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Perspective

Accounting Conservatism on Assessing M&A Prospects

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DESCRIPTION

Mergers and acquisitions (M&As) are among the most significant investment operations for businesses, yet they come with significant risks. We look into how accounting conservatism affects M&A target choice and risk. We find that organizations with high accounting conservatism are more likely to purchase profitable targets and steer clear of loss-making targets for risk-averse reasons. The conservatism's risk-control function lessens M&A risk and improves M&A performance when such firms purchase loss-making targets, but only when control of the target is transferred and the acquirer has substantial long-term debt and minimal management power. Additionally, accounting conservatism lowers risk by extending the maturity gap between debt and cash flow. Our findings provide further support for the utility of accounting conservatism in M&A decisions by indicating that it serves both risk-aversion and risk-control functions.

The success of M&As depends on choosing the correct target, but this is one of the trickiest aspects of these selections. Significant risks and uncertainties frequently accompany both the target itself and the post-merger integration. Accounting conservatism, a crucial component of corporate governance, has a big influence on a company's M&A choices. Regarding the governance mechanisms of accounting conservatism and its effect on M&A success, the literature is still debatable. According to certain studies, accounting conservatism aids management in making M&A choices that increase a firm's worth. According to other research, organizations that are motivated by accounting conservatism to be risk adverse avoid M&A targets with positive net present value (NPV) but high risk, which results in underinvestment. We contend that the lack of in-depth investigation into the function of accounting conservatism in the M&A process is the root of the research debate. We investigate the role of accounting conservatism in M&A target selection from the standpoint of target profitability based on this argument. We specifically want to respond to the following queries: Do businesses with a high level of accounting conservatism avoid acquiring targets that are losing money because they are risk averse? More importantly, does accounting conservatism aid a company in properly managing M&A risk and enhancing M&A performance if it chooses to buy a loss-making target?

The Chinese institutional backdrop shapes one's perspective on desired profitability. First, after experiencing erratic and quick development, Chinese enterprises' profitability is currently decreasing, and many are suffering significant losses (Lin et al., 2010). Many distressed enterprises are under pressure to restructure and upgrade as China's economic development moves into the "new normal." Most businesses can only leave the market through M&As as bankruptcy legislation and enforcement procedures are still being developed. For instance, 32% of the M&A prospects in our sample were losing money the year before to the purchase. Second, compared to other markets, the institutional environment in China presents listed businesses with additional uncertainties and dangers when acquiring loss-making targets. The China Securities Regulatory Commission has tight regulations regarding the acquisition of loss-making targets (CSRC). Additionally, the acquirer's operational performance will be directly impacted by the probable loss of the M&A target. Such a loss may hinder the acquirer's qualifying for the secondary equity offering (SEO), which has a high profitability requirement. Additionally, if a business has losses for two straight fiscal years, it will be designated as a "ST" stock and run the possibility of being delisted. As a result, a target's capacity for generating profits could expose investors to additional risks unique to Chinese listed companies. Our research is distinctive since it is profit target-based. The outcomes are consistent with the current state of the Chinese economy and China's unique institutional framework.

Loss-making targets may give excellent purchase prospects for listed corporations. Neoclassical economics claims that increased operational effectiveness and tax-shielded gains make it simple for businesses to acquire distressed targets in order to create synergies. Loss-making targets, however, may pose greater risks to acquirers than do prosperous targets. First, acquiring a loss-generating target could raise operational risk, and idle assets and

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ongoing losses after the acquisition could reduce operational effectiveness. Poor operating results of a listed firm may have an impact on its SEO certification when taking into account applicable Chinese capital market requirements. Second, because they are badly run, loss-making businesses frequently have a lot of debt. , when compared to other targets, troubled targets transfer more risks to the acquirers, raising the potential that the acquirer may experience financial difficulty and a financial crisis of its own.