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Analysis the Effect of Mergers and Acquisitions on Firm Performance and Earning Quality in Firms Listed on the IDX

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Abstract

This study determine whether the firm performance and earning quality has changed after mergers and acquisitions. Firms that conducted mergers and acquisitions between 2010-2014 and were listed on the IDX were the objects of this research. The results showed that after mergers and acquisitions, the firm's overall profitability, liquidity and solvency decreased significantly. However, this decline was also accompanied by an increase in earning quality, although not so significant. These research findings provide a new insight that after mergers and acquisitions, the firm focus on improving earnings quality first, thus sacrificing other financial performance such as profitability, liquidity and solvency.

Keywords

Mergers and Acquisitions, Firm Performance, Earning Quality, Profitability, Liquidity, Solvency.

Introduction

Every company aims to use its business resources efficiently to get an advantage in business competition and to be able to survive in it for years. The strongest factor in keeping a company can survive in today's fast-growing competitive world is the company's growth strategy and the results obtained from implementing the strategy. Increasingly intense competition among companies increases the importance of scale in business. Therefore, growth is no longer just a company goal, but a necessity for the company. In order to meet these needs, the company can expand its business through growth from both internal and external to the company.

Expanding the scale of business work through increasing sales, support, and equity by the company without external interaction is a company's internal growth strategy. Meanwhile, the company's external growth strategy can be carried out by merging two or more companies (Durmaz & İlhan, 2015). The form of business expansion from outside the company that is often applied is mergers and acquisitions. The merger is defined as an affiliation of two or more organizations to become one larger organization, whereas an acquisition is a purchase of one organization by another (Berrioategortua et al., 2018). Mergers are one of the most important corporate actions that significantly affect different stakeholder groups within a company (Yaghoubi et al., 2016).

Decisions regarding merger and acquisition agreements require serious focus and more attention because they will affect the company's financial performance. When mergers and acquisitions occur, the acquiring company may not always be in a profitable position, this has an impact on the liquidity, profitability, operations and managerial efficiency of the acquirer (Gupta & Banerjee, 2017). The success of the merger depends on how well the two companies integrate themselves in carrying out day-to-day operations and is evaluated by taking into account the financial performance of the two companies after the merger and acquisition.

According to data compiled by Bloomberg.com (2020), the volume of M&A was indeed cut drastically in 2020. It cannot be denied that many companies are forced to focus on surviving economic downturn due to the impact of the corona virus pandemic (Covid-19). The value of M&A announced, excluding minority investment, was only US $ 100 billion in April and May 2020, the lowest two-month period in 22 years. Meanwhile more than US $ 15 billion in transactions have been concluded by mutual consent due to the impact of the virus. However, in June 2020, officials at Citigroup Inc and UBS Group AG have forecast a wave of consolidation after Covid-19 in Europe in key sectors such as financial services. The private equity market is also seen as showing signs of revival. One of them is the process of selling the agrochemical company Rovensa to the Bridgepoint company with US $ 1.3 billion, which has also begun to be discussed again. Multinational companies in Europe and Asia have echoed similar plans after the pandemic, and are starting to consider expansion in the US according to Jim Langston, M&A partner at law firm Cleary Gottlieb & Hamilton LLP. By sector, the pharmaceutical and technology industries are seen as the most fertile as much positive sentiment emerged from these two sectors during the pandemic.

In Indonesia, until July 2020, merger and acquisition activities carried out by a number of issuers in the Indonesian capital market exceeded IDR 89.92 trillion. From the data collected by Bisnis.com (2020), until mid-2020 the companies that carried out mergers and acquisitions reached nine companies. Of the nine companies, five of them came from the financial services sector. Then, the rest comes from the consumer goods sector, mining, basic industry and pharmaceuticals.

Based on the explanation above, it illustrates that the actions of mergers and acquisitions continue to attract the interest and attention of companies from various countries. This is due to its potential in developing competitive advantages, creating renewal, and increasing company growth. On the other hand, the results of merger acquisitions also have a high failure rate. Although a lot of research on mergers and acquisitions has developed to date, from an economic and financial perspective, the results of previous research has shown that not all of the results obtained from these strategies have a positive impact.

This research was conducted to see how changes in company financial performance such as profitability, liquidity and solvency after carrying out mergers and acquisitions. This study also examines changes in the earning quality after the company carries out mergers and acquisitions. This research provide a new insight about how the effect of mergers and acquisitions on company performance and earnings quality. The results of this study are useful for company management who want to plan business strategies to advance company performance by carrying out mergers and acquisitions. The results of the research can complement the results of previous research, and also serve as a guidance for the development of research on future mergers and acquisitions.

Literature Review

Mergers and acquisitions are defined as corporate restructuring activities, which relate to corporate takeovers, which affect the company's ownership structure (Rao & Kumar, 2013). Mergers and acquisitions can bring about significant restructuring results and also contribute to industry growth by generating economies of scale, increasing competition in the market and increasing shareholder vulnerability because the value of shares will rise and fall after a merger or acquisition. Although the concepts of mergers and acquisitions are different from one another, they can be used as engines of growth (Gupta, 2013). Through mergers and acquisitions, the company's profits and shareholder wealth will increase and the company's operating costs will be reduced (Georgios & Georgios, 2011). Mergers and acquisitions are supported by company management because it will increase their authority and also achieve the company's goals (Gattoufi *et al.*, 2009).

There have been various previous studies regarding changes in company performance after mergers and acquisitions. Mergers or acquisitions have a significant effect on company performance. This is because the M&A action has succeeded in increasing management efficiency by combining the resources of the two companies, which can save operational and non-operational costs, thereby simultaneously increasing revenue and shareholder value (Kithitu *et al.*, 2012). Mergers and acquisitions affects changes in the number of shares outstanding and also has an impact on increasing company profits (Sujud & Hachem, 2018). After mergers and acquisitions, company's performance may have increased, proving that the company has succeeded in increasing revenue from sales and other operating activities (Neethu & Viswanathan, 2015).

In the banking sector, liquidity, profitability and investment of the company are positively and significantly affected by M&A actions. This is because bank revenues increase after M&A and banks can obtain a relatively larger pool of available funds after they are combined or acquired (Adebayo & Olalekan, 2012; Patel, 2014; Muhammad *et al.*, 2019). Mergers and acquisitions assist the company in increasing its revenue, thereby reducing the risk of loss that the company may face and helping to improve the company's cash flow (Anderibom & Obute, 2015).

Company's profitability performance can also decrease significantly after M&A, due to the fact that the company has not utilized its resources to increase sales optimally and reduce operational and non-operational costs (Jallow *et al.*, 2017; Patel, 2018; Edi & Irayanti, 2019). Merger acquisitions can have a negative impact on the company's performance because M&A actions lead to inappropriate and inefficient corporate risk management in the use of company resources that have joined, as well as improper handling of post-merger board room conflicts (Oduro & Agyei, 2013).

The decline in the company's post-merger performance can also be caused by poor execution of the merger process by the acquiring company, human resources that are not properly managed, which results in higher employee turnover which also adds to company costs, and lack of acquisition experience (Ashfaq *et al.,* 2014).

From the statement above, there is the hypothesis concluded as following:

H_1 = Gross profit ratio has changed significantly after mergers and acquisitions.
H_2 = Operating profit ratio has changed significantly after mergers and acquisitions.
H_3 = Net profit ratio has changed significantly after mergers and acquisitions.
H_4 = Return on capital employed has changed significantly after mergers and acquisitions.

H_5 = Earning per share has changed significantly after mergers and acquisitions.
H_6 = Return on assets has changed significantly after mergers and acquisitions.
H_7 = Return on equity has changed significantly after mergers and acquisitions.
H_8 = Return on net worth has changed significantly after mergers and acquisitions.
H_9 = Current ratio has changed significantly after mergers and acquisitions.
H_{10} = Quick ratio has changed significantly after mergers and acquisitions.
H_{11} = Debt to equity ratio has changed significantly after mergers and acquisitions.
H_{12} = Interest coverage ratio has changed significantly after mergers and acquisitions.
H_{13} = Total asset to debt ratio has changed significantly after mergers and acquisitions.
H_{14} = Earning quality has changed significantly after mergers and acquisitions.

Research Methods

1. Sample Selection

This study collected financial information on company financial reports with a span of 5 years before and 5 years after mergers and acquisitions. Companies that carry out mergers and acquisitions from 2010 to 2014 are listed on the IDX (Indonesia Stock Exchange) and provide audited financial reports that will be selected as research objects.

2. Measurement of Profitability

2.1 Gross Profit Ratio (GPR)

Gross profit margin is a ratio that assesses financial condition and a model of the company's business activities, where GPR shows the amount of money left from sales after deducting the cost of goods sold.

$$\textit{Gross Profit Ratio} = \frac{\textit{Gross Profit}}{\textit{Sales}} \times 100\%$$

Source: (Singh & Gupta, 2015)

2.2 Operating Profit Ratio (OPR)

Operating profit margin estimates how much profit a company makes from every dollar of sales, after paying variable costs of production, such as wages and raw materials, but before paying interest and taxes.

$$\textit{Operating Profit Ratio} = \frac{\textit{Operating Profit}}{\textit{Sales}} \times 100\%$$

Source: (Singh & Gupta, 2015)

2.3 Net Profit Ratio (NPR)

Net profit margin is a financial ratio to calculate the percentage of net profit a company generates from its total revenue.

$$\textit{Net Profit Ratio} = \frac{\textit{Net Profit}}{\textit{Sales}} \times 100\%$$

Source: (Singh & Gupta, 2015)

2.4 Return on Capital Employed (ROCE)

Return on capital employed is a benchmark for company profitability and the efficiency of using its capital. The ROCE ratio is considered an important profitability ratio and is often used by investors when screening suitable investment candidates.

$$\text{Return on Capital Employed} = \frac{\text{Earning Before Interest \& Tax}}{\text{Total Asset - Current Liabilities}} \times 100\%$$

Source: (Aggarwal & Singh, 2015)

2.5 Earning Per Share (EPS)

Earning per share describes the company's profit, which is allocated to each share of common stock marketed. EPS is a part of the net profit that will be received by each share, if all profits are paid to the shareholders.

$$\text{Earning Per Share} = \frac{\text{Profit After Tax} - \text{Dividend On Preferred Stock}}{\text{Average Outstanding Shares}} \times 100\%$$

Source: (Singh & Gupta, 2015)

2.6 Return on Asset (ROA)

Return on asset is an indicator measuring the company's profitability level relative to all of its assets. ROA helps managers, even investors, as well as analysts in assessing the level of management efficiency of a company managing its assets, to create revenue.

$$\text{Return on Asset} = \frac{\text{Net Income}}{\text{Total Asset}}$$

Source: (Aggarwal & Singh, 2015)

2.7 Return on Equity (ROE)

Return on equity measures the company's capability to bring in net profit for investors or company shareholders using their own capital.

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Total Equity}}$$

Source: (Aggarwal & Singh, 2015)

2.8 Return on Net Worth (RONW)

Return on net worth measures the amount of profit that a company generates, with the money invested from equity shareholders. The increase in RONW reflects a company that is increasing its ability to generate profits without having large capital. It also means how well the management of a company uses shareholder capital.

$$\text{Return on Net Worth} = \frac{\text{Operating Profit}}{\text{Total Equity}}$$

Source: (Mardianto, Christian, & Edi, 2018)

3. Measurement of Liquidity

3.1 Current Ratio (CR)

Current ratio measures the company's ability to complete short-term liabilities. CR considers how the company can optimize current assets on the balance sheet to meet short-term liabilities.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Source: (Aggarwal & Singh, 2015)

3.2 Quick Ratio (QR)

Quick ratio is an indicator of the company's short-term liquidity position and estimates the company's capabilities, in settling short-term liabilities using its most liquid assets, besides inventory.

$$\text{Quick Ratio} = \frac{\text{Current Assets - Inventory}}{\text{Current Liabilities}}$$

Source: (Aggarwal & Singh, 2015)

4. Measurement of Solvability

4.1 Debt to Equity Ratio (DTE)

Debt to equity ratio estimates the level of a company's liabilities for its capital. The greater the DER value, it means that the company's financial resources are mostly funded by lenders, not from their own financial sources.

$$\text{Debt to Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Total Equity}}$$

Source: (Aggarwal & Singh, 2015)

4.2 Interest Coverage Ratio (ICR)

Interest coverage ratio determines how well a company can pay interest expense on its debts.

$$\text{Interest Coverage Ratio} = \frac{\text{EBIT}}{\text{Interest Expense}}$$

Source: (Aggarwal & Singh, 2015)

4.3 Total Asset to Debt Ratio (ATD)

Total asset to debt ratio is an indicator of the company's financial leverage. this ratio describes the percentage of the company's total assets sourced from lenders.

$$\text{Total Asset to Debt Ratio} = \frac{\text{Total Asset}}{\text{Total Liabilities}}$$

Source: (Aggarwal & Singh, 2015)

5. Measurement of Earning Quality (EQ)

Earning Quality, namely the quality of earnings describes the company's performance based on the income earned in the current year. Earnings quality is the ability of earnings to represent the reality of company earnings and predict future earnings by reviewing the persistence and stability of earnings (Bellovary *et al.* 2005). Adjusted current accruals (REDCA) are used to measure the quality of earnings (Healy & Wahlen, 1999), and (Dechow *et al.*,2003).

$$REDCA_{i,t} = TCA_{i,t} - EPTCA_{i,t}$$

$$TCA_{i,t} = \Delta\ (Current\ Assets)_{i,t} - \Delta\ (Current\ Liabilities)_{i,t} - \Delta\ (Cash)_{i,t} + \Delta\ (Short\text{-}term\ and\ Current\ Portion\ of\ Long\text{-}term\ Debt)_{i,t}$$

$$EPTCA_{i,t} = \beta_1 \frac{1}{Assets_{i,t-1}} + \beta_2 \frac{(\Delta Net\ Sales_{i,t} - \Delta AR_{i,t})}{Assets_{i,t-1}} + \beta_3\, ROA_{i,t\text{-}1} + \beta_4\, Inflation_{i,t\text{-}1} + \beta_5\, GDPgrowth_{i,t\text{-}1}$$

Source: (Ding *et al.* 2016)

Results and Discussion

Descriptive statistics giving a brief information about the minimum, maximum, average and standard deviation values for each variable from all research sample companies that conduct mergers and acquisitions (see Table 1). There are changes between before and after mergers and acquisitions.

Table 1. Descriptive Statistics Test Results

	N	Minimum	Maximum	Mean	Std. Deviation
GPR_BEF	175	0.000	1.000	0.318	0.219
GPR_AFT	175	0.000	0.924	0.314	0.222
OPR_BEF	175	-0.380	1.445	0.202	0.172
OPR_AFT	175	-0.898	0.984	0.164	0.160
NPR_BEF	175	-2.305	2.297	0.111	0.358
NPR_AFT	175	-0.842	1.903	0.082	0.248
ROCE_BEF	175	-0.217	0.667	0.150	0.114
ROCE_AFT	175	-1.010	2.077	0.100	0.222
EPS_BEF	175	-120.090	1868.000	137.841	249.702
EPS_AFT	175	-308.000	373.200	72.596	100.990
ROA_BEF	175	-0.169	0.341	0.062	0.073
ROA_AFT	175	-0.427	0.607	0.033	0.092
ROE_BEF	175	-0.993	0.626	0.121	0.175
ROE_AFT	175	-0.781	6.163	0.133	0.667
RONW_BEF	175	-0.200	1.617	0.222	0.193
RONW_AFT	175	-0.956	1.950	0.142	0.274
CR_BEF	175	0.334	14.998	2.053	1.786
CR_AFT	175	0.152	6.872	1.733	1.183

QR_BEF	175	0.254	14.998	1.612	1.834
QR_AFT	175	0.139	5.689	1.282	0.989
DTE_BEF	175	0.071	12.458	1.832	2.112
DTE_AFT	175	-15.817	13.152	1.438	2.635
ICR_BEF	175	-29.695	158.064	9.943	20.006
ICR_AFT	175	-6.793	114.759	7.472	16.627
ATD_BEF	175	1.080	15.097	2.288	1.710
ATD_AFT	175	0.345	8.616	2.117	1.218
EQ_BEF (in millions)	175	-6,610,437.000	15,031,729.900	969,271.515	2,731,533.269
EQ_AFT (in millions)	175	-11,227,134.000	86,238,648.200	1,567,747.262	7,364,358.442

Source : Author's calculation (2020)

The results of the research hypothesis test in Table 2 prove that almost all variables experience significant changes after mergers and acquisitions. Variables that experience significant changes are the variable Operating Profit Ratio (OPR), Return on Capital Employed (ROCE), Earning Per Share (EPS), Return on Asset (ROA), Return on Net Worth (RONW), Current Ratio (CR), Quick Ratio (QR), and Debt to Equity Ratio (DTE). The eight variables decreased significantly after the company conduct mergers and acquisitions. The variables that did not change significantly were the Gross Profit Ratio (GPR), Net Profit Ratio (NPR), Return on Equity (ROE), Interest Coverage Ratio (ICR), Total Asset to Debt (ATD) and Earning Quality (EQ). The gross profit ratio, net profit ratio, interest coverage ratio, and total asset to debt variables experienced an insignificant decline, while the return on equity and earning quality variables experienced an insignificant increase after the mergers and acquisitions took place. The results of this test provide a new understanding that the company after conducting mergers and acquisitions has a primary focus on improving earnings quality first so that it sacrifices other financial performance such as profitability, liquidity and solvency.

Table 2. Result of Paired Sample t-Test

Variable	N	Mean(BEF)	Mean(AFT)	t	Sig. (2-tailed)	Hypothesis
GPR	175	0.3184062	0.3138346	0.518	0.605	Insignificant
OPR	175	0.2024372	0.1635611	2.803	0.006	Significant
NPR	175	0.1105377	0.0822049	1.091	0.277	Insignificant
ROCE	175	0.1495470	0.1000878	2.952	0.004	Significant
EPS	175	137.8405669	72.5955166	3.571	0.000	Significant
ROA	175	0.0620206	0.0327136	3.967	0.000	Significant
ROE	175	0.1208428	0.1332922	-0.241	0.810	Insignificant
RONW	175	0.2221464	0.1416133	3.449	0.001	Significant
CR	175	2.0529320	1.7327633	2.536	0.012	Significant
QR	175	1.6124632	1.2819785	2.506	0.013	Significant
DTE	175	1.8323977	1.4376631	2.001	0.047	Significant
ICR	175	9.9429079	7.4718220	1.690	0.093	Insignificant
ATD	175	2.2883445	2.1174416	1.471	0.143	Insignificant
EQ	175	969271.52	1567747.26	1.176	0.241	Insignificant

Source : Author's calculation (2020)

The GPR variable decreased not significantly after mergers and acquisitions. This indicates that the company is not able to take full advantage of the combined resources of the two companies from mergers and acquisitions to save cost of goods sold. Such as not making savings on fixed costs and production costs, and also due to inventory devaluation or even an increase in the price of goods.

The OPR variable decreased significantly after mergers and acquisitions. This situation can be due to companies that enter new geographic areas after conducting mergers and acquisitions, have not been able to adapt to the new company's different operating systems, so that they fail to save on expenses related to operational activities. The decline in the company's operating profit can also be said to be the result of a decrease in the company's gross sales profit after mergers and acquisitions.

The NPR variable decreased not significantly after mergers and acquisitions. Although not significantly, the decline in NPR indicates that after mergers and acquisitions, the company was unable to save on operating and non-operating costs. Mergers and acquisitions also did not succeed in increasing the company's revenue from sales or other income from non-operational activities, they could even cause a decrease in company revenue. The company's failure to maximize its profit efficiency can be due to the company's management being unable to take advantage of synergies to increase the company's competitiveness, not precisely the fields between companies that have joined or been acquired, or the company is still in its transition stage to develop.

The ROCE variable decreased significantly after mergers and acquisitions. The decline in ROCE may be due to the increase in the company's working capital after mergers and acquisitions, while the company's income has decreased. In other words, the income available to company stakeholders is higher before mergers and acquisitions. In addition, it can be caused by the inability of management to manage the company's budget system which results in investment decisions that are detrimental to the company.

The EPS variable decreased significantly after mergers and acquisitions. The company's inability to adapt after joining to make cost savings, as well as the decline in company revenue after mergers and acquisitions, can be said to be the main cause of the decline in EPS. Or under certain conditions, the acquiring company uses shares, it will cause an increase in the number of shares outstanding, which at the same time reduces the availability of net profit that can be distributed to shareholders.

The ROA variable decreased significantly after mergers and acquisitions. The merger of the two companies' resources after the merger and acquisition did indeed increase the asset value of the combined proceeds, but because it was not managed properly by management, the company did not get optimal returns, which was the cause of the decline in ROA. In addition, the decline in ROA can also be due to losses arising from changes in the fair value of assets, or certain conditions for companies that buy assets with debt. That way it will increase interest expense while reducing profit.

The ROE variable increased not significantly after mergers and acquisitions. Although not significant, the increased ROE illustrates that the company's management has been able to take advantage of financial synergies after the joining of the two companies' capital to increase the company's ability to generate positive income. Merger of companies and also especially for companies that acquire use of shares will increase the value of equity, company management is able to manage it well, which makes the company get maximum returns.

The RONW variable decreased significantly after mergers and acquisitions. RONW has decreased because the joining companies have not been able to adjust the operating system of the new company which has changed, so it is unable to save on operating costs which in turn will reduce the resulting operating profit. The increase in shareholder capital after mergers and acquisitions, if not used efficiently by company management to increase operating profit, will certainly result in a poor return on net worth for the company.

The CR variable decreased significantly after mergers and acquisitions. The decrease in the CR could be due to the decline in the company's profitability after mergers and acquisitions, which in turn caused problems in the company's finances, as a result of the company failing to create good synergies. A new company experiencing cash flow problems will reduce its capacity to settle short-term liabilities.

The QR variable decreased significantly after mergers and acquisitions. The QR decline is predicted because the company is still in its transition period, so it has not been able to maintain the management of its liquid assets. In fact, the decline in company revenues after the merger and acquisition will cause problems in the company's cash flow. A problematic company's cash flow will make it difficult for the company to pay off debt or even increase the amount of its debts.

The DTE variable decreased significantly after mergers and acquisitions. The creation of financial synergy after the merger of assets and capital of the two companies conducting mergers and acquisitions, especially for companies acquiring using shares, will further increase the company's equity value. That way the company's financial sources will come mostly from their own financial sources, not from loan donors. This can lead to a significant decrease in the DTE after mergers and acquisitions.

The ICR variable decreased not significantly after mergers and acquisitions. ICR has decreased after mergers and acquisitions due to the company's inability to take advantage of synergies to increase income, making it increasingly difficult to pay off its debts. In addition, the cash flow problems experienced by the company also resulted in an increasing use of debt by the company, which of course at the same time increased the company's loan interest expense. Increasing interest expense accompanied by decreasing company income will reduce the company's capacity to pay off its interest expense, which in turn will result in a poor company's ICR.

The ATD variable decreased not significantly after mergers and acquisitions. The decrease in ATD was due to companies experiencing cash flow problems, which resulted in difficulties in paying off their debts after mergers and acquisitions, or even increasing the amount of debt. In addition, it can be caused by the merger process of these companies which is funded by loans (Harvey, 2015). The company is still in its transition period, so it has not been able to maintain maximum asset management, or its asset value has indeed decreased due to decreased company revenues after the merger and acquisition.

The EQ variable increased not significantly after mergers and acquisitions. The increase in EQ can be due to the resources, quality and value of the company that have undergone changes after mergers and acquisitions, so that the company's ability to generate profits is more stable and promising compared to previous periods. This means that the income that the company earns can be reproduced more easily for the next period, so that it is marked by higher earnings quality results. An increase that is still insignificant is estimated because the companies are still adapting after the merger of the two companies.

Conclusions

This study determine whether the firm performance and earning quality has changed after mergers and acquisitions. The results showed that after mergers and acquisitions, the firm's overall profitability, liquidity and solvency decreased significantly. However, this decline was also accompanied by an increase in earning quality, although not so significant. These research findings provide a new insight that after mergers and acquisitions, the firm focus on improving earnings quality first, thus sacrificing other financial performance such as profitability, liquidity and solvency. This study are useful for company management who want to plan business strategies to advance company performance by carrying out mergers and acquisitions.

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