

# THE FINANCIAL AUDIT FOR THE DIVISION OF ECONOMIC ENTITIES

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## **Abstract:**

*The division is considered by the jurists an operation of reorganization. The purpose of reorganization depends by some factors, like the competition seizure, cost reduction, development and expansion of the sales markets. The operations of reorganization, especially of division, is achieved starting from financial statements drawn by the participating entities at the division. One of the important steps in the achievement of the division could be the financial audit of financial statements of division, if there is a legal binding audit.*

*The importance of the financial audit of financial statements is to express a reasonable opinion on the financial statements of division and to assess the correct evaluation of the contribution of the entities who participate to the division in the purpose of establishing exchange parity and division premium. Expressing the auditor's opinion is done by a report who must comply with the procedures applied and the missions of contracted audit.*

*The paper is based on situations encountered in practice on the division of different categories of economic entities, like commercial companies, whose procedures of division have different features. In our paper we wish to bring some further clarification on financial audit of financial statements of division, seen mainly in accounting or financial terms.*

**Keywords:** *financial audit, division, financial statements, independent auditor's report*

**JEL classification:** M42 - Auditing

## **Introduction**

The purpose of this paper is to approach the division of the economical entities in terms of mandatory financial audit of the financial statements division. The division should be approached in several ways: economic, legal and accounting. In the specialty literature most articles published refers to the legal aspects of the division and Recognition of division operations, and less financial audit of the financial statements division.

To understand the division in its full complexity, we present division as conceptual delimitation, modalities of its socio-economic objectives and the characteristics of division operations.

The division of economic entities is a hot topic and of wide interest and therefore we believe that further study is needed on this topic.

## **The research methodology**

Our approach aims to clarify the importance and necessity of the financial audit of financial statements of division and an awareness of the parties involved in the division of this need.

Research will focus on systematizing and synthesizing concepts contained in the specialty literature, both legal and financial accounting regulations issued by state authorities and by the professional bodies.

To achieve our research we used a deductive and inductive methodology for identifying opinions, criticisms and opportunities. In the first part we performed a comparative analysis of legal, financial and accounting regulations. For further research we identified the situations encountered in practice, problems in the process of division and have formulated solutions to improve procedures for dividing economic entities.

### **The presentation of the characteristics of the division and of the normative acts that regulate it**

#### **a. Regulations and legal opinions**

The division is a commercial operation under paragraph 2 of art. 238 of the Companies Act no. 31/1990 as amended and supplemented, which defines the two types of division: the division of companies with end of their existence and division without ending their existence, by transferring assets to one or more existing or to one or more new companies formed. Division may be total or partial.

The opinions on the reorganization of companies are different. Some authors include the reorganization, division, division and transformation of a company<sup>124</sup>, others only merger and division<sup>125</sup>, on the grounds that if they leave intact the legal personality changes, merger and division involving a multitude of companies, some of which disappear while others remain into being or being taken as appropriate. Another opinion considers that the reorganization of companies is done through merger, division or transformation of a legal person where a company ceases to exist, while creating in its place other company (change of legal form)<sup>126</sup>.

According to ISA 315, "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment" for the audit, the auditor should obtain sufficient information about the entity and its regulatory framework. Depending on the category they belong to entities where division applies special provisions provided for in other regulations, as shown in the following table.

| <b>The category of the entity</b>    | <b>The normative act</b>  |
|--------------------------------------|---|
| Societies                            | Society Company Law no. 31/1990   |
| Banks                                | The norm of the National Bank of Romania (NBR) no. 5/2000 on the the division and the division of banks   |
| Credit unions                        | The norm B.N.R. no. 6/2003 on the division and the division of credit unions  |
| Insurance companies                  | Order of the Insurance Supervisory Commission (CSA) no. 113111/2006 for the approval of the Norms regarding merger or division insurers and insurance authorization follows |
| Insurance and Reinsurance Brokers    | C.S.A Order no. 113112/2006 for the approval of the Norms regarding the merger / spin-insurance and / or reinsurance  |
| Financial institutions - non banking | Head. 4 of Law no. 93/2009 on banking financial institutions  |

<sup>124</sup> Lupan, E., *Unele probleme privind reorganizarea persoanelor juridice*, Revista de Drept comercial, nr.5/2000;

<sup>125</sup> Băcanu, I., Noua reglementare a fuziunii și divizării societăților comerciale, Revista de Drept Comercial, nr. 5/1999, p.20;

<sup>126</sup> Imbrescu, C. *Reorganizarea și lichidarea societăților comerciale, O abordare financiar-contabilă și juridică*, pag 83, Editura Mirton, Timișoara, 2005.

From the data presented it is understood that all entities applying Law no. 31/1990, but depending on the business still need to be complied with the provisions of regulations issued by their supervisors.

**b. The financial-accounting regulations of the professional organisms**

The international institutions of accounting regulators have sought to achieve a global accounting harmonization in the divisions. From a European perspective, these efforts focused on three levels.

The first level is the international level, where the goal was to establish common accounting standards, and therefore the IASB issued International Financial Reporting Standard IFRS 3 on business combinations.

On the second level, the European one, changes have occurred in order to establish similar laws in the Member States. This goal was achieved by issuing European accounting directives.

The third level applies nationwide in Romania by the Minister of Finance (OMPF). no. 1376/2004 approving the Methodological Norms regarding splitting, division, dissolution and liquidation of companies and associates withdrawal or exclusion of the companies and their tax treatment.

**The financial audit of the financial statements of division**

References to the financial audit, in the case of division, we meet in two basic laws of functioning societies of which we selected paragraphs on audit, presented in the table below.

| The accounting law  | The company law   |
|---|---|
| Paragraph 4 Article 34<br>They are also subject to financial audit financial statements for operations of merger, division [...] of persons who are required audited annual financial statements. | Article 244 paragraph 1<br>At least one month before the date of the extraordinary general meeting which is to decide on the draft terms of merger or division [...] the governing bodies of companies taking part in the division [...] will provide shareholders / associates at the company the following documents:<br>[...]<br>e) the auditors' report and, where appropriate, financial auditor's report;<br>f) if appropriate, according to report of the article 243 <sup>3</sup> |

From the specific regulations of financial audit follows that is financial audit "work performed by auditors to express an opinion on the financial statements or their components, performance assurance and other professional services according to international auditing standards and other regulations adopted by the House Financial Auditors of Romania".

The reference to "financial audit" listed in the Accounting Law could be replaced with the "financial audit report / independent" as mentioned by the company law, a situation that leaves the auditor, based on professional judgment, up to the type of report that will be prepared according to the standards of the audit, such audit or review, based on available financial statements of entities participating in the division.

Note that the terminology of accounting law, the date on which it was filed, referred to as auditing statutory audit only after legislative changes were made above.

One aspect to note in the law no.31/1990 at the paragraph 243 index 3, is that at the division documentation it may also be requested the report of one or more experts to

examine the draft terms of division and to report to shareholders. At art. 244 lit. f) a states that the division documentation available to shareholders / associates will feature expert report only if necessary, i.e. it is optional.

If we analyze the secondary legislation or procedural provisions we meet the following specifications:

| <b>O.M.F.P. no. 1376/2004</b>   | <b>Documentation required by the National Trade Register Office (N.T.R.O.)</b>  |
|---|---|
| Head. Article 4. 1<br>Financial statements on the merger, division [...] companies apply accounting regulations [...] are audited financial [...] | At the joint request of the companies participating in the division, the Director of the Trade Register Office by the tribunal and / or the person designated shall designate one or more experts acting for all the companies involved, but independent of them.<br>Consideration of draft division and report posted to shareholders will not be required if all the shareholders / members or all holders of other securities conferring the right to vote in each of the companies participating in the division so decide. |

We assess that if the financial statements are audited entities would not be appropriate for shareholders / associates require an expert report, which is necessary only in a situation where it is not made a report of the auditor or of the censor, even if the auditors express their opinion on the financial statements underlying the division, and the expert verifies project division.

From examination of the above we can draw the conclusions that will be presented in the following table:

| <b>Characteristics</b>                            | <b>The auditor's report</b>                                     | <b>The expert's report</b>   |
|---|---|--|
| Compulsoriness                                    | Yes, to those entities which are legally required to have audit | Optional at the request of the shareholders / associates                   |
| The purpose (objective) of the report             | The financial situations of division                            | The division project   |
| The obligation of submitting to O.N.R.C.          | No, it is shown only to the shareholders/associates             | Yes, if requested<br>No, if an application for waiver of expertise is made |
| The obligation of submitting to other authorities | Yes, at the supervised institutions                             | There aren't any provisions.   |

In the case of the entities supervised by different authorities, the financial audit is of major importance, underlined by the fact that in the event that in the auditor's report the opinion is unreserved then there is a reason to reject the proposed division, as specified for credit unions art. 4 paragraph 3 letter b. the norm B.N.R. no. 6/2003 on the division and the division of credit unions.

We consider that we have clarified the subject about the compulsory or optional character of the report, auditor or expert, next we will focus on the type of the auditor's report. To determine the correct category in which the financial audit of the financial statements of division we mention the types of audits that auditors can perform:

- Statutory audit of financial statements completed by the end of the financial year;
- Review of historical financial statements, most often made for other times than the financial year;

- Missions insurance other than audit and review of historical financial information;

- Related Services - work performed on the basis of agreed procedures.

The division of the economic entities is realized, in practice, based on financial statements prepared on a date which does not coincide with the financial year end. That the financial statements are not prepared at the end of the year may lead question: What kind of work will make the financial auditor?

The problem that can occur in practice is the type of financial statements of entities participating in the division. Thus we encounter two situations:

- Developing an incomplete set of financial statements, usually only the balance sheet (even if the period prescribed is "of financial statements"), because accounting is based on the net asset exchange ratio of contributions made, so the auditor can apply all procedures of audit and then can not issue an audit report, respectively an audit opinion, but in the best case, a review report and thus the opinion expressed will have a lower level of assurance;

- Developing a full set of financial statements, in which case the auditor will issue an audit report and will issue an audit opinion.

We can assess that the statements set forth above put the auditor in a delicate situation, but in practice the auditor should apply professional judgment, that is to issue a report based on information from documents provided by the client, and not to issue a particular type of report, only because it is required, without having appropriate audit evidence.

On the other hand, the users of financial statements and recipients of financial audit - the shareholders of the entities involved in the division do not distinguish sometimes between the two cases presented, so it does not matter the content of the report prepared by the auditor, but the formal existence of the signal auditor, and what is the worst that it is not always known it must undertake financial audit, especially at companies that are not supervised by a designated authority.

The effective realization of division - existing possibilities

At division it occurs an inconvenience namely time or more specifically the period between the date of the draft terms of division, based on the financial statements completed and the date of approval of the division and its effective implementation.

In the documentation required by N.T.R.O. it is noted that: "In the event that decides the division to affect the adoption decision at a later date, the judgment will be entered in the commercial register and the division will be recorded on the date determined by the parties to produce such effects."

As mentioned, we believe that the shareholders should decide on another term of the effects of division, and the best solution is that the entities may choose as the date of actual division to be the last day of the approved division, which would facilitate the personnel accounting departments, human resources, legal and administrative framework for the actual closing of the period at the end of the month.

The aim of the work was to draw attention to the objectivity of the audit work to be performed for the division of the economic entities by auditors and to clarify the issues of the documentation content division in terms of binding and / or optional component documentation.

We believe that through the issues raised we will contribute to the awareness of the users of financial statements regarding the importance of the financial audit of division, especially in the native private entities, the owners or shareholders also have the quality of managers giving them a false impression that they can effectively manage business and avoid information that may be provided by auditors and thus depriving the specialized partnership generated by external audit service. All these are caused by

incorrect perception of such a service as an act of control and not as a work by an independent external expert.

Due to the various legal changes in the accounting field we notice that it is appropriate to update the regulations set out in O.M.F.P. no. 1376/2004 approving the Methodological Norms regarding the recognition of major operations of division, division, dissolution and liquidation of companies and associates withdrawal or exclusion in society and their tax treatment.

In fact on the website of the Ministry of Public Finances it is posted a draft order approving the Methodological Norms regarding the recognition of major merger, division, dissolution and liquidation of companies, and withdrawal or exclusion of associates within companies and for completion of accounting regulations. This project will repeal existing regulations the project is updated with any changes in accounting legislation, but so far not approved.

This paper is a mirror presentation of a previous work on the audit of financial statements fusion because both operations of division and of fusion are considered reorganizing operations and are regulated similarly.

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