Carmen NISTOR,
Monica PUIU,
Anca Simona HROMEI
Doctoral School of Economics and Business Administration,
Alexandru Ioan Cuza University, Ia i, România

COMBATING FRAUD IN CROSS-BORDER MERGER OF COMPANIES

Keywords
Fraud
Cross-border
Mergers
Acquisitions
National and international accounting regulation

JEL Classification
M41, M48, M49

Abstract

The number of cross-border mergers and acquisitions has increased lately. Along with these the possibilities to commit fraud have multiplied. This article synthesizes the research undertaken so long in this field, aiming to approach specific issues related to fraudulent practices in the reorganizational process of companies.

Beginning with the analysis of the international accounting framework regarding companies restructuring operations, we present specific issues related to fraudulent practices. Many researchers have tried to explain the poor performance of the acquisition process and the fact that many deals do not create value to companies involved. In our approach we identify key problems faced and solutions used by acquirers during the stages of the acquisition process. Based on the international practices the results show that cross-border mergers and acquisition is a complex process, in which companies involved have to pay attention to national and international accounting regulation and the features identified in each country.

BACKGROUND

Mergers have occurred in the 1960s in the U.S., followed shortly by the UK as a significant strategic option to diversify by external development. The mergers have been continuously developed until the early 1970s when they experienced a period of stagnation, caused by the oil crisis[1]. In the late 1970s and early 1980s there was a second phase of significant growth, so in 1984, acquisitions and mergers carried out by British companies reached the value of 938.1 million pounds. Increased and fast growing operations worldwide of mergers and acquisitions took place between 1991 and 2000, so that their number has tripled. Despite this increase, after 2000 there was a rapid reduction of these operations worldwide, uneven development that enables us to think that, over recent decades, mergers occurred in waves.

For industries that are mature or declining (either they lose their competitive advantages, struggling with low demand or not working at full capacity) tobacco, automotive, petroleum, mergers of companies have always been the usual ways of restructuring. [2] . And as competition has undergone a more intense process of globalization, companies in these sectors have increased research to find new ways to cut costs, including the mergers. Even if global mergers and acquisitions were numerous, most have created value, mainly due to lack of appropriate procedures for the regulation of this process. In this respect, Europe has adopted Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies[3].

1. SOME THEORETICAL AND LEGISLATIVE CROSS-BORDER MERGER OPERATIONS

According to European legislation[4] merger is an operation whereby:

• one or more companies, which, following the dissolution without liquidation, transfer all their assets and liabilities to another existing company, the acquiring company in exchange for the issue to shareholders of securities or shares representing the capital of the other company, and where appropriate by making a cash payment not exceeding 10% of the nominal value or, in the absence of a nominal value, the accounting par value of those shares of the securities;

• two or more companies, which, following the dissolution without liquidation, transfer all their assets and liabilities to a company that they set up the new company in exchange for the issue to its shareholders of securities or shares representing the capital of the new company and where appropriate, by making a cash payment not exceeding 10% of the nominal value or, in the absence of a nominal value, the accounting par value of those securities or shares;

• company which, following the dissolution without liquidation, transfer all their assets and liabilities to the company holding all the securities or shares representing its capital.

This Directive aims at facilitating cross-border mergers between limited liability companies and aims to identify the applicable law of merger, for each merging company. Once created, the new entity arising from the merger, applies a single national legislation: the Member State in which it has established.

A merger operation is characterized by:[5]

- is solely between companies;
- can be made between companies of different legal forms;
- requires the involvement of at least two companies, the number of participating companies is unlimited;
- determines universal transfer of assets to the acquiring company or the company being acquired by the new company that was founded as a result of the merger;
- contributions have to be paid, payment is made by sending social rights, such associations of acquired company must receive shares in the acquiring company, or, if the merger consideration associations generating companies should receive shares in the new company.

2. PROCEDURES GOVERNING CROSS-BORDER MERGERS

Management or administrative bodies of each of the merging companies must develop a joint cross-border merger. The directive defines, through a list of twelve mandatory

items, the minimum content of the joint project which has to be published in the manner prescribed by the laws of each Member State, according to the advertising companies' share at least one month before the general meeting which has to decide this. However, advertising is not mandatory if the company puts the project to the public on its Internet site or a site designated by the Member State concerned, one month before the date fixed for the general meeting.

Management or administrative bodies of each of the merging companies shall draw up **a report on the merger border** for shareholders and employees, explaining the legal and economic aspects and implications of cross-border merger.

Then, it makes **a report of an independent expert** to review the merger. This report is not required if all the members of each of the companies participating in the merger decide this. The expert report and the report on the draft cross-border merger must be available at least one month before the date of the General Assembly meets[6].

Based on the documents mentioned before, the general meeting of each of the merging companies shall decide on the approval of the joint cross-border merger.

The lawfulness

Each Member State shall designate the competent authority to review the legality of cross-border merger in terms of the procedure concerning each merging company is subject to its national legislation. This authority shall issue **a certificate proving the correct pre-merger acts** and formalities necessary for fusion.

Each Member State shall designate the competent authority to review the legality of cross-border merger regarding the procedure for the realization of cross-border merger and, if necessary, to form a new society in cross-border merger where the company created by the cross-border merger is subject to its internal laws. That authority must verify that the merging companies have approved the common draft terms of cross-border merger in the same terms.

Legal effects

After checks legality, the State law under which is the company resulting from the cross-border merger shall set the date from which the cross-border merger takes effect, and the disclosure of its public register. The register of the company resulting from the cross-border merger must notify the entry into force of the registry in which each company must file documents. The exchange of information will be done through a system of interconnection of central (available since 2014), registers and registers of companies established by the Directive on the protection of members and third parties. Deletion of the old registration cannot be made before receiving notification of cross-border merger.

Cross-border mergers produce the following effects:[7]

- the acquiring or merging companies cease to exist;
- all assets and liabilities of the merging companies are transferred to the new entity (either the acquiring company or the new company);
- associations merging companies become partners of the new entity.

Where the Member States requires special formalities enforceability against third parties before the transfer of certain assets, rights and obligations of the merging companies, they are met by the company resulting from the merger.

Employee participation

Regarding the participation rights of employees, according to the general principle, it applies the national law which the resulting company from the cross-border merger obeys.

Exceptionally, the principles and procedures concerning employee participation, set out in Regulation and the Directive on European company (SE), are applying in the following conditions:

- if at least one of the merging companies has, in the six months preceding the publication of the draft cross-border merger, a number of employees that exceeds 500 and is operating under an employee participation system;
- if the national law applicable to the company resulting from the cross-border merger does not provide at least the same level of employee participation as that applying the merging companies, measured by number of members of the administrative body that manages the profit units of the

company, provided that there is a representation of employees;

- if the national law applicable to the company resulting from the cross-border merger does not provide that employees of establishments concerned company located in another Member State may exercise the same rights of participation as those enjoyed by the employees in the Member State where the company resulting from the cross-border merger has its registered office.

In Directive supplementing the Statute for European company with regard to the involvement of employees, the threshold for applying the standard rules set for European society is set at 33 1/3% from the total number of employees of all companies involved in the merger and which had to be managed under a system of worker participation.

The provisions for employee participation apply to any domestic merger following a cross-border merger for a period of three years after entry into force of the cross-border merger.

3. METHODS FOR FRAUD

The companies involved in the merger process may appeal to a range of creative practices in various purposes: either to improve the financial position and performance with financial statements or to the overall assessment of the entity or the operations on the choice of valuation method and taking items from the balance sheet or by canceling the shares of a company in the capital of another company[8].

If we consider the practices related to improving the information on the position and financial performance of companies planning to merge, it can be used several options.

In this respect, when drafting financial statements, are made estimates of the degree of impairment of assets of entities, by internal experts or authorized assessors. They contain a high degree of subjectivity, which managers can use to carry out optimistic and positive reviews. Thus, if it is desired, for example, increasing income, management entities involved in the merger process will be tempted to manipulate the outcome of the analysis in that assets have suffered impairment to reflect a positive image of them[9].

Another way is the lever provisions. This involves either reducing their income by re-provisioning or failure of provisions. Both measures lead to reflect a higher result. In this way, pension provisions or litigation can be insufficient estimated, based usually on technical justification slightly modified in future financial years and difficult to be detected by auditors.

Also in order to increase income, some loss claims may be unrecognized. For example, if one of the companies planning to merge notes that there is the possibility of future loss claims, it may enter into an insurance contract to guarantee payment. Thus, in exchange for a insurance premium, the payment of nominal value of claims is guaranteed for a certain period of time, depending on the number of years enrolled in the contract. The premium paid in this financial year represent expenditure that was made payment, the need for a provision being removed and profit increased[10].

For stocks there is a wide range of creative and fraudulent possibilities. For example, when performing inventory, there may be a number of stocks (obsolete, difficult to sell and so on) which are not removed from inventory. Therefore, failure to record expenses related to removal from the management of these stocks will have a positive impact on the result.

The major problem that arises in the merger process is the evaluation of the companies involved. Reason for this is to determine each company assets, according to this aspect determining the number of shares to be issued by the acquiring company/beneficiary.

The starting point for the assessment is the annual financial statements reflecting financial position information (equity and debt) and financial performance (year result). Based on the balance sheet, the evaluator moves to development of economic balance, at which distortion may arise from the use of instruments revaluation. These ones are the result of the action of various factors: market prices, the exchange rate of the national currency, the internal management of companies.

4. LIMITATIONS

To limit these methods and fraudulent practices the accounting regulatory bodies may appeal to a number of solutions[11]:

- Reduce the possibility of choice for accounting methods by decreasing the number of permitted accounting methods or by separating situations in which every method that can be used. Also, in this sense, it can be insist on Consistency, imposing to the companies to retain the accounting method from year to year, regardless of the evolution of exercise outcome.
- Invoking the principle of substance over form in artificial transactions. Invoking economic substance rather than legal form would result in accounting for transactions linked together as one.
- Reduce abuse of judgment either by the imposition of consistency, either by minimizing the use of so wide judgment.
- Focusing on the time of the transaction - regular reassessment of mandatory items, gains or losses in a given period of time would cause recognition in the accounts when they occur, not after the time of the revaluation.

CONCLUSIONS

Economic development fierce competitive environment, economic-financial impediments lead companies to choose the best solutions to cope with the often difficult conditions in which they operate. To develop the company they lead, managers often resort to restructuring, resulting in the development or at least its survival in a dynamic market, an important part of which is represented by the merger.

Mergers are the most important restructuring operations of economic entities, outlining a special category within operational restructuring through the effects they generate, namely external growth companies. Analysis of multiple perspectives of the merger (economic, legal and accounting) reveals the complexity of this operation. Thus, in economic terms, they are treated as external growth operations or concentration of capital, from a legal perspective are seen as techniques for achieving business combinations that are met by obtaining control of one or more entities and from a financial accounting approach due to determine the cost of such transactions and the coverage in their accounts.

The complexity of this process creates favorable conditions for the manifestation of fraudulent techniques in which company managers try to create a positive or negative image of the entity's assets. In order to limit these practices, accounting rules should be as detailed and concise, focusing on uniform accounting policies and practices, reducing the possibilities of choice and delimitation of their interpretative.

References

[1] Bruner, R.F. (2004). *Applied mergers and acquisition book*. New Jersey: John Wiley & Sons, Inc.

[2] DePhamphilis, D.M. (2010). Mergers, acquistion, and other restructuring activities. 5th edition. San Diego: Elsevier Inc.

[3] Directiva 2005/56/CE a Parlamentului European i a Consiliului din 26 octombrie 2005 privind fuziunile transfrontaliere ale societ ților comerciale pe acțiuni, retrieved at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32005L0056:RO:NOT, 21.05.2013, 22.32

[4] Directiva 2005/56/CE a Parlamentului European i a Consiliului din 26 octombrie 2005 privind fuziunile transfrontaliere ale societ ților comerciale pe acțiuni, retrieved at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32005L0056:RO:NOT, 21.05.2013, 22.32

[5] Directiva 2005/56/CE a Parlamentului European i a Consiliului din 26 octombrie 2005 privind fuziunile transfrontaliere ale societ ților comerciale pe acțiuni, retrieved at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32005L0056:RO:NOT, 21.05.2013, 22.32

[6] Directiva 2005/56/CE a Parlamentului European i a Consiliului din 26 octombrie 2005 privind fuziunile transfrontaliere ale societ ților comerciale pe acțiuni, retrieved at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32005L0056:RO:NOT, 21.05.2013, 22.32

[7] Elango, B. (2006). *When does cross-border acquisition of insurance firms lead to value creation?*. Journal of The Risk Finance. Vol. 7, Issue 4, pp. 402 – 414, doi: http://dx.doi.org/10.1108/15265940610688964

[8] B l oiu, R. (2012). *Aspecte privind contabilitatea creativ în cazul opera iunilor de fuziune i divizare ale entit ilor din România*. Revista Contabilitatea, expertiza i auditul afacerilor, Nr. 8, pp. 31 - 35

[9] Very, Ph., Schweiger, D.M. (2001). *The acquisition process as a learning process: Evidence from a study of critical problems and solutions in domestic and cross-border deals*. Journal of World Business Volume 36, Issue 1, pp. 11–31. Doi: http://dx.doi.org/10.1016/S1090-9516(00)00052-3

[10] B l oiu, R., Ghimi , A.C., Borfoaia, A.T. (2012). *Aspecte privind politica contabil a entit ilor. Revista Audit financiar*, Nr. 8

[11] B l oiu, R. (2012). *Aspecte privind contabilitatea creativ în cazul opera iunilor de fuziune i divizare ale entit ilor din România*. Revista Contabilitatea, expertiza i auditul afacerilor, Nr. 8, pp. 31 - 35