

Research on Financial Risk Prevention in Corporate Mergers and Acquisitions

Shuai Jiang

School of International Business, Yunnan University of Finance and Economics, Yunnan, Kunming, 65002, China

Abstract: Since the beginning of the reform and opening-up, enterprises have been continuously growing and expanding under the impetus of various reform measures. However, internal accumulation alone cannot meet the demands of rapid growth and domestic and international market competition. Corporate mergers and acquisitions, as one of the crucial strategic approaches, have become an effective means for achieving low-cost expansion and sustainable development, providing companies with growth opportunities and market advantages. Nevertheless, along with these benefits come a series of potential financial risks that, if not effectively managed, can lead to severe losses for the enterprise. This research aims to explore the financial risks during the process of corporate mergers and acquisitions and propose corresponding risk prevention strategies.

Keywords: Corporate mergers and acquisitions, Financial risk, Risk prevention strategies.

1. Introduction

Over the past 40 years of reform and opening-up, Chinese enterprises have achieved significant development and accomplishments in both domestic and international markets. Corporate mergers and acquisitions have emerged as important strategic tools, providing crucial opportunities for companies to expand their markets, optimize resource allocation, and enhance competitiveness. However, with the deepening of economic globalization and intensified market competition, enterprises face numerous risks and challenges during the merger and acquisition process, particularly the threats posed by financial risks, which cannot be overlooked.

Scholars have offered their insights and suggestions on the prevention of financial risks in corporate mergers and acquisitions. Kyung jin Yoo believes that due to the diverse operational logic and business models across industries, preventive measures for mergers and acquisitions need to vary according to the industry. Strict differentiation between different types of mergers and acquisitions is necessary to ensure the implementation of targeted measures. Robert proposes a comprehensive assessment of a target company's value during the due diligence and valuation process at the initiation stage of a merger to avoid financial risks stemming from high acquisition costs. Smidt emphasizes the importance of thorough pre-merger due diligence, the development of feasible work plans, and post-merger integration strategies to reduce the risks associated with the acquisition. Williams suggests that financial risk prevention should not be limited to the post-merger financial integration phase but should encompass a series of preventive measures during the merger initiation and implementation stages, such as the formulation of compensation clauses or the purchase of insurance to mitigate risks. Jing Yan suggests that in merger and acquisition activities, all parties should focus on each aspect, develop well-defined merger plans, and timely devise response measures based on the trends of the merger, to control risks and address potential issues, thereby minimizing financial risks associated with mergers and acquisitions.

2. Basic Concepts and Theoretical Foundations

2.1. Basic Concepts

2.1.1. Corporate Mergers and Acquisitions

Corporate mergers and acquisitions refer to strategic actions taken by a company to expand its scale, consolidate resources, increase market share, or achieve strategic objectives through the purchase or merger of the equity or assets of other companies. In a merger and acquisition, one company (known as the acquiring or parent company) acquires the assets or equity of another company (known as the target or subsidiary company) and integrates them into its own operating system, forming a larger and more powerful entity.

2.1.2. Financial Risk

Financial risk refers to the potential risks that a company faces during its business and investment activities, which may lead to financial losses or economic uncertainties. It is the potential threat arising from internal and external factors during a company's economic operations that can adversely impact the company's financial condition, operational performance, and investment returns.

2.2. Theoretical Foundations

2.2.1. Synergy Theory

Synergy theory suggests that after a corporate merger or acquisition, the integration of resources and capabilities of both parties can create a synergy effect, resulting in overall performance that exceeds the sum of their individual performances when operated independently. Considering synergy effects can help companies better assess the potential value and risks of mergers and acquisitions and optimize resource allocation during the integration process to achieve synergies.

2.2.2. Risk Management Theory

Risk management theory emphasizes that companies should identify, assess, and control risks, including financial risks. In the context of mergers and acquisitions, risk management theory guides companies to develop preventive

strategies and response measures to mitigate the impact of financial risks.

2.2.3. Valuation Pricing Theory

Valuation pricing theory focuses on the valuation of companies and transaction pricing. In mergers and acquisitions, accurate valuation and pricing are essential prerequisites for successful implementation, and they are closely related to the management of financial risks.

3. Financial Risk Analysis in Corporate Mergers and Acquisitions

During the process of corporate mergers and acquisitions, different financial risks may arise at various stages, and these risks interact and influence each other. Therefore, a comprehensive risk management approach is essential when studying financial risks in mergers and acquisitions. Scientifically classifying the financial risks can help us better analyze, evaluate, and control the risks. This article focuses on the chronological stages of mergers and acquisitions and classifies the financial risks in cross-industry mergers and acquisitions into four major categories: valuation risk, financing risk, payment risk, and financial integration risk.

3.1. Valuation Risk

Valuation risk is one of the most critical risks in the corporate merger and acquisition process. It involves the possibility of overpricing the target company's equity during the pricing phase, leading to the risk of overvaluation. The main reasons for valuation risk can be categorized into three aspects: Firstly, inappropriate valuation methods where evaluation agencies fail to adequately consider industry and target company characteristics, resulting in significant valuation deviations. Secondly, inaccurate or incomplete data used for valuation, as the target company may provide erroneous or omitted information, leading to valuation errors. Thirdly, inadequate due diligence or miscommunication due to differences in industries between the target company and the acquirer, resulting in inaccurate valuations.

Valuation risk can impact the acquiring company in two ways: Firstly, when the valuation is too high, the acquirer may have to pay a price higher than the actual value, increasing financial pressure, potentially leading to increased liabilities, or even financial crises. Secondly, when the valuation is too low, the target company's shareholders may be unwilling to sell their equity or fail to provide higher bids, causing the acquirer to miss suitable investment targets and increasing opportunity costs.

3.2. Financing Risk

Financing risk is another significant risk in the cross-industry mergers and acquisitions process. It involves the instability of fund-raising or an inappropriate capital structure, which may hinder the smooth completion of the transaction or create financial pressure during post-acquisition operations. The main reasons for financing risk are as follows: Firstly, cross-industry mergers and acquisitions often involve large investment scales, requiring substantial financial support. If a company's financing channels are limited or insufficient, it may affect the progress of the transaction. Secondly, an unreasonable financing structure, such as high debt financing, may increase the company's debt burden and reduce its debt-paying capacity, while high equity financing may dilute the company's equity, affecting control rights. Additionally,

market uncertainties and fluctuations in financing costs may also influence the smooth implementation of financing.

Financing risk can impact the acquiring company in two ways: Firstly, if the financing plan is not successful, the company may not raise sufficient funds promptly, leading to the failure of the merger and acquisition transaction and missing favorable opportunities. Secondly, after the completion of the acquisition, an inappropriate financing structure may increase the company's financial burden, causing financial pressure and affecting subsequent operations and development.

3.3. Payment Risk

Payment risk is another critical risk in cross-industry mergers and acquisitions. It refers to the risk of overpaying or encountering payment obstacles in the acquisition transaction due to improper payment methods or conditions. This may result in actual transaction costs exceeding expectations, adversely affecting the company. The main reasons for payment risk include: Firstly, improper payment method selection. Companies may use cash payments, equity exchanges, or a combination of both in mergers and acquisitions. However, different payment methods entail different risks. Choosing a payment method that does not match the transaction target may lead to payment risk. Secondly, unreasonable payment conditions. For example, ambiguous or unclear payment terms after the completion of the merger may cause payment delays or deviations from expectations, increasing payment risk. Additionally, external factors such as exchange rate fluctuations and policy changes may also affect the payment process, adding uncertainty.

Payment risk can impact the acquiring company in two ways: Firstly, overpaying may lead to the company paying a price higher than the actual value, increasing financial pressure, and affecting financial stability. Secondly, payment obstacles, such as unclear payment conditions or risks arising from the counterparty, may cause payment delays or prevent the transaction from completing, delaying the merger process, and even facing legal risks such as contract breaches.

3.4. Integration Risk

Integration risk is equally important in the cross-industry mergers and acquisitions process. It refers to the risks faced when integrating the acquired company with the acquiring company after the acquisition is completed. Integration risk involves various challenges, including cultural integration, business integration, and management consolidation. The main reasons for integration risk include: Firstly, conflicts and friction may arise during the integration process due to different corporate cultures and management styles between the acquired company and the acquiring company. Secondly, business integration may face instability due to differences in business models or organizational adjustments, affecting normal business operations. Additionally, management consolidation may involve issues such as employee cooperation and role allocation, which, if not handled properly, may lead to employee dissatisfaction and turnover.

Integration risk can impact the acquiring company in two ways: Firstly, unsuccessful integration may lead to delays or losses in business, affecting the company's profitability and development potential. Secondly, the integration process may involve high integration costs, such as human resource adjustments and information system integration, increasing financial pressure on the company.

4. Recommendations for Financial Risk Prevention in Corporate Mergers and Acquisitions

4.1. Financial Risk Prevention at the M&A Initiation Stage

Financial risk prevention is crucial during the initiation stage of a merger and acquisition. To ensure the success of the M&A, companies should conduct comprehensive due diligence, reviewing the target company's financial statements and business model to understand its financial condition and risks. Additionally, it is essential to select appropriate valuation methods, considering industry prospects and the target company's operational status to ensure accurate valuation. Seeking professional advice from financial and legal advisors can help identify potential financial risks and provide corresponding solutions. Establishing an effective financial risk control mechanism enables timely identification and response to potential risks, ensuring a smooth M&A process and laying a solid foundation for the company's long-term development.

4.2. Financial Risk Prevention during M&A Implementation

Financial risk prevention remains crucial during the implementation stage of a merger and acquisition. Companies need to closely monitor risks related to financial integration and fund operations during this phase. It is advised to strictly adhere to the integration plan, ensuring accurate transfer of assets and liabilities to prevent duplication or omissions. Properly planning fund operations ensures sufficient post-merger capital, avoiding operational difficulties resulting from funding shortages. Strengthening communication with suppliers, customers, and partners helps prevent risks associated with delayed accounts receivable or increased uncertainties. Regular monitoring and analysis of key financial indicators in the M&A process enable the timely detection of anomalies and the adoption of effective measures. Through the establishment of a sound financial risk monitoring and response mechanism, companies can effectively reduce financial risks during the implementation phase, ensuring a successful M&A process and the achievement of expected objectives.

4.3. Financial Risk Prevention during M&A Integration

Financial risk prevention is critical during the integration phase of a merger and acquisition, as it involves the crucial process of integrating the acquired company with the acquiring company. During this phase, companies should pay particular attention to the following financial risks: First, strengthen the verification and auditing of post-integration financial data to ensure accurate transfer of assets and liabilities, avoiding problems arising from erroneous financial data. Second, focus on tax compliance to avoid potential risks and additional costs resulting from improper tax treatment. Additionally, conduct a thorough review of employee compensation and benefits to safeguard their rights and reduce the risk of employee dissatisfaction. Establishing robust financial control and reporting mechanisms ensures timely transparency of financial information and enhances monitoring and early warning capabilities regarding financial conditions. By actively preventing and responding to

financial risks, companies can smoothly achieve business integration during the M&A integration phase, ensuring the overall success of the M&A process and value realization.

5. Lessons for the M&A Industry

The research above provides important insights for companies engaging in future mergers and acquisitions, helping them to be more cautious and successful in their M&A activities. Here are some lessons for the M&A industry:

5.1. Thorough Due Diligence

Thorough due diligence is a necessary step for companies before engaging in an M&A. By comprehensively understanding and extensively researching the target company, companies can reduce M&A risks, ensuring the accuracy and feasibility of their decisions. During due diligence, companies should gather relevant information about the target company, including financial statements, organizational structure, business models, and ownership structure, to ensure the completeness and accuracy of the information. Additionally, auditing the target company's financial statements confirms their authenticity and identifies potential financial risks and unethical practices. Furthermore, gaining a deep understanding of the target company's business model, market position, competitors, and customer base helps assess its industry position and potential growth opportunities. Investigating legal risks of the target company, such as contract disputes and intellectual property issues, ensures legal compliance during the M&A process. Through thorough due diligence, companies can make informed decisions, find suitable M&A targets, and achieve a smooth M&A process with successful realization of expected objectives.

5.2. Focus on Financial Integration

Paying attention to financial integration is one of the critical tasks for companies after completing an M&A. It involves organically merging the financial systems, processes, and accounting data of two independent companies to optimize resource allocation and achieve synergies. During financial integration, companies need to conduct comprehensive verification and auditing of financial data from both parties to ensure accurate transfer of assets and liabilities, avoiding problems arising from data errors. Additionally, paying attention to tax compliance and properly planning tax strategies reduces tax risks and potential tax costs. Simultaneously, companies should review and adjust the post-merger compensation system and benefits to safeguard employees' rights, promote team cooperation, and ensure business stability. Establishing sound financial control and reporting mechanisms, as well as transparently disclosing financial information, enhances monitoring and early warning capabilities regarding financial conditions, thereby laying a solid foundation for the company to achieve operational advantages and sustained growth after the M&A. By focusing on financial integration, companies can better achieve M&A objectives, reduce risks, improve business performance, and ultimately realize post-merger synergies and strategic value.

5.3. Implement Earn-out Conditions

Implementing earn-out conditions is a preventive measure taken by companies during M&A transactions to protect their interests and reduce M&A risks. Earn-out conditions involve setting agreements on future performance or other key indicators of the acquired company. Failure to meet these

conditions triggers corresponding adjustment measures. When implementing earn-out conditions, companies need to reasonably consider the acquired company's operational status, market prospects, and risk factors. Common earn-out conditions include agreements on the acquired company's performance, market share, profit forecasts, and other related aspects. If the acquired company fails to meet the agreed performance indicators, it may trigger subsequent measures such as price adjustments, equity ratio adjustments, or partial return of M&A funds, ensuring that the acquirer does not suffer significant losses due to the acquired company's underperformance. Through implementing earn-out conditions, companies can make more cautious M&A decisions, enhance the stability and success probability of M&As, and also encourage the acquired company to strive to achieve the expected objectives, promoting the healthy development of cooperation between both parties.

References

- [1] Kyung jin Yoo, Youah Lee, Eunny eong Heo. Economic effects by merger and acquisition types in the renewable energy sector: An event study approach [J]. *Renewable and Sustainable Energy Reviews*, 2013, 25(26): 694-701.
- [2] Robert Conn, Paul Mgh Guest. The Impact on UK Acquires of Do-mestic, Cross-border, Public and Private Acquisitions [J]. *Journal of Business Finance and Accounting*, 2005, 32: 815-870.
- [3] Smidt. Mergers and Acquisitions Performance System: Integrated Framework for Strategy Formulation and Execution Using Flexible Strategy Game-Card [J]. *Global Journal of Flexible Systems Management*. 2012, 13: 41-56.
- [4] Jing Yan. Do mergers and acquisitions promote trade Evidence from China [J]. *The Journal of International Trade & Economic Development*, 2018, 27(07): 792-805.