

Accounting, Analysis and Governance in Complex Deals

Arndt Weinrich
weinrich@rsm.nl
Rotterdam School of Management

Canvas

Situation May/13/2026

Canvas

- Canvas is back online after a week of downtime due to a cyber attack at the software provider (EUR Update Blog)
- I will continue to use arndtupb.github.io as an alternative platform to share *some* important information and materials with you in case we loose access again
- **Week 1 Quiz**
  - Goes online no later than May/15
  - **Deadline to complete 20 multiple choice questions is May/18 at 11:59 PM** (Rotterdam Time)
  - Let's walk through more details at the deadline vault

Target Identification

BMME303

Accounting, Analysis and Governance in Complex Deals

Lecture Overview

Structure and Learning Objectives

Key Topics

- Fundamentals of target identification
- Value-creating acquisition archetypes
- Financial metrics for target screening
- Practical screening framework
- Governance and accounting quality issues

Why?

- Strategic drivers behind M&A decisions
- Link acquisition archetypes to specific financial indicators
- Screening frameworks to evaluate potential targets
- Importance of corporate governance in target selection

Lecture Overview

Structure and Learning Objectives

Key Topics

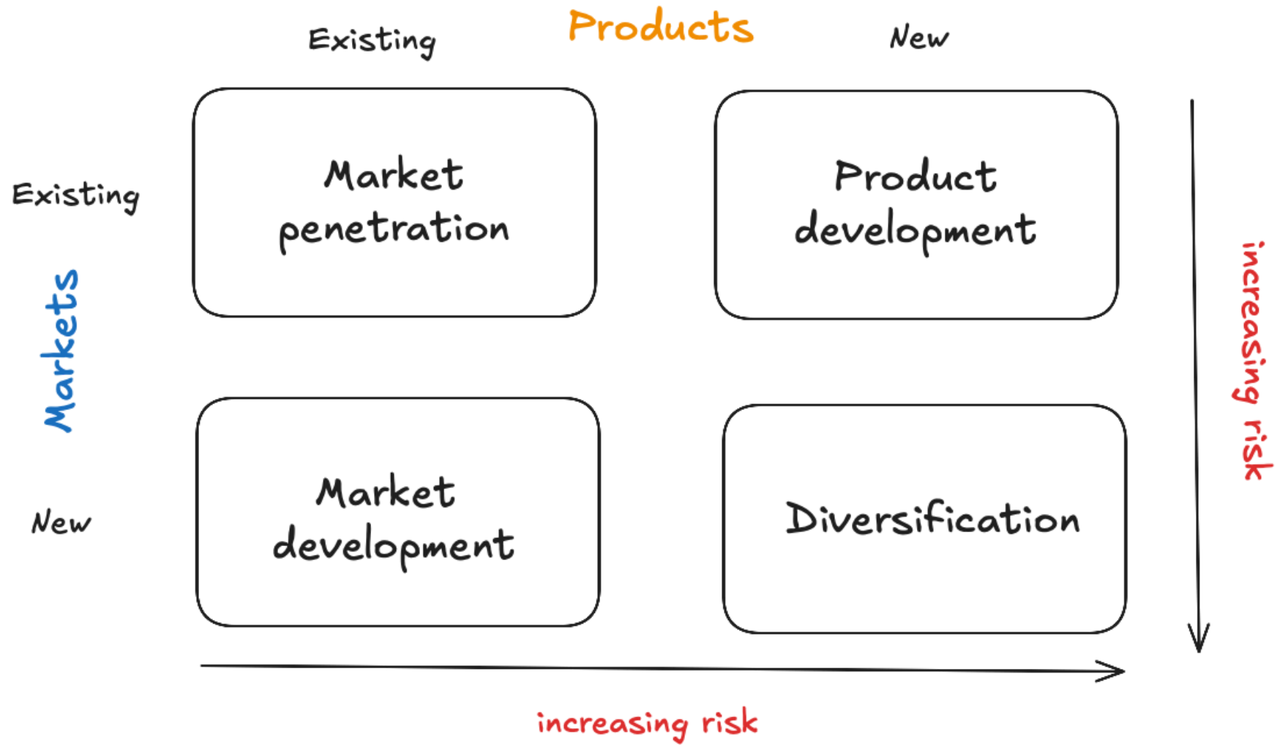
- Fundamentals of target identification
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- Governance and accounting quality issues

Relevance for Practice?

- Corporate development roles, strategy consulting, investment banking, and private equity
- Today’s content is intended to help you evaluate M&A decisions

Fundamentals of Target Identification

A Simple Strategy Perspective



> *"Strategy is about making choices, trade-offs; it's about deliberately choosing to be different."* Michael Porter

Fundamentals of Target Identification

Examples

Market Penetration

- Facebook's acquisition of Instagram (FB)

Product Development

- Microsoft's acquisition of GitHub (MS)

Market Development

- Walmart's acquisition of Flipkart (BBC)

Diversification

- Amazon's acquisition of Whole Foods (CNBC)

⇒ **first, you must understand your own core competencies, market position, and growth aspirations!**

Fundamentals of Target Identification

The Process



Why do M&As happen?

Value Creating Strategies in Complex Deals

Why do M&As happen?

Chapter 1 DePamphilis (2025)

Operating Synergy • Economies of Scale • Economies of Scope • Complementary Resources	Improve operating efficiency through economies of scale or scope by acquiring a customer, supplier, or competitor or to enhance technical or innovative skills or to gain access to scarce resources
Financial Synergy	Lower cost of capital
Diversification • New Products / Current Markets • New Products / New Markets • Current Products / New Markets	Position the firm in higher-growth products or markets
Strategic Realignment • Technological Change • Regulatory and Political Change	Acquire capabilities to adapt more rapidly to environmental changes than could be achieved if the capabilities were developed internally
Hubris (Managerial Pride)	Acquirers believe their valuation of the target is more accurate than the market's, causing them to overpay by overestimating synergy
Buying Undervalued Assets (Q-Ratio)	Acquire assets more cheaply when the equity of existing companies is less than the cost of buying or building the assets
Mismanagement (Agency Problems)	Replace managers not acting in the best interests of the owners
Managerialism	Increase the size of a company to increase the power and pay of the managers
Tax Considerations	Obtain unused net operating losses and tax credits, asset write-ups, and substitute capital gains for ordinary income
Market Power	Increase market share to improve ability to set prices above competitive levels
Misvaluation	Investor overvaluation of acquirer's stock encourages M&As

Why do M&As happen?

Fundamentals of Target Identification

Creating Value?

- **Synergies** most cited as primary motivation
- Operational and financial synergies commonly concern
  - Profitability
  - Growth

Some Sources of Value Creation

- Economies of scale/scope
- Improving target performance
- Market power
- Market access/entry (e.g. cross-border)
- Restructuring and break-up

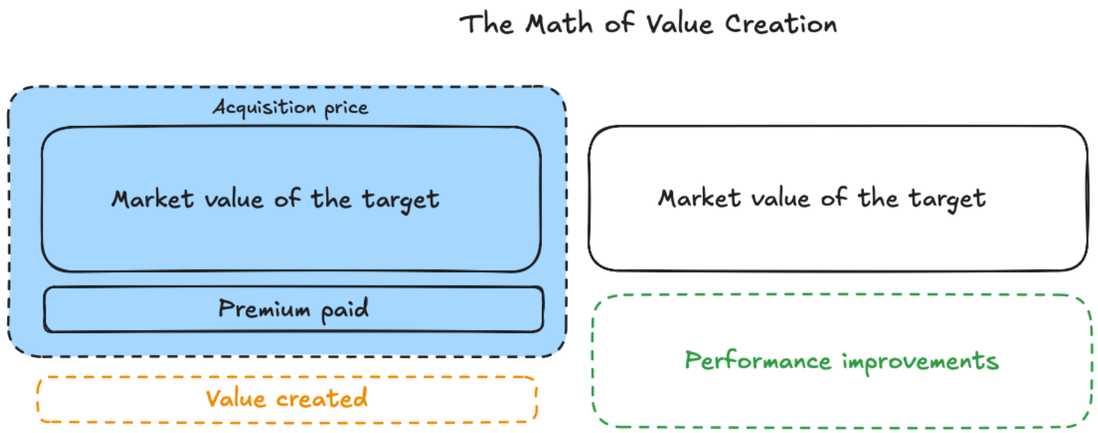
(!) Synergy is the value realized from the incremental cash flows generated by combining two firms

Value Creation Framework

Fundamentals of Target Identification

The Math of Value Creation

Target standalone value
+Performance improvements
–Purchase price
Value created for acquirer



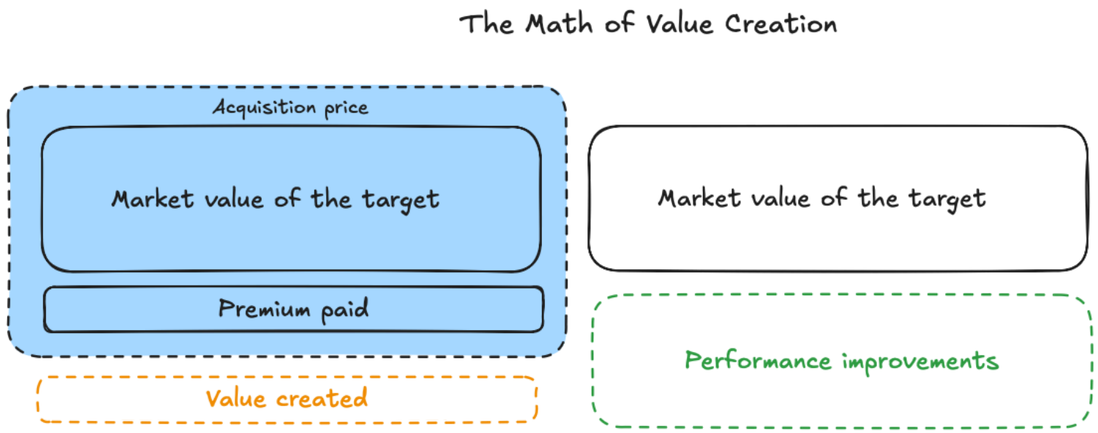
⇒ **Value is created only when performance improvements exceed the premium paid**

Value Creation Framework

Fundamentals of Target Identification

Implications

- Identify targets with significant improvement potential
- Have a clear and realistic plan for achieving those improvements
- **Maintain pricing discipline** in negotiations



Winner's curse: as multiple bidders compete for a target, the winning bid often approaches or exceeds the value of potential synergies, leaving little or no value for the acquirer's shareholders.

Sources of Value Creation

Fundamentals of Target Identification

Economies of Scale

- Cost advantages that a firm can achieve by increasing its level of production.
- Average cost per unit decreases due to the spreading of fixed costs over a larger number of units.

Examples

- Consolidation of production facilities
- Elimination of duplicate administrative functions
- Greater purchasing power with suppliers
- More efficient utilization of capital equipment

Sources of Value Creation

Fundamentals of Target Identification

Economies of Scope

- Cost advantages via producing multiple products or services together
- Reduces the overall production costs compared to producing them in separate locations or divisions

Examples

- Shared distribution channels for complementary products
- Cross-selling opportunities to existing customers
- Leveraging common technologies across multiple product lines
- Sharing corporate servicess (e.g., bookkeeping)

Economies of Scope

Example: Data Processing Consolidation

Case

> Two firms, A and B, each operate separate data processing centers supporting their respective manufacturing facilities. Firm A has 5 facilities, while Firm B has 3. The two firms decide to merge their data processing operations into a single center that will support all 8 facilities.

Economies of Scope

Example: Data Processing Consolidation

Pre-Merger Situation

Firm A

Category	Annual Cost
Direct labor costs	$1,500,000
IT expenses	$450,000
Leased space	$900,000
G&A expenses	$350,000
Total Firm A	**$3,200,000**

Firm B

Category	Annual Cost
Direct labor costs	$1,040,000
IT expenses	$275,000
Leased space	$575,000
G&A expenses	$230,000
Total Firm B	**$2,120,000**

Combined Pre-Merger Cost: $5,320,000

Economies of Scope

Example: Data Processing Consolidation

Post-Merger Situation (Combined)

Category	Pre-Merger	Post-Merger	Savings
Labor costs	$2,540,000	$1,700,000	$840,000
IT expenses	$725,000	$450,000	$275,000
Leased space	$1,475,000	$800,000	$675,000
G&A expenses	$580,000	$350,000	$230,000
Total	**$5,320,000**	**$3,300,000**	**$2,020,000**

Economies of Scope

- 38% overall cost reduction
- Single operation achieves efficiencies that neither company could realize independently
- No reduction in service capacity while supporting all 8 facilities

Consolidate to Remove Excess Capacity

Financial signals that would flag this target? → high fixed costs relative to revenue and geographic facility overlap between the two firms

What works in practice?

7 Archetypes for Value-Creating Acquisitions

Chapter 31 Koller, Goedhart, and Wessels (2025)

Improve target company performance

- Target with operational inefficiencies or underutilized assets
- Radical cost reduction/margin improvement/revenue acceleration
- Capability to execute turnarounds

Consolidate to remove excess capacity

- Mature industries with overcapacity
- Shut down least productive facilities
- Reduce overhead and sales capacity

Accelerate market access for products

- Relatively small targets with innovative products but limited market reach capabilities
- Own global market access/commercial footprint can accelerate target's revenues

Acquire skills or technologies faster

- Enhancement of existing products
- Patent acquisition to avoid royalty payments
- Technical capabilities in emerging areas

7 Archetypes for Value-Creating Acquisitions

Chapter 31 Koller, Goedhart, and Wessels (2025)

Exploit industry-specific scalability

- Large companies often operate at scale
- Economies of scale, e.g.:
  - Incremental capacities are sizeable
  - Enhanced purchasing power

Pick winners early and develop them

- Early in product/industry lifecycle
- Help refine promising technology
- Multiple bets with expected failures

Build a new business or capability

- Invest significantly to **integrate** acquired assets and organically build on them
- Apply products/capabilities in own core business
- Attain full market potential externally

Is that relevant for practice?

BCG knows Archetypes, too!

Archetypes for Value-Creating Acquisitions

Different M&A Archetypes Apply to Different Strategic Objectives

Acquisition intent		Strategic archetype	Value-creation objective
Support and grow existing business	1	Roll-up	Acquire direct competitors to build competitive advantage through scale and scope
	2	Consolidate	Acquire direct competitors in an overcapacity market to consolidate and reduce costs
	3	Leverage operational excellence	Acquire companies in same or close industries to deploy superior operational capabilities
	4	"Feed the machine"	Acquire small, early-stage companies to fill an R&D pipeline into an advantaged distribution network
	5	Accelerate access	Acquire strong companies in same industry to access attractive geographies or customer segments where acquirer currently has no position
Extend business by adding to the portfolio	6	Enter adjacency	Acquire companies with adjacent products or capabilities to diversify portfolio in related markets
	7	Create new leg	Acquire unrelated companies to diversify into new higher-margin or growth industry
Change business	8	Change existing leg	Acquire unrelated companies to migrate portfolio by exiting one market to enter one with better growth potential

Source: BCG analysis

Matching Financial Indicators to Acquisition Archetypes

Exercise

> One of the most practical applications of understanding acquisition archetypes is the ability to link them to specific financial indicators for target screening → **translate strategic archetypes into practical screening criteria**

Your turn!

Matching Financial Indicators to Acquisition Archetypes

Exercise

Improve Target Performance

- Low operating margins/ROE
- High SG&A expense ratios
- Lagging inventory turnover

Accelerate Market Access

- Geographic revenue concentration
- Limited distribution infrastructure
- Growing products with limited reach

Consolidate Excess Capacity

- Fixed vs. variable cost structure
- Geographic facility overlap
- High fixed costs relative to revenue

Acquire Skills/Technologies

- R&D intensity metrics
- Patent count and quality
- Technology development cycle time

Matching Financial Indicators to Acquisition Archetypes

Exercise

Exploit Industry Scalability

- Incremental margin analysis
- Unit cost curves by volume
- IT and infrastructure investments

Build a New Business or Capability

- Unprofitable but in top n of their market
- Capital-constrained
- Relatively small to allow multiple acquisitions

Pick Early Winners

- Revenue growth trajectory
- Total addressable market penetration
- Early market share movements

Executing Strategy

What's the problem?

Information Asymmetry

- Target companies (especially private ones) have better information about their own operations, risks, and prospects than potential acquirers
- Information asymmetry creates risk for acquirers and may lead to adverse selection → **lemons problem** (Akerlof 1970)
- **BUT:** It is also an opportunity for firms with superior information-processing capabilities to create value (Makadok and Barney 2001)

Executing Strategy

Where to start?

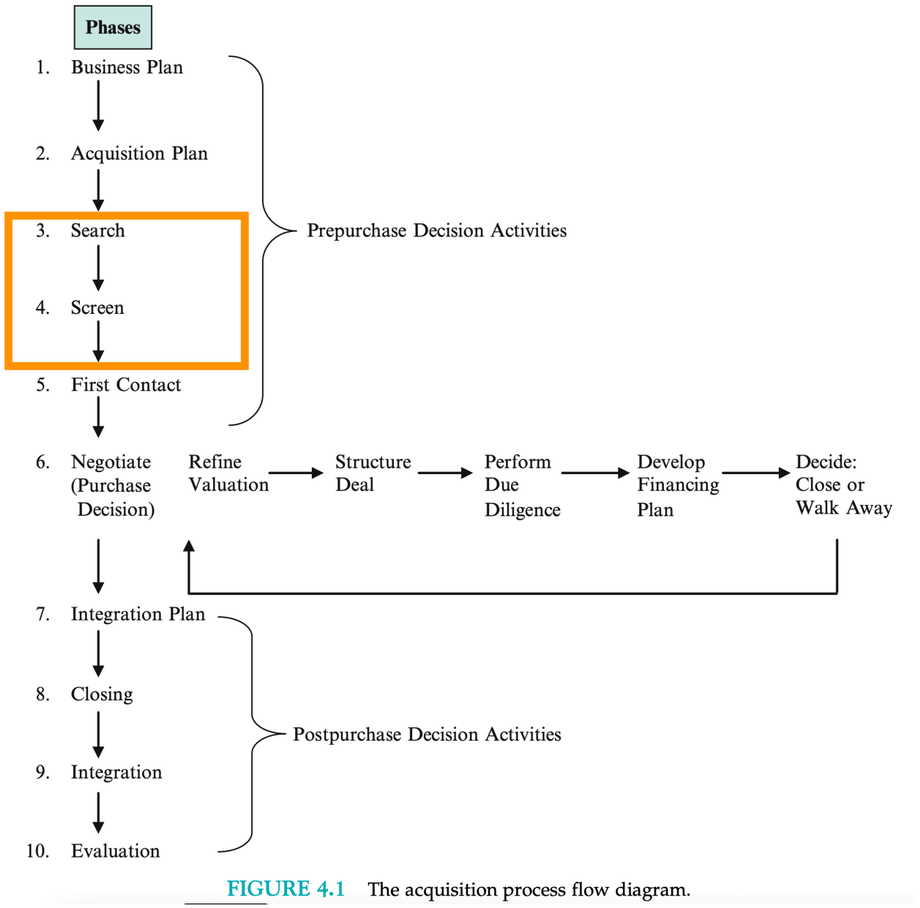


FIGURE 4.1 The acquisition process flow diagram.

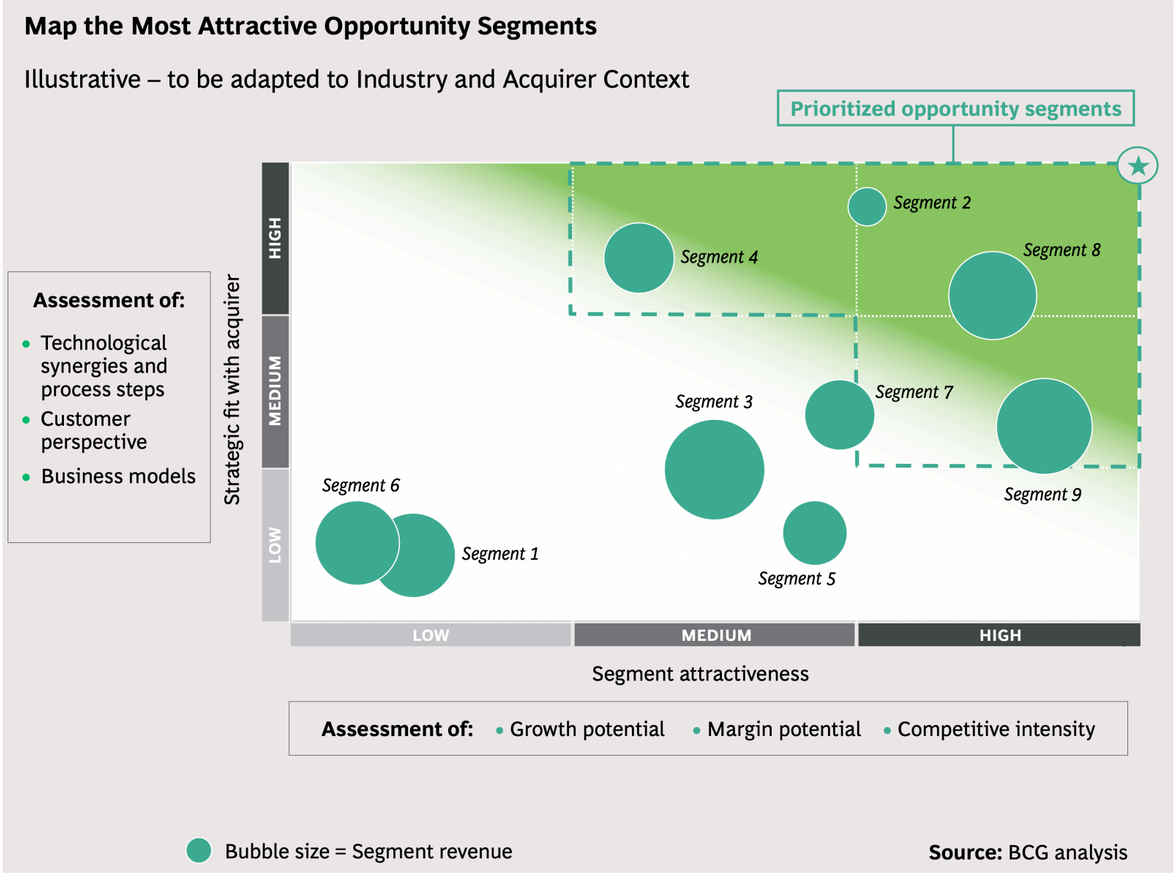
The Initial Search

- Industry classification (to consider strategic fit)
- Transaction size parameters (reflecting acquisition capacity)
- Geographic restrictions (based on market entry goals or operational considerations)

→ **Universe of potential targets**

The Search Process: Selection á la BCG

Executing Strategy



Executing Strategy

Where to look?

Initial Search: Sources

- Company disclosures, e.g. EDGAR or registries
- Investor presentations and earnings calls
- Industry association data
- Credit rating agency reports
- Sell-side analyst research
- Social media and company websites

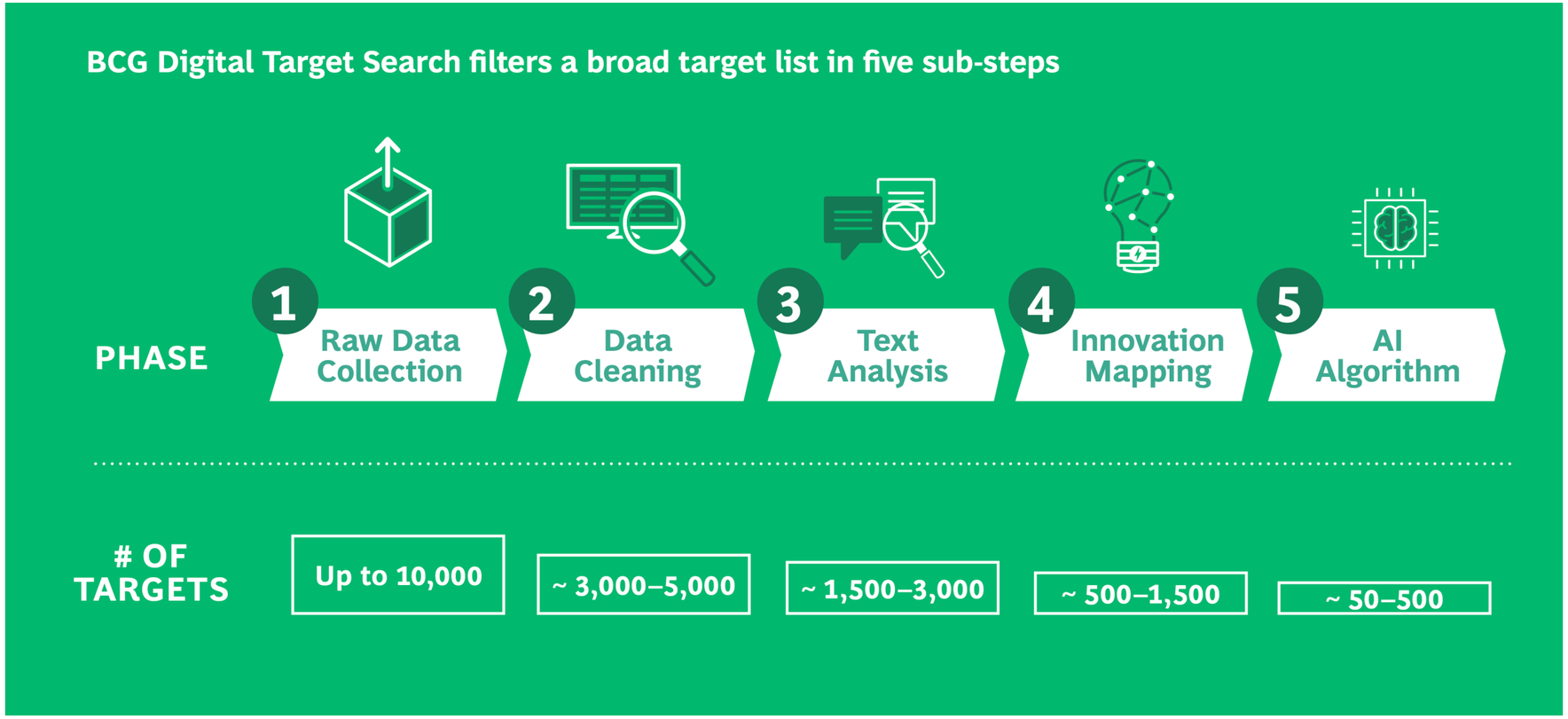
Screening

- Market segment alignment
- Product line complementarity
- Profitability metrics
- Degree of leverage/capital structure
- Market share/position
- Cultural comparability

⇒ **Quantify** if possible

Refining the Search Process á la BCG

Executing Strategy



Fundamentals of Target Identification

The Search & Screening Process

Early Takeaways

- The search and screening process is iterative
- The search phase involves using relatively few criteria to identify potential targets
- Screening involves narrowing the list by employing more criteria

Let’s practice this!

OpenAI’s Attempted Acquisition of Windsurf

Target Identification Example: Strategic Success, Deal Failure

Case

> In April 2025, OpenAI entered talks to acquire AI code editor Windsurf for approximately $3 billion, representing a strategic pivot after unsuccessful acquisition attempts with Cursor’s parent company Anysphere. Despite Cursor’s larger market presence ($300M ARR versus Windsurf’s $100M ARR), OpenAI’s **systematic target selection identified Windsurf as the superior choice**—though the deal ultimately collapsed for reasons beyond the screening framework.

Some Facts

- Cursor and Windsurf are both AI-powered code editing tools
- Annual recurring revenue (ARR) is a metric of predictable and recurring revenue generated by customers within a year

OpenAI’s Attempted Acquisition of Windsurf

Target Identification Example

The Search Process - Let’s speculate!

- What is OpenAI’s strategy?
- What archtypes are relevant?
- What are the key criteria for selecting a target?
- Where would you look for information?

OpenAI agrees to buy Windsurf for about $3 billion, Bloomberg News reports

By **Reuters**

May 6, 2025 8:47 AM GMT+2 · Updated a day ago



FILE PHOTO: A keyboard is placed in front of a displayed OpenAI logo in this illustration taken February 21, 2023. REUTERS/Dado Ruvic/Illustration/File Photo/File Photo Purchase Licensing Rights

May 5 (Reuters) - OpenAI has agreed to buy artificial intelligence-assisted coding tool Windsurf for about $3 billion, Bloomberg News reported on Monday, citing people familiar with the matter.

The deal has not yet closed, the report added.

Systematic Target Scoring Methodology

Target Identification Example

Step 1: Define Acquisition Strategy

- Select primary acquisition archetype
- Determine key screening criteria based on archetype
- Establish weight for each criterion
- Set minimum thresholds for must-have elements

Step 2: Initial Search and Screening

- Develop universe of potential targets
- Apply initial financial filters
- Create shortlist of candidates
- Score each candidate on key criteria

Practical M&A Screening Framework

Target Identification Example

Step 1: OpenAI's Acquisition Strategy?

- **Primary archetype:** Accelerate market access for products
- **Secondary archetype:** Acquire skills or technologies faster
- **Key criteria:** User base, enterprise readiness, content workflow integration
- **Must-have elements:** Direct access to content creation workflows, complementary to ChatGPT

Step 2: AI Editor Targets?

- Universe: AI-powered code editing tools
- Filter criteria: Growing user base, enterprise-readiness
- Shortlist: Windsurf, VSCode, Cursor
- Deep evaluation: Integration potential, developer adoption, data acquisition

Practical M&A Screening Framework

Stylized Target Scoring Template for AI Code Editor Acquisition

Category	Metric	Weight	Windsurf	VSCode	Cursor
Market Access	Active user base growth	15%	8/10	10/10	9/10
	Enterprise-ready infrastructure	15%	9/10	8/10	6/10
	Content workflow integration	10%	9/10	6/10	7/10
Technology/Skills	Complementary to OpenAI products	15%	8/10	5/10	7/10
	Developer talent acquisition	10%	8/10	4/10	9/10
Integration Factors	Technical integration ease	10%	8/10	6/10	7/10
	Acquisition feasibility	10%	8/10	3/10	3/10
Market Position	Revenue trajectory	5%	7/10	9/10	9/10
	Competitive differentiation	5%	8/10	7/10	9/10
	AI agent capabilities	5%	9/10	5/10	8/10
Total Score		**100%**	**8.25**	**6.30**	**7.00**

Practical M&A Screening Framework

Key Strategic Advantages of Windsurf vs. Competition

Better Enterprise Integration

- According to industry comparisons, Windsurf's "Cascade" feature excels in handling enterprise legacy systems
- Stronger focus on enterprise deployments and compliance requirements
- Native plugins for multiple IDEs maintain consistent experience across corporate environments

Complementary AI Technology

- Windsurf's multi-file automation capabilities fill a gap in OpenAI's product lineup
- Provides "agentic automation" for complex coding tasks with minimal prompts
- Sustain competitive positioning against Google and Anthropic

Practical M&A Screening Framework

Key Strategic Advantages of Windsurf vs. Competition

Strategic Acquisition Considerations

- Reports indicate Cursor’s parent company (Anysphere) declined acquisition offers to remain independent
- Cursor is reportedly seeking funding at a $10 billion valuation, making Windsurf’s $3 billion price tag more attractive
- Windsurf CEO has already appeared in OpenAI product videos, suggesting existing collaboration

User Data Acquisition

- Access to valuable editing and coding behavior data to improve OpenAI’s models
- Higher enterprise penetration provides data from professional developers
- Windsurf reported to be gaining market share with growing user adoption

OpenAI's Attempted Acquisition of Windsurf

External Barriers Despite Sound Target Selection



The Deal Failed!

- Deal collapsed: reportedly over concerns about Microsoft's access to technology through OpenAI's partnership arrangements → external stakeholder dynamics, not target fundamentals, derailed negotiations
- Alternative outcome: Windsurf leadership to Google; Google pays $2.4B licensing fees
- **Lesson:** Sound target identification can still fail due to external factors

Governance and Target Selection

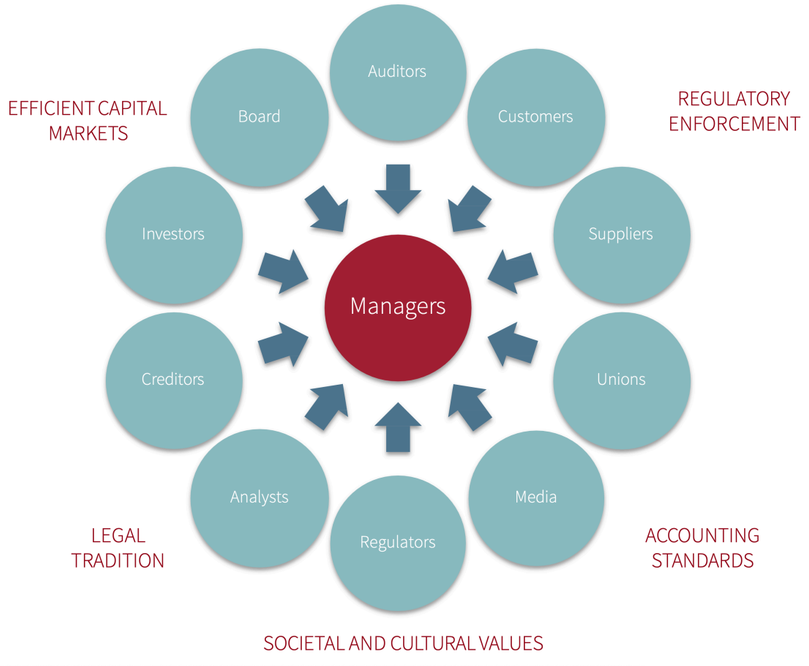
An Overlooked Aspect of Target Selection?

Governance and Target Selection

Recap of Session 1

Governance in M&A - Who is involved?

- CEO, CFO, and other senior executives
- Board of directors
- Shareholders
- Stakeholders (employees, customers, suppliers)
- Regulators



Governance and Target Selection

Research

Governance Examples

1. The impact of employment protection laws on takeover activity
2. How financial statement comparability affects acquisition efficiency
3. The role of common auditors in reducing information asymmetry

Link to M&A motivations

1. Operational synergies and their relationship to labor restructuring
2. Information asymmetry in target selection
3. Mechanisms for reducing uncertainty in the acquisition process

Governance and Target Selection

Employment protection and takeovers (Dessaint, Golubov, and Volpin 2017)

Research question

How important is labor restructuring as a driving force for the market for corporate control and as a source of merger synergies?

Why do we care?

- If workforce restructuring represents an important consideration in takeovers, then fewer takeover attempts are likely to materialize when employment is highly protected and redundancies are costlier
- When bids are made, the rigidity of labor regulation is expected to reduce the synergy gains from mergers and acquisitions made

Governance and Target Selection

Employment protection and takeovers (Dessaint, Golubov, and Volpin 2017)

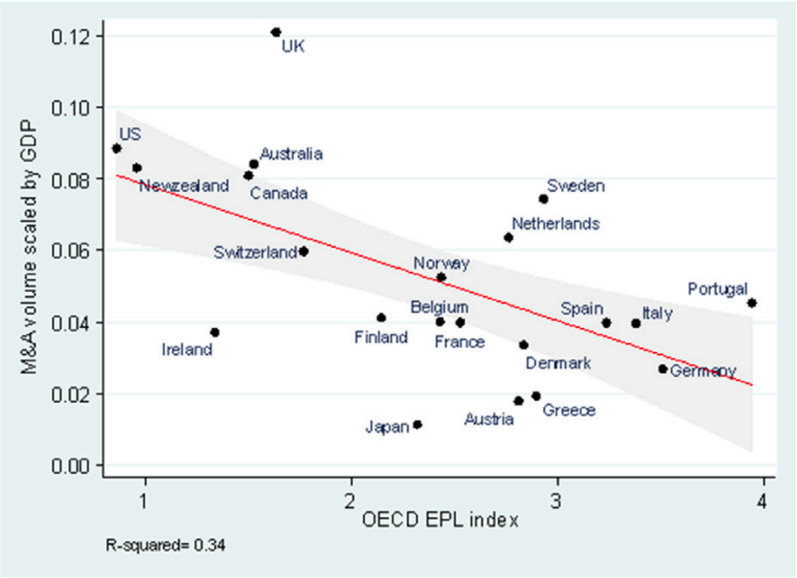


Fig. 1. Mergers and acquisitions (M&A) volume scaled by gross domestic product (GDP) versus Organisation for Economic Co-operation and Development (OECD) Employment Protection Legislation (EPL) index. This figure presents the average volume of M&A deals (scaled by GDP) by country relative to the average EPL index (as published by the OECD and corrected by Allard, 2005) over the 1985–2007 period. The analysis is based on all deals reported in Thomson Reuters SDC. The slope and the R^2 correspond to a regression of the mean M&A volume to GDP on the mean EPL index across countries. The gray-shaded area represents the 90% confidence interval for the fitted values from this regression.

Governance and Target Selection

Employment protection and takeovers (Dessaint, Golubov, and Volpin 2017)

Findings

Increases in employment protection reduce takeover activity by 14–27% and (synergies) by over half

Table 3
Industry-level mergers and acquisitions (M&A) activity and Employment Protection Legislation (EPL) reforms.
This table presents difference-in-differences estimates of the effect of EPL reforms on the volume (Columns 1–3) and the number (Columns 4–6) of M&A deals at the target industry level. Industries are the 13 macro industries defined by SDC. *EPL* is a reform indicator that is set to zero in 1985 and then increments by 1 (−1) each time the target firm country tightens (loosens) employment protection. $EPL^{y-(+)i}$ is a dummy equal to one if the year of the deal is the *i*th year before (after) the reform and zero otherwise ($^{y++}$ denotes year +4 and beyond). Country control variables include *GDP per Capita, GDP Growth*, and *Creditor Rights Index* dummies. Industry-year and industry-country fixed effects are based on the 13 macro industries defined by SDC. All variables are defined in Table A1 in the Appendix. Regressions are weighted by the number of listed firms in the country over the pre-treatment period. Standard errors are heteroskedasticity-robust and double-clustered by industry-country and industry-year (*t*-statistics in parentheses). Symbols *, **, and *** indicate statistical significance at the 10%, 5%, and 1% level, respectively.

	Dependent variable: deal volume (log)			Dependent variable: deal number (log)		
Variable	(1)	(2)	(3)	(4)	(5)	(6)
EPL	−0.270***			−0.144***		
	(−3.33)			(−3.73)		
EPL^{y-2}		0.008			−0.047	
		(0.06)			(−0.64)	
EPL^{y-1}		0.055			0.037	
		(0.34)			(0.49)	
EPL^{y+0}		−0.174			−0.032	
		(−1.35)			(−0.48)	
EPL^{y+1}		−0.432***			−0.259***	
		(−2.93)			(−3.26)	
EPL^{y+2}		−0.447***			−0.251***	
		(−3.19)			(−3.59)	
EPL^{y+3}		−0.373**			−0.240***	
		(−2.38)			(−3.47)	
EPL^{y++}		−0.221**			−0.131***	
		(−2.25)			(−2.63)	
$EPL^{Positive}$			−0.254**			−0.232***
			(−1.98)			(−3.72)
$EPL^{Negative}$			0.288***			0.044
			(2.68)			(0.90)
Country controls	Yes	Yes	Yes	Yes	Yes	Yes
Industry × year fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Industry × country fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
N	3,646	3,646	3,646	3,646	3,646	3,646

Governance and Target Selection

Employment protection and takeovers (Dessaint, Golubov, and Volpin 2017)

Additional Findings

- *Increases in employment protection impede layoffs, resulting in wage costs that match the magnitude of synergy losses*
- *Offer prices are not fully adjusted, with both bidders and targets exhibiting lower returns following the reforms*

Table 5
Deals motivated by labor restructuring and Employment Protection Legislation (EPL) reforms.
This table presents difference-in-differences estimates of the effect of EPL reforms on the incidence of mergers and acquisitions (M&A) deals motivated by labor restructuring. Four proxies for labor restructuring–motivated deals are used. In Column 1, *Business Overlap* is a dummy equal to one if the bidder and the target are located in the same country and operate in the same four-digit Standard Industrial Classification (SIC4) industry. In Column 2, *High Productivity* is a dummy equal to one if *Target Abnormal Productivity* is in the top tercile of its distribution over the whole sample, where *Target Abnormal Productivity* is the difference between labor efficiency of the target and industry average prior to deal announcement. In Column 3, *High Restructuring* is a dummy equal to one if *Industry Post-Merger Restructuring* is in the top tercile of its distribution over the whole sample, where *Industry Post-Merger Restructuring* is the average workforce reduction in the target firm industry (SIC4) over the sample period. In Column 4, *High Growth* is a dummy equal to one if the target firm industry *Growth* is in the top tercile of the distribution of all industries in Worldscope in that country-year, where *Growth* is the weighted-average growth in revenues of all firms in a given country and industry (SIC4) over the prior three years. *EPL* is a reform indicator that is set to zero in 1985 and then increments by 1 (−1) each time the target firm country tightens (loosens) employment protection. Country controls include *GDP per Capita*, *GDP Growth*, and *Creditor Rights Index* dummies. Target controls include *Deal Value (log)* and *Defense*. Bidder controls include *Toehold*. Deal controls include *Same Industry*, *Cross Border*, *Stock Payment*, *Multiple Bidders*, *Hostile*, *Public Target* and *Public Bidder*. Industry-year and industry-country fixed effects are based on 13 macro industries defined by SDC. All variables are defined in Table A1 in the Appendix. Standard errors are heteroskedasticity-robust and double-clustered by country and year (*t*-statistics in parentheses). Symbols *, **, and *** indicate significance at the 10%, 5%, and 1% level, respectively.

	Dependent variable			
	Business Overlap	High Productivity	High Restructuring	High Growth
Variable	(1)	(2)	(3)	(4)
EPL	−0.013*	0.052**	−0.022***	0.047*
	(−1.86)	(2.16)	(−3.57)	(1.72)
Industry × year fixed effects	Yes	Yes	Yes	Yes
Industry × country fixed effects	Yes	Yes	Yes	Yes
Country controls	Yes	Yes	Yes	Yes
Target controls	Yes	Yes	Yes	Yes
Bidder controls	Yes	Yes	Yes	Yes
Deal controls	Yes	Yes	Yes	Yes
N	30,569	11,975	28,693	23,292

Governance and Target Selection

Employment protection and takeovers (Dessaint, Golubov, and Volpin 2017)

Implication for Synergy Estimation

Labor-intensive cost reductions (a key driver in *Improve Target Performance* and *Consolidate Excess Capacity* archetypes) may be significantly lower in jurisdictions with strong employment protection.

→ Adjust synergy estimates and acquisition feasibility scores accordingly in cross-border deals.

Governance and Target Selection

Financial Statement Comparability and the Efficiency of Acquisition Decisions (Chen et al. 2018)

Research question

Do acquirers make better acquisition decisions when target firms' financial statements exhibit greater comparability with industry peer firms?

Why do we care?

- Primary role of consolidated financial statements is to provide information
- Better decisions lead to more efficient capital allocation
- Better decisions create value

Governance and Target Selection

Financial Statement Comparability and the Efficiency of Acquisition Decisions (Chen et al. 2018)

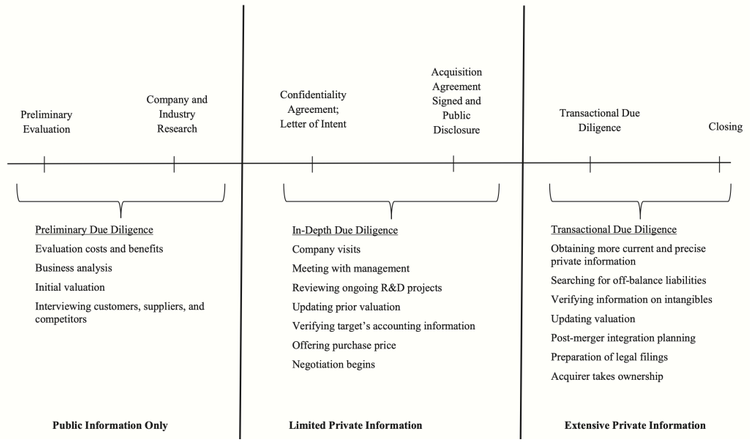
Findings

Acquirers make more profitable acquisition decisions when target firms' financial statements are more comparable.

→ Why do you think that is?

M&A Process

Figure 1 Mergers and acquisitions process



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Findings

- Acquirers make more profitable acquisition decisions when target firms' financial statements are more comparable
- Post-acquisition goodwill impairments and post-acquisition divestitures are less likely

TABLE 3
The effect of target firm's pre-acquisition financial statement comparability on measures of acquisition efficiency

	(1)		(2)		(3)	
	ACQ_CAR		*SYNERGY*		*ΔROA*	
	Coefficient	*t*-stat	Coefficient	*t*-stat	Coefficient	*t*-stat
Intercept	−0.012	−0.88	0.029**	2.29	0.012	0.39
TRG_COMPRNK	**0.017****	**2.04**	**0.018****	**2.22**	**0.025*****	**2.51**
ACQ_SIZE	0.003*	1.77	−0.005**	−2.56	0.006*	1.72
ACQ_LEV	0.047***	3.20	0.020	1.51	0.001	0.03
ACQ_TOBIN_DUM	0.010*	1.69	0.007	1.30	0.017	0.98
ACQ_ROA	−0.005	−0.09	−0.055	−1.00	0.621**	2.42
ACQ_FCF	0.027	0.47	0.065	1.26	−0.655***	−2.70
ACQ_TOBIN_DUM×FCF	−0.016	−0.39	−0.032	−0.85	−0.091	−0.61
TRG_SIZE	−0.009***	−4.12	0.000	−0.14	−0.006	−1.54
TRG_LEV	−0.007	−0.67	0.007	0.68	0.031*	1.85
TRG_TOBIN	−0.001	−1.36	0.000	−0.11	0.001*	1.64
TRG_ROA	0.002	0.17	0.004	0.36	0.006	0.40
STOCK_CORR	−0.072**	−2.58	−0.068***	−2.64	−0.012	−0.32
SYNC	0.032	0.97	0.054*	1.80	0.045	0.86
BLOCK	0.004	0.78	0.008*	1.64	0.005	0.41
ALL_CASH	0.024***	3.66	0.014**	2.35	0.009	1.14
ALL_STOCK	−0.011*	−1.89	−0.016***	−3.05	−0.012	−1.08
TENDER	0.003	0.45	0.015**	2.44	−0.012	−1.43
HOSTILE	0.022	1.43	0.052***	3.69	−0.005	−0.26
DIFFIND	−0.004	−0.77	−0.002	−0.47	0.002	0.26
REL_SIZE	−0.001	−0.17	0.014***	3.22	−0.008	−0.74
Observations	1,307		1,277		1,042	
Adjusted R^2	7.92%		10.73%		6.38%	

Notes: This table reports results of our main tests that examine the relation target firm's pre-acquisition financial statement comparability and the profitability of acquisition-investment decisions. The profitability of acquisition decisions are measured as acquirer's abnormal return (*ACQ_CAR*), combined value-weighted acquirer and target abnormal returns (*SYNERGY*), and post-acquisition firm performance (*ΔROA*) in columns (1), (2), and (3), respectively. Target's comparability (*TRG_COMP*) is ranked into deciles and scaled between zero and one to form a scaled-rank value of comparability (*TRG_COMPRNK*). *t*-stats are based on robust standard errors. ***, **, and * denote two-tailed (one-tailed for targets' comparability) statistical significance at the 1 percent, 5 percent, and 10 percent levels, respectively. See the Appendix for variable definitions.

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Financial Statement Comparability and the Efficiency of Acquisition Decisions (Chen et al. 2018)

Findings

Acquirers benefit most from comparability when acquirers' ex ante information asymmetry is higher, acquirers operate in volatile operating environments, and management knows relatively less about the target

TABLE 5
Tests of the effects of comparability on goodwill impairments and post-merger divestitures

	(1)		(2)	
	GW_IMPAIR		*DIVEST*	
	Coefficient	*p*-value	Coefficient	*p*-value
Intercept	−0.974**	0.032	−3.211***	<0.0001
TRG_COMPRNK	**−0.506****	**0.037**	**−0.405****	**0.040**
ACQ_SIZE	−0.071	0.396	0.305***	<0.0001
ACQ_LEV	0.896*	0.069	1.213**	0.022
ACQ_TOBIN	0.225	0.207	−0.366	0.152
ACQ_ROA	−6.193**	0.041	−4.792*	0.098
ACQ_FCF	5.480*	0.069	7.382**	0.012
ACQ_TOBIN×FCF	−1.360	0.257	3.038*	0.095
TRG_SIZE	0.129*	0.065	−0.068	0.331
TRG_LEV	0.021	0.948	0.168	0.626
TRG_TOBIN	−0.028	0.380	−0.050	0.288
TRG_ROA	−0.650*	0.052	−0.140	0.699
STOCK_CORR	0.893	0.310	0.097	0.916
SYNC	−0.688	0.465	−2.193**	0.045
BLOCK	0.133	0.429	0.233	0.197
ALL_CASH	0.021	0.915	0.238	0.252
ALL_STOCK	0.069	0.683	0.277	0.138
TENDER	−0.019	0.931	0.045	0.833
HOSTILE	−1.000	0.212	−0.112	0.837
DIFFIND	0.182	0.219	−1.583***	<0.0001
REL_SIZE	−0.016	0.926	0.176	0.326
Observations	332/574		298/989	
Percent concordant	61.00%		75.80%	

Notes: This table reports the results of two additional tests that examine whether financial statement comparability results in better merger and acquisition outcomes. In these tests, we examine whether acquirers of high comparability targets are less likely to impair goodwill (*GW_IMPAIR*) or divest the target (*DIVEST*) in the years following the acquisition. *GW_IMPAIR* is an indicator variable equal one if firm *i* records a goodwill impairment (GDWLIP) in fiscal year *t*, *t*+1, *t*+2, *t*+3, or *t*+4, and zero otherwise. An acquisition is defined as having a subsequent divestiture if the acquired target has the same 3-digit SIC code as the divested firm over a seven-year post-acquisition window. Target's comparability (*TRG_COMP*) is ranked into deciles and scaled between zero and one to form a scaled-rank value of comparability (*TRG_COMPRNK*). ***, **, and * denote two-tailed (one-tailed for targets' comparability) statistical significance at the 1 percent, 5 percent, and 10 percent levels, respectively. See the Appendix for variable definitions.

Governance and Target Selection

Common auditors and M&A (Cai et al. 2016)

Research question

Is the quality of mergers and acquisitions (M&As) higher when the acquiring firm and target firm share the same external auditor?

Why do we care?

- Auditors are information intermediaries and can help managers more efficiently allocate their capital
- Auditors can help reduce information asymmetry between acquirers and targets throughout the acquisition process

→ What do you think are the pros and cons of sharing an auditor?

Governance and Target Selection

Common auditors and M&A (Cai et al. 2016)

Findings

- Deals with common auditors have higher acquisition announcement returns than do non-common-auditor deals
- *Common-auditor* effect is more pronounced for deals with greater pre-acquisition uncertainty

Table 4
Common-auditor effect and target uncertainty.
This table presents regression results with interaction terms of common auditor and target uncertainty proxies. The dependent variable is *ANN_CAR*, the cumulative abnormal returns of the value-weighted portfolio of the acquirer and the target from one day before to one day after the deal announcement. The other variables are defined in Appendix A. All the regressions include controls for calendar year fixed effects and Fama and French 48 industry fixed effects whose coefficients are suppressed for brevity. *t*-statistics based on standard errors adjusted for heteroskedasticity (White, 1980) and firm clustering are reported in parentheses. *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively, based on two-tailed tests.

Variable	(1)	(2)	(3)	(4)
Common auditor	0.785**	−0.823	0.992***	−0.852
	(2.117)	(−1.057)	(2.702)	(−1.148)
Common auditor × *Target sales growth*	0.928**			
	(2.026)			
Target sales growth	−0.044			
	(−1.225)			
Common auditor × *Target stock return volatility*		49.922**		
		(2.327)		
Target stock return volatility		−29.836**		
		(−2.373)		
Common auditor × *Target R&D intensity*			0.158***	
			(3.814)	
Target R&D intensity			−0.134***	
			(−3.923)	
Common auditor × *Target bid–ask spread*				37.430**
				(2.532)
Target bid–ask spread				−16.330*
				(−1.764)
Controls	Yes	Yes	Yes	Yes
Year fixed effect	Yes	Yes	Yes	Yes
Industry fixed effect	Yes	Yes	Yes	Yes
Observations	1971	1971	1971	1971
Adjusted R^2	0.196	0.199	0.197	0.199

Governance and Target Selection

Common auditors and M&A (Cai et al. 2016)

Findings

- Increased probability of an M&A for firms with a common auditor

Table 6
Common auditors and M&A likelihood.
This table presents probit regression results of the probability of merger and acquisition (M&A) transactions (marginal effect reported). For each acquirer (target), we define the set of all potential acquirer (target) firms as the ones in the same three-digit standard industrial classification industry with similar size (within 20% band of market capitalization). Our dependent variable is an indicator variable that equals one if an M&A transaction takes place between the potential acquirer and the potential target and zero otherwise. *ROA* is operating income before depreciation, scaled by book value of total assets. *Stock return* is stock returns over the one-year period ending two months prior to the deal announcement. *Industry Herfindahl* is the sum of the squares of the sales market shares over all firms within the industry. The other variables are defined in Appendix A. All the regressions include controls for calendar year fixed effects and Fama and French 48 industry fixed effects whose coefficients are suppressed for brevity. *Z*-statistics based on standard errors adjusted for heteroskedasticity (White, 1980) and firm clustering are reported in parentheses. *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively, based on two-tailed tests.

Variable	(1)	(2)
Common auditor	0.003***	0.002***
	(8.199)	(7.223)
Acquirer characteristics		
Acquirer size		0.001***
		(9.507)
Acquirer Tobin's Q		−0.000
		(−0.732)
Acquirer leverage		−0.001*
		(−1.764)
Acquirer ROA		0.001
		(1.543)
Acquirer sales growth		0.000**
		(2.281)
Acquirer stock return		0.000*
		(1.791)
Acquirer stock return volatility		−0.030***
		(−4.051)
Acquirer industry Herfindahl		−0.027***
		(−2.688)
Target characteristics		
Target size		0.001***
		(5.147)
Target Tobin's Q		−0.000**
		(−2.409)
Target leverage		0.000
		(0.867)
Target ROA		0.001**
		(2.432)
Target sales growth		−0.001***
		(−4.331)
Target stock return		−0.000
		(−1.484)
Target stock return volatility		−0.005
		(−0.939)
Target industry Herfindahl		0.047***
		(7.236)
Year fixed effect	Yes	Yes
Industry fixed effect	Yes	Yes
Observations	232,604	232,604
Pseudo-R^2	0.192	0.237

Governance and Target Selection

Common auditors and M&A (Cai et al. 2016)

Findings

- Lower earnings management
- Higher financial statement comparability

Table 7
Common auditors and financial statement comparability.
This table presents regression results of financial statement comparability measures. The dependent variable in Column 1 is *Diff_Total_Accruals*, the absolute value of the difference in total accruals between the acquirer and the target in the year prior to acquisition announcement, where total accruals are calculated as the difference between income before extraordinary items and cash flows from operations, scaled by beginning of year total assets. The dependent variable in Column 2 is *ECOMP_COV*, the earnings co-movement between the acquirer and the target in the 16 quarters prior to acquisition announcement. In the total accruals difference regression, we control for the minimum value of and the difference in size, leverage, market-to-book, cash flow from operations, losses, standard deviation of sales, standard deviation of cash flow from operations, and standard deviation of sales growth. In the earnings comovement regression, we also control for cash flow comovement and return comovement across 16 consecutive quarters. Refer to Francis et al. (2014) for definitions of control variables. All the regressions include controls for calendar year fixed effects and Fama and French 48 industry fixed effects whose coefficients are suppressed for brevity. *t*-statistics based on standard errors adjusted for heteroskedasticity (White, 1980) and firm clustering are reported in parentheses. *, **, and *** denote statistical significance at the 10%, 5%, and 1% level, respectively, based on two-tailed tests.

	(1)	(2)
Variable	*Diff_Total_Accruals*	*ECOMP_COV*
Common auditor	−0.020**	0.026*
	(−2.215)	(1.742)
Size_diff	−0.006	0.008
	(−1.490)	(1.270)
Size_min	−0.004	0.002
	(−0.808)	(0.255)
LEV_diff	0.041	−0.092**
	(1.165)	(−2.202)
LEV_min	−0.000	−0.024
	(−0.014)	(−0.456)
MB_diff	0.010	−0.010*
	(1.286)	(−1.837)
MB_min	−0.004	0.001
	(−0.582)	(0.067)
CFO_diff	0.380***	
	(4.893)	
CFO_min	0.043	
	(0.500)	
LossProb_diff	0.023	−0.046
	(1.538)	(−1.601)
LossProb_min	0.030	0.005
	(1.094)	(0.134)
STD_Sales_diff	−0.000	−0.000**
	(−1.214)	(−2.047)
STD_Sales_min	−0.000	0.000
	(−0.438)	(0.807)
STD_CFO_diff	0.000	−0.000
	(0.916)	(−0.625)
STD_CFO_min	−0.000	0.000
	(−0.120)	(0.783)
STD_Sales_Grth_diff	−0.007*	−0.006
	(−1.788)	(−1.016)
STD_Sales_Grth_min	0.141***	0.046
	(3.070)	(0.650)
CFO_COMP_COV		0.090**
		(2.261)
RET_COV		0.087**
		(2.458)
Year Fixed Effect	Yes	Yes
Industry Fixed Effect	Yes	Yes
Observations	1679	1513
Adjusted R^2	0.229	0.029

Governance and Target Selection

Summary of Red Flags in Target Governance

Board Structure Concerns

- Insider-dominated board
- CEO/Chairman role combination
- Limited financial expertise on audit committee
- Related party transactions
- Concentrated ownership

Management Team Assessment

- Excessive compensation relative to performance
- Frequent senior leadership changes
- Opaque succession planning
- Limited insider ownership
- Poor track record of capital allocation

Disclosure Quality Indicators

- Minimal voluntary disclosure
- Non-GAAP metrics without reconciliation
- Limited segment reporting
- Vague MD&A discussion
- Delayed filings or frequent extensions
- Minimal investor communications

Accounting Quality Indicators

- Discretionary accruals/Earnings management patterns
- Revenue recognition aggressiveness
- Audit committee independence
- Auditor reputation and tenure
- Financial restatement history

Target Selection

Key Takeaways

Strategic Clarity

- Choose a specific acquisition archetype
- Develop clear criteria based on archetypes
- Measurable performance improvements
- Maintain discipline on premium payments

Governance Matters

- Evaluate target’s governance quality
- Assess acquirer’s governance safeguards
- Watch for CEO hubris and empire building
- Ensure board oversight of acquisition process

Search & Screening

- Tailor financial metrics to strategy
- Look beyond conventional metrics (P/E, EV/EBITDA)
- Assess accounting quality as risk factor
- Quantify potential synergies realistically

Best Practices

- Programmatic approach outperforms occasional large deals
- Focus on improvements that exceed premium paid
- Post-acquisition integration planning
- Update performance targets

Thank You!

RSM Ezafung

Appendix

The Lemons Problem

Akerlof (1970)

- In markets with information asymmetry, sellers know more about quality than buyers
- Buyers therefore price assets based on average expected quality, not true quality
- High-quality sellers may then withdraw because the offered price is too low
- The average quality of assets left in the market declines
- This can lead to adverse selection and even market breakdown

The Lemons Problem in M&A Markets

Akerlof (1970)

- A target's management usually knows more about the business than the acquirer
- Acquirers may fear hidden problems in earnings, assets, contracts, or governance
- That uncertainty reduces willingness to pay or increases the required risk discount
- Due diligence, warranties, earn-outs, and governance checks help reduce the lemons problem

> The lemons problem explains why credible information and verification are essential in acquisition markets: without them, good targets may be undervalued together with bad ones.

OpenAI’s Acquisition of Windsurf

Resources

- TechCrunch: “Why OpenAI wanted to buy Cursor but opted for the fast-growing Windsurf”
- CNBC: “OpenAI looked at buying Cursor creator before turning to AI coding rival Windsurf”
- Dualite.dev: “Windsurf vs. Cursor: Which AI Code Editor is Better?”
- Builder.io: “Windsurf vs Cursor: which is the better AI code editor?”
- TechCrunch: “OpenAI pursued Cursor maker before entering into talks to buy Windsurf for $3B”
- The Prompt Warrior: “Windsurf vs. Cursor - which AI coding app is better?”
- DEV Community: “Windsurf vs Cursor — Initial Thoughts”
- CNBC: “OpenAI in talks to pay about $3 billion to acquire AI coding startup Windsurf”
- TechCrunch: “Windsurf slashes prices as competition with Cursor heats up”
- Cursor.com: Official Website
- Visual Studio Code: Official Website
- Heise Online: OpenAIs acquisition of Windsurf fails, bosses and developers move to Google

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English

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Nederlands

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