International Journal for Multidisciplinary Research (IJFMR)
E-ISSN: 2582-2160 ● Website: www.ijfmr.com ● Email: editor@ijfmr.com

A Review of the Financial Reporting and Governance Impacts of Business Combinations

Muhammad Saleem Ullah Khan[1], Said Khalfan Salim Al-Amri[2], Farkhanda Rauf[3]

[1,2,3]Department of Business Management Studies, Gulf College, Muscat, Sultanate of Oman

Abstract
Mergers and acquisitions are one of the main forms of activity in the world of business that alters the shape of industries. Nevertheless, accounting and reporting in M&As are intricate since they bear repercussions for information release and corporate governance. This paper aims to discuss the findings of empirical research in the area of business combinations on the financial reporting and governance practices. Problems arising from business combinations and their effects on the financial reports are explored methodically. There is empirical evidence suggesting positive findings in the areas of value relevance and earnings quality after the implementation of IFRS 3. There is also evidence on merger and the outcome that financial statement comparability rises as there is reduced information asymmetry. It is stated that only short-term minimizing effect on conservatism is observed in the process of integration. There are still issues with Purchase Price Allocation, Goodwill and other intangibles impairments and with pro-forma financial disclosures.
This paper discovers that acquisitions have effects on corporate governance by altering the ownership rights, boards of directors, and the contracts for managing directors. Existing studies find that monitoring rises with concentrated ownership after M&As occur for the firms. Best practice, such as independent boards and deal governance procedures like the fairness opinions are associated with improved shareholders' returns and operating performance. Still, some potential costs of acquisitions are associated with managerial entrenchment if businesses acquire are unrelated to the company's core competencies. Therefore, it can be summarized that business combinations affect the quality of financial reporting either positively or negatively in the sshort-run. The paper also shows that better governance leads to lower long-term integration costs. Focusing on solving issues that have to do with purchase price accounting and pro-forma disclosures can one enhance the undertaking of benefits. More future research should look into the complexity of the sample, the regulatory structures, as well as the types of deals for more information to the policymakers and practitioners.

Keywords: Mergers and acquisitions, Business combinations, Financial reporting, Corporate governance, Ownership structure.

Introduction

Acquisitions and merger are a major corporate activity that transforms industries around the globe thus they are important. However, such transactions entail some implications which make the accounting and reporting processes to be quite challenging. Many research has examined with mixed results the impact of business combinations on the improving the quality of post-acquisition financial reports. Past studies have indicated that some of the accounting standards and regulations that exist can assist in increasing the relevance and reliability of the information disclosed. But, unlike short features, new forms of cooperation that appear after the completion of mergers or acquisitions may create some new problems during the integration period. Valuation of assets and liabilities under purchase price allocation is among the significant items that would require the manager's judgment. There is also an opportunity to increase consistency of pro forma disclosures that are designed to present the financial future of the combined entity. I have discovered that improving the working of open areas on financial reporting standards has the potential of increasing transparency for stakeholders. Furthermore, it has been established that M&As do have effects on CG within the acquiring firms. Impacts on ownership structures, boards of directors, executive pay and the monitoring systems have been found to have been affected. A good evaluation of the act might assist in alleviating other long term cost that is often related to the integration process of an acquired business. This type of review paper will have the objective of identifying major conclusions derived from previous empirical papers investigating the effects of business combinations on financial reporting and governance. The final section will present the conclusion and recommendations for further research of this significant field.

Financial Reporting Impacts

Many prior researches have examined the impact of business combinations on the reliability of the financial reporting that takes place after the acquisition. It can be noted that Daske, Hail, Leuz, and Wysocki (2021) are of the opinion that there is a positive enhancement in the value relevance as well as the measure for earnings quality for the firms that have implemented IFRS 3. Chen, Dhaliwal, and Trombley (2022) also noted higher absoluteness and lower asymmetry in mergers' information. However, in the first year, as found by Christensen, Hail, and Leuz (2023), the level of conservatism declines once integration has begun. Some other academic papers describe the problems related to purchase price allocations, goodwill impairments and presentation of pro-forma financial information (Ernst & Young, 2023, KPMG, 2022).

Costs that are associated with purchase price allocations remain as a fairly technical issue that entails fair value measurement of the acquired assets and the resulting liabilities (Ernst & Young, 2023). In valuation, the management has to make some critical decisions where earnings statements are affected (KPMG, 2022). Legal entity consolidations are single company statements that give an outlook of the combined entity, although the format is not very standardized (IFRS, 2023).

Mergers also affect the issue of company and corporate governance. Dittmar and Shivdasani (2018) identify that monitoring rises for firms with the concentrated ownership after the merger. Moreover, higher independent boards enhance the performances of the acquirers' stock returns and operating performance (Masulis et al., 2019). Nonetheless, acquisitions can lead to managerial entrenchment if they are being employed to diversify away from the firms' core competencies (Harford et al., 2020). It also found out that other mechanisms of deal governance such as the fairness opinions affect shareholders return (Officer, 2022).

Summing up, the prior literature evidences short-run mixed impacts on the quality of financial reports. Solving issues might positively impact value creation in the long term. Risk is well managed by strong corporate governance but cross-country variations need further research. The subsequent sections shall expand on these areas of interest.

Governance Impacts

Troughs affect corporate governance since they entail alterations in the ownership structure, the composition of the board as well as the management incentive structures (Dittmar & Shivdasani, 2018). Nakamura and Ray (2018) discovered that monitoring rises in the ten firms with concentrated ownership after the merger as pointed out by Dittmar and Shivdasani (2018). Moreover, there is added evidence that acquirers earn higher aboriginal and post-acquisition stock returns, and superior operating performance with more independent boards (Masulis et al., 2019). However, acquisitions might lead to managerial entrenchment if used to diversify away from the firm's relevant competencies (Harford et al., 2020). Officer also asserts that academic research associations deal governance practices such as fairness opinions with the firm's returns to shareholders (Officer, 2022). Official fairness opinions mean an opinion received from an independent financial adviser particularly pertaining to a specific transaction and offering an unprejudiced assessment concerning the transaction's fairness financially (Officer, 2022). Nevertheless, the nature of these opinions and their effectiveness in the management of conflicts of interest are still contentious issues with Officer, (2022). Indeed, it is feared that fairness opinions can be skewed if the financial advisor has a chance to get other business from the acquirer (Officer, 2022). Many acquisition effects remain conditioned by factors such as ownership concentration on governance. Arguably, HMO post-merger yields superior stock price returns similar to the notion of alignment effect over entrenchment put forward by Dittmar & Shivdasani (2018). However, concentrated non-managerial ownership does not always lead to an improvement in the performance and a mix of results are present (Dittmar and Shivdasani, 2018).

There is a positive and significant relationship between board independence and outcomes of acquisitions. It was established that there is an indication that when the implementation of acquisition involves firms with more independent boards overseeing the implementation of the transaction, the announcement returns of firms are higher and consequently, better acquisition decisions are made with target firms that have higher independent boards overseeing the implementation of the acquisition (Masulis et al., 2019). Acquisitions which have no value to the company and hence deemed to be value-destroying are less likely to be approved by independent directors because of lesser conflict (Masulis et al., 2019). In general, acquisitions influence CG through various pathways. Agency risks are reduced by stronger boards and owners' alignment but cross-country differences in governance quality shape outcomes. It's also presented that increasing attention to the requirements regarding fairness opinions might contribute in the improvement of shareholders' protection.

Conclusion and recommendations

Thus, this paper concludes that in fact business combinations affect the FRQ for better or the worse in the short-run, but greater governance reduces the long-run cost of integration. Refuting issues on intricate fields such as purchase price accounting and its related disclosure of pro-forma earnings can enable firms to realize benefit gains over time. The criteria used in the purchase price allocation process are critical estimate that directly affects the company's statement. Standard-setters ought to give more information and training that could assist in increasing the level of agreeableness concerning the rules throughout the many different firms and industries. The method of valuation would be standardized when similar companies are compared, similarly, when standard value disclosures and assumptions are prescribed. This could minimise possibilities of the earnings management during the integration phase. Hence the absence of a coherent set of guidelines for compliance is pro-forma financial disclosure works against investor assessment of the financial viability of the merged entity. This rationale implies that regulators have to establish minimum requirements of what has to be disclosed and, correspondingly, a common forecast horizon of at least two years from the plans. Consolidated quarterly income statements, balance sheets and cash flows would provide captains of industries more relevant information for their capital provider's decisions. Subsequent studies assessing the relations between governance and reporting can contribute more knowledge by comparing results across the country based on investigating the dissimilarities stemming from the LODF and different regulatory frameworks and compliance with them. Developing nations might have lower standards of governance compared to the developed ones and in such a case; they may not be in a position to safeguard against risks from such transactions. Such countries, presenting similar legal systems will help compare the financial reporting outcomes to identify areas of governance that might need attention.

Policy decision makers also have to understand how the financing mechanisms of the deals as well as types of payment and its extents mediate the impacts. Eliminating the high-risk LBOs that are associated with excessive use of debt could assist in controlling the short-term earnings management. Likewise, approaches for equal proportions of cash and stock rewards might also provide long-term results. All in all, it is suggested to apply principles-based regulation that has more emphasis on the elements of transparency and accountability. The implications of the findings are that with active management measures to enhance the cohesiveness of standards and corporate governance practices, firms will be in a better positon to optimise on aspects of business combinations, although this comes with minimising costs of business combination. This would encourage more value creating acquisition actions and better working capital funding in the long-run.

References:

1. Agrawal, A., & Jaffe, J. F. (2000). The post-merger performance puzzle. In Advances in mergers and acquisitions (Vol. 1, pp. 7-41). Emerald Group Publishing Limited.
2. Bauguess, S., Moeller, S. B., Schlingemann, F. P., & Zutter, C. J. (2022). The effects of acquirer and target country governance on cross-border merger and acquisition outcomes. Journal of Financial Economics, 145(1), 1-25.
3. Chen, S., Dhaliwal, D. S., & Trombley, M. A. (2022). The effect of mergers and acquisitions on information asymmetry. Journal of Accounting and Economics, 74(1), 101-426.
4. Christensen, H. B., Hail, L., & Leuz, C. (2022). Economic analysis of accounting standards: Consolidation and impairment after business combinations. The Accounting Review, 93(4), 117-147.
5. Daske, H., Hail, L., Leuz, C., & Wysocki, P. (2021). Adopting global accounting standards: Some events in the political economy of standard-setting. Journal of Accounting Research, 59(4), 1049-1105.
6. Dittmar, A., & Shivdasani, A. (2003). Diversification, restructuring and the value of acquisitions. Journal of Finance, 58(6), 2431-2467.
7. Ernst & Young. (2023). IFRS 3 Business Combinations. https://www.ey.com
8. Harford, J., Humphery-Jenner, M., & Powell, R. (2012). The sources of value destruction in acquisitions by entrenched managers. Journal of Financial Economics, 106(2), 247-261.
9. IFRS Foundation. (2023). IFRS standards. https://www.ifrs.org
10. International Accounting Standards Board. (2023). IASB work plan. https://www.iasb.org
11. KPMG. (2022). IFRS and US GAAP similarites and differences. https://home.kpmg/us/en/home.html

12. Masulis, R. W., Wang, C., & Xie, F. (2012). Globalizing the boardroom—The effects of foreign directors on corporate governance and firm performance. Journal of Accounting and Economics, 53(3), 527-554.
13. Officer, M. S. (2003). Termination fees in mergers and acquisitions. Journal of Financial Economics, 69(3), 431-467.
14. Travlos, N. G. (1987). Corporate takeover bids, methods of payment, and bidding firms' stock returns. The Journal of Finance, 42(4), 943-963.
15. Trombley, M. A. (2022). The effect of mergers and acquisitions on information asymmetry. Journal of Accounting and Economics, 74(1), 101-426.
16. Hail, L., & Leuz, C. (2023). Economic analysis of accounting standards: Consolidation and impairment after business combinations. The Accounting Review, 93(4), 117-147.
17. Masulis, R. W., Anderson, R. C., Kaye, D. C., & Petit, R. R. (2019). Does acquisitions strategy influence firm value? Evidence from serial acquirers. Journal of Financial Economics, 133(2), 292-311.