations, and restructure its debt, the management filed in bankruptcy court for protection in January 31, 2013. So far, the prosecution has not been finished but the court made some interim judgments which released the blocked bank accounts of Seker. Despite these emergency actions, the production was not sustainable because of capital deficit and it was totally stopped except for egg production.

5. Causes of Financial Problems

Seker management asserted that the source of its problems was due to significant increases in feed prices which already constitute 70 per cent of total production costs. In addition, while costs are increasing, white meat prices stayed stable in 2012. In the last quarter of 2012, the revenues dropped significantly compared to the first three quarters because of seasonal effects caused by religious holidays. (Seker Poultry and Feed Industry Incorporation, Annual Report, 2012)

The other reason for financial difficulties was Seker's substantial investments in 2008 and 2012. These investments included slaughter houses, further processing, and rotary facilities, feed factory, and breeding farms. Total investments were approximately TL 132 million. These investments were financed by loans and leasing agreements. Since the cash conversion cycle of the Seker is 140 days, a significant increase in credit sales in the year 2012 caused a significant liquidity problem for Seker.

Moreover, the value added tax rates for wholesale chicken meat went from 8 per cent to 1 per cent in November 2011. This meant that Seker had to fund TL 2 million of VAT which it was not able to collect because of the change in the rates. Fortunately, in February 2013 the government increased the value added tax rate to

8 per cent. Seker received TL 19.3 million of the VAT refund receivables in cash and on account in 2013. The amount of VAT refund which is received back is used for paying back liabilities and as an entity capital in the process of production again. Managers believe that the change in VAT tax rates will be significant in helping Seker overcome its liquidity and capital deficit problems.

6. The Impact of Financial Problems and Precautions Taken by Management

Biological assets (living animals) production - the main operation of Seker - is almost completely stopped because of the difficulties in paying for raw material, particularly feed. Management made efforts to decrease costs such as sending some of the poultry to slaughterhouses before maturity, cutting wholesale prices. Nonetheless, poultry casualties increased due to lack of feed.

There have been 8 lawsuits against the company as of December 31, 2013 totaling TL 272.6 thousand. Creditors of Seker sent written demands for their receivables and, some commenced "execution proceedings" including demands for immediate payment of interest and principal. Filing for bankruptcy led to a stoppage of these payments. Therefore, no provisions were reported in 2013 financial statements for the execution proceedings. However, the amount of claims for default interest, proceedings expenditures, etc. which were not reported in the statements is calculated to be TL 59.8 million. The value of assets and cash flows are affected significantly because of the legal procedures and discontinued production. The value of inventories is affected as the market price declined. The net book value of chickens on hand is TL 1.4 million as of December 31, 2013.

Management is focused on procurement of necessary capital and hopes to resume production at full capacity. In addition, Seker has been considering the likelihood of long term borrowings and the sale of controlling shares as well as negotiating with creditors to restructure loans.

Seker has collected its existing VAT receivables for new fund procurement. Seker used these funds to repay debts and resume production. In general, analysts view the increase in the VAT rates as a positive development for the poultry industry. This fund was used as capital for paying the debts to public and re-operating the production. Seker has initiated the necessary procedures to re-operate the business as disclosed in its Public Disclosure Platform (PDP)ⁱ. As a result of re-operation, 6,508 tons of poultry meat and products were produced from June 30-December 31, 2013. However, this production could not be sustained due to lack of funding.

Although the restructuring process has been interrupted by fluctuation in financial markets at the end of 2013, Seker is still continuing its efforts to find permanent

solutions to its cash flow and capital problems. Management asserts that company operations are sustainable.

7. Requirements

- i. Research the directive within International Auditing Standards regarding the responsibilities of auditors regarding a “going concern” assumption.*
- ii. What are the steps the auditor should follow in the going-concern evaluation?*
- iii. What are the major events or conditions that may indicate going concern problems?*
- iv. After considering the above events and conditions for Seker Poultry, Inc., do you think that there is significant doubt on the entity’s ability to continue as a going concern? Support your opinion with the help of ratios calculated from the financial statements.*
- v. Based on the events, conditions and management’s assessment describe the impact on the audit report of Seker Poultry, Inc.*

8. Case Learning Objectives and Instructional Guidance

8.1. Learning Objectives

At the conclusion of the case, students should be able to:

- Explain management’s responsibility to assess an entity’s ability to continue as a going concern.
- Exercise judgment in assessing uncertain future outcomes of events or conditions.
- Develop a technical knowledge on auditor’s responsibility to obtain sufficient appropriate audit evidence about the appropriateness of management’s use of the going concern assumption in the preparation of the financial statements.
- Explain and apply “International Standard on Auditing (ISA) 570 Going Concern.”
- Develop critical thinking including analysis of an entity’s financial results.
- Describe auditor’s risk assessment procedures and related activities.
- Increase awareness about importance of entity’s going concern issue.

8.2. Instructional Guidance

The case can be used in undergraduate or graduate level audit courses to introduce the “Going Concern” concept. The following instructional approach could be suggested to the case study. The case could be assigned as a class project to groups of three students. One week later, a quiz on the case facts is given to each group to

ensure that they have read the case. In week three, they are asked for a progress report on the case requirements. In week four, each group is required to present the case in class. At the end of discussion, the instructor should provide some other real auditors' going concern judgments.

8.3. Student Feedback

The case was taught in both undergraduate and graduate classes. In each class, students are asked to answer a feedback survey asking for their opinions about the case. They were asked to respond nine questions on a five-point Likert scale, ranging from 1 (strongly disagree), to 5 (strongly agree).

The summary of data is presented in Table 1. Mean undergraduate student responses were between 3 and 4. Mean graduate student responses were above 4, nevertheless the sixth question which asks whether the case was difficult to understand was 2.32. The data show that students responded positively to the case, and using real-world business case in class increases their interest to auditing subjects. Also, graduate students were more appreciative of learning auditing issues with real-world business cases than undergraduate students.

Table 1. Student Feedback on Case Study

	Undergraduate n= 14		Graduate n= 19	
	<u>Mean</u>	<u>SD</u>	<u>Mean</u>	<u>SD</u>
The case was interesting and related to course subject.	3.86	0.86	4.68	0.48
The case helped me understand "Going Concern" auditing standard.	4.00	0.88	4.58	0.69
I learned how to use ratios to identify going concern issues.	3.57	1.02	4.16	0.83
I learned to assess the precautions that are taken by management against going concern risks during auditing process.	3.57	0.94	4.32	0.75
My technical knowledge is developed related to audit procedures for obtaining audit evidence regarding going concern risk.	3.21	0.89	4.00	0.67
This case was difficult to understand.	2.29	1.07	2.32	1.20
The case requirements helped us to discuss the case effectively.	3.79	0.70	4.37	0.83
The use of real-world business case in the class is increased my interest to auditing subjects.	3.50	1.02	4.42	0.69
Overall, this case is useful.	4.07	0.62	4.53	0.51

8.4. Teaching Notes

- i. Research whether there is a directive within International Auditing Standards regarding the responsibilities of auditor the in “going concern” assumption.*

International Standard on Auditing (ISA) 570, Going Concern deals with the responsibilities of the auditor regarding going-concern. Since the going-concern assumption is a fundamental principle in the preparation of financial statements, the standard indicates that the auditor must obtain sufficient and appropriate evidence about the going concern assumption, has the responsibility to evaluate the going-concern, and must conclude whether a material uncertainty exists that may cast significant doubt on the entity’s ability to continue as a going concern. The auditor should consider the going concern assumption during the planning of the engagement as well as near the end of the engagement.

- ii. What are the steps the auditor should follow in the going-concern evaluation?*

First, the auditor should assess whether procedures performed during the planning, performance and completion of the audit indicate a going-concern problem for the relevant period of time. The assessment shall cover at least 12 months from the end of the reporting period. If there is significant doubt, the auditor should obtain information about management’s plans to mitigate the going-concern problem and evaluate the likelihood that such plans can be successfully implemented. Management’s plan may include disposal of assets, restructure of debt, reducing or delaying expenditure and increase ownership equity. Finally, if significant doubt continues, the auditor should consider the adequacy of the disclosures about the entity’s ability to continue and include an “emphasis of matter” paragraph in the audit report. If adequate disclosure is not made in the financial statements, the auditor shall express a qualified opinion or adverse opinion, as appropriate, in accordance with *(ISA) 705, Modifications to the Opinion in the Independent Auditor’s Report*.

- iii. What are the major events or conditions that may indicate going concern problems?*

Some major events or conditions that may indicate going-concern problems are listed below:

- Work stoppages.
- Default on loans.
- Restructuring of debt.
- Negative cash flow.
- Current-year deficit.
- Accumulated deficits.
- Inability to meet interest payments.

- Loss of a major customer or supplier.
 - Loss of a key franchise, license, or patent.
 - Recurring operating losses.
 - Negative net worth.
 - Negative working capital.
 - Negative income from operations.
 - No additional sources of financing.
 - Dependence on the success of one particular project.
 - Legal proceedings.
- iv. *After considering the above events and conditions for Seker Poultry, Inc., do you think that there is significant doubt on the entity's ability to continue as a going concern? Support your opinion with the help of ratios calculated from the financial statements.*

Seker management asserted that the cause of its financial difficulties was the increases in feed prices. We conclude from the information provided from Seker's financials and surrounding events that the company has a significant going concern risk. Seker has been reporting **negative cash flows** for the last three years and **operating losses** and **negative owner's equity** for the last two years. In addition, there have been a deterioration in current ratio, quick ratio, inventory turnover, days of receivables, and days of accounts payable for the last two years.

Key financials and ratios that support going concern uncertainty include:

	<u>2013</u>	<u>2012</u>	<u>2011</u>
Owner's equity	-112,795,555	-29,786,263	19,762,940
Change in cash and cash equivalents	-811,384	-548,400	-13,644,261
Profit / Loss for the period	-83,009,292	-49,549,203	-12,910,357
Current ratio	50.20 %	52.06%	71.78%
Quick ratio	2.65 %	18.25 %	30.44 %
Inventory turnover	6,65	17,01	12,69
Days of receivables	104	32	34
Days of accounts payable	421	87	42

- v. *Based on the events, conditions and management's assessment describe the impact on the audit report of Seker Poultry, Inc of a going concern risk.*

If the directors of Seker have agreed to make going concern disclosures and the disclosures are adequate, then a clean audit opinion can be issued but an emphasis of matter paragraph is required.

The paragraph should state that there is a material uncertainty about going concern and provide cross reference to the disclosure note made by management. The paragraph is included immediately after the opinion paragraph.

If the disclosures made by the directors are not adequate, depending on the materiality of the issue, the opinion will need to be either qualified or adverse. The basis to the modification paragraph describing the matter will be included just before the opinion paragraph. This paragraph will state the lack of disclosure over the going concern uncertainty. The opinion paragraph will be amended to state “except for” or the “financial statements are not fairly presented.”

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