MANAGERIAL INCENTIVES, OWNERSHIP STRUCTURE AND GOODWILL IMPAIRMENT: THE CASE OF PUBLIC LISTED COMPANIES IN MALAYSIA

BY

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ABSTRACT

The introduction of International Financial Reporting Standards (IFRS) resulted in a significant change of the accounting treatment for goodwill. This change has been represented by the issuance of FRS 3 - Business Combinations, and FRS 136 - Impairment of Assets. These standards require goodwill to be tested for impairment and the impairment losses to be written off against income instead of amortizing it to earnings over useful economic life. Many countries have adopted these standards with the aim of enhancing the financial reporting quality including Malaysia which adopted Financial Reporting Standards (FRS) in 2006 and beginning 1 January 2006, Malaysian companies are required to comply with all Financial Reporting Standards (FRSs) including FRS 3 - Business Combinations, and FRS 136 - Impairment of Assets. Standard setters' and regulatory bodies such as the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) stated that IFRS 3, which regulates business combinations and IFRS 36, which regulates impairment of assets were issued to provide users with more useful information about the underlying economic value of goodwill. However, the new standards have been criticized by academics and practitioners members for leaving significant rooms for management interpretation, judgment, and bias. Hence, the main purpose of this study is to examine the relationship between managers' incentives and the magnitude of goodwill impairment losses reported by public listed companies in Malaysia. Additionally, this dissertation examines whether the impact of managerial incentives on the magnitude of goodwill impairment losses is moderated by ownership structure. Based on the agency framework it is expected that the magnitude of reported goodwill impairment is influenced by the managerial incentives. Three incentives have been identified, namely debt covenant avoidance, managerial compensation maximization, and political interventional avoidance. This dissertation employs secondary data of listed firms in the Bursa Malaysia derived from annual reports over five years spanning from 2007 to 2011. Based on Tobit multiple regression technique, it is found that managerial incentives to avoid violation of debt covenant is negatively associated with the magnitude of goodwill impairment, which support the debt covenants hypothesis. In addition, firm performance is found to be negatively related to goodwill impairment losses which suggests that firms with low performance record higher goodwill impairment losses and confirmed the Healy (1985) compensations hypothesis. While the direct relationship between firm size and the magnitude of goodwill impairment does not support the political cost hypothesis, the analysis of the moderating effect of ownership structure surprisingly show that, firms with highly concentrated owners, the larger the firm size the higher the amount of goodwill impairment losses, consistent with the political cost hypothesis. However, none of the incentives variables are significantly related to the magnitude of goodwill impairment in the presence of institutional owners.

ملخّص البحث

إن إدخال المعايير الدولية لإعداد التقارير المالية (IFRS) نتج عنه تغيير جوهري في المعالجات المحاسبية لشهرة المحل. هذا التغيير تمثل في اصدار المعيار FRS3 (دمج الاعمال) و FRS136 (انخفاض قيمة الاصول). تتطلب هذين المعيارين من ان تخضع الشهرة لاختبار انخفاض القيمة بحيث تخفض من الدخل بعيدا عن مدى منفعتها الاقتصادية. العديد من الدول تبنت هذه المعايارين بهدف تحسين جودة التقارير المالية ومن ضمنها ماليزيا والتي بدءا من ٢٠٠٦ اصبحت تطالب الشركات بان تتوافق مع جميع معايير إعداد التقارير المالية FRS. هدفت الهيئات التنظيمية لوضع المعايير من إصدار هذين المعيارين الى ان تزود المستخدمين بالمزيد من المعلومات المفيدة حول القيمة الاقتصادية الكامنة وراء الشهرة. في الواقع يوجد هناك انتقادات للمعيارين من اكاديمين ومختصين بسبب انها تترك حيز كبير لتقدير الإدارة، والحكم الشخصي. لذا فان الهدف الرئيسي من هذه الدراسة هو أختبار العلاقة بين دوافع المدراء و حجم خسارة انخفاض شهرة المحل في الشركات المساهمة العامة المدرجة في ماليزيا ومدى تاثرها بتركيبة الملكية. إستنادا الى نظرية الوكالة حددت هذه الدراسة ثلاثة دوافع للمدراء وهي تجنب انتهاك الديون المعهوده وتعظيم التعويضات الإدارية إضافة الى تجنب التدخلات الأجنبية. من خلال التقارير السنوية للشركات المدرجة في البورصة الماليزية من العام ٢٠٠٧ حتى ٢٠٠١ و إستناداً إلى نموذج إنحدار توبت تبيَّن أن دوافع المدراء لتجنب انتهاك عهد الدين يرتبط سلبا مع حجم انخفاض قيمة الشهرة. كما ان أداء الشركات يرتبط سلبيا مع حجم انخفاض قيمة الشهرة وهذا مايؤكد فرضية التعويضات ل Healy (1985). في حين لا توجد علاقة مباشرة بين حجم الشركة و حجم انخفاض قيمة الشهرة الا أن نتيجة تحليل العوامل المعدلة لتركيبة الملكية أشارت الى أن الشركات التي لها ملكية مركزة كلما كبر حجم الشركة كلما كان لها مقدار عالي من خسارة انخفاض قيمة الشهرة وهذا مايتوافق مع فرضية الكلفة السياسية. مع ذلك لم توجد الدراسة أي ارتباط بين دوافع المدراء و حجم خسائر انخفاض قيمة الشهرة في ظل وجود مالكين تأسيسيين.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Sciences (Accounting).

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Alwi Abdulgader Al-Aidaros

Signature …………………………………… Date ……………………….

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LIST OF ABBREVIATIONS

IFRS	International Financial Reporting Standards
FRS	Financial Reporting Standards
IAS	International Accounting Standard
IASB	International Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
MASB	Malaysian Accounting Standards Board
CGU	Cash-Generating Units
MACPA	Malaysian Association of Certified Public Accountants
MIA	Malaysian Institute of Accountants
CIC	Capital Issuance Committee
CEO	Chief Executive Officer
UK	United Kingdom
US	United States
i.e.	That is
etc.	(et cetra): and so forth
et al.	(et alia); and others
e.g.	For example
GDP	Gross Domestic Products
MSWG	Minority Shareholder Watchdog Group
EPF	Employee Provident Fund
LTAT	Lembaga TabungAngkatanTentera4
LTH	Lembaga Tabung Haji5
SOCSO	Social Security Organization

LIST OF TERMS USED IN THE DISSERTATI

No	Term	Definition
1	Goodwill (Excess Profit Approach)	The present value of a number of years of abnormal expected returns for the type of business concerned.
2	Goodwill (Residuum Approach)	The difference between the purchase price and the fair market value of an acquired company's assets.
3	Goodwill (FASB)	The excess of the cost of an acquisition price over the fair value of acquired net assets.
4	Goodwill (IFRS)	An asset representing the future economic benefits arising from other assets acquired which are not individually identified and cannot be recognized separately.
5	Impairment of Goodwill	Verifying whether any changes in the value of goodwill have occurred.
6	Cash-Generating Unit (CGU)	The smallest identifiable group of assets that generates cash inflows which are substantially independent of cash inflows from other assets or group of assets.
7	Value in Use	The standards as "the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life.
8	Exit Value	The amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, which is also referred to as the fair value, less the costs of disposal.

CHAPTER ONE

INTRODUCTION AND OBJECTIVE OF STUDY

1.1 INTRODUCTION

The dissertation examines the association between managerial discretion and the impairment of goodwill reported by public listed firms in Malaysia. The issue of goodwill has been extremely debatable topic for decades which received a great deal of attention from various accounting standard-setting bodies. The attention accorded to this topic is motivated by the growing recognition of goodwill as an economic resource for both investors and managers (Wang, 2008).

January 2006 marked the introduction of accounting standards on goodwill in Malaysia with its implementation in February of the same year. Starting from 1 February 2006, Malaysian companies are required to comply with FRS 3 - Business Combinations, and FRS 136 - Impairment of Assets in the preparation and presentation of financial statements that were issued by the Malaysian Accounting Standards Board (MASB).

Prior to this period, accounting standard on goodwill did not exist in Malaysia (Carlin, Finch, and Laili, 2009). During this period, three approaches were commonly employed for accounting treatment of purchased goodwill. First, goodwill used to be capitalized as a permanent item but subjected to periodic review for write down purposes. Second, goodwill used to be capitalized and subjected to systematic amortization against profit and loss and third, immediate write-off against reserves.

The new standards introduced a formal requirement that transformed goodwill from being amortized to systematic impairment testing (MASB, 2005, para. 55).

Goodwill impairment testing is based on specific procedures which are designed to prevent the carrying value of an asset to exceed its recoverable value. As such, two values are to be calculated in order to get the recoverable amount of an asset. The two values are the fair value less costs to sell and its value in use. Value in use is defined in the standards as “the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life” (IFRS, 2007).

Standard setters and regulatory bodies such as the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) argue that goodwill impairment testing under the new standards is aimed to provide users with more useful information about the underlying economic value of goodwill; thereby increasing the quality and consistency of reporting practices. However, the new standards have been criticized by academics and practitioners, for leaving significant room for management interpretation, judgment, and bias in determining the recoverable amount of an asset (Lin and Hsu, 2008). Likewise, it is stated in prior literature that goodwill impairment testing introduces a significant range for uncertainty and bigger opportunity for creative accounting (Wines, Dagwell and Windsor 2007); allows for substantial management judgments (Pettersen and Plenborg, 2010), and hence, given rise to opportunistic behaviours (Bini and Bella, 2007) and bias (Guler, 2007).

According to AbuGhazaleh, Al-Hares and Roberts, (2011), goodwill impairment testing provides an opportunity for managers to use the discretion permitted in the standards to overstate, understate, or simply unable to recognize the goodwill impairment loss. As a result, it will not reflect the underlying economics of the firms.

The existence of managerial discretion can be explained by the agency theory which can be described as the relationship between the principals, such as shareholders, minority owners or the creditors, and the agents, such as managers, or majority owners. It is believed that the agents have an incentive to act in their own interest to the detriment of the principals (Jensen and Meckling, 1976).

Accordingly, it is argued that managers will exercise the discretion inherent in the goodwill standards in circumstance where they have agency-based motives to act opportunistically in terms of their own incentives (Watts, 2003). Contracting cost theory suggests that managers' incentives to act opportunistically are derived from the flexibility available in both the contracts and accounting procedures. Specifically, it is expected that managers' choice will be driven by their desire to avoid the violation of debt covenant; to maximize the managerial compensation, and to minimize the possibility of regulatory interference (Watts and Zimmerman, 1990). Thus, based on the managerial discretion permitted on goodwill impairment testing approach (AbuGhazaleh, et al., 2011; Ramanna and Watts, 2012), and on related implications of agency theory (Jensen and Meckling, 1976), and contracting theory (Watts and Zimmerman, 1986, 1990), the objective of this dissertation is therefore aimed at investigating the influence of managerial incentive on the goodwill impairment losses reported by the public listed companies in Malaysia. The next section presents the objectives, motivations and significance of this dissertation.

1.2 OBJECTIVES OF THE DISSERTATION

This dissertation has three main objectives. Firstly, to examine the association between managerial incentives and the magnitude of goodwill impairment losses reported by public listed companies in Malaysia. Specifically, this dissertation focuses on managerial incentives to avoid debt covenants; to maximize managerial compensation and to avoid political intervention. Secondly, this dissertation also aims at exploring the association between "big bath" reporting behaviour and the magnitude of reported goodwill impairment losses. Particularly, this dissertation investigates the impacts of CEO changes and crisis effect on the magnitude of goodwill impairment losses. Thirdly, this dissertation extends the existing literature by examining whether the association between managerial incentives and the magnitude of goodwill impairment losses reported by public listed companies in Malaysia is influenced by the ownership structures of the companies. In particular, this dissertation investigates the impacts of concentrated ownership and institutional ownership on the relationship between managerial incentives and the magnitude of goodwill impairment losses.

1.3 RESEARCH QUESTIONS

Sequel to the research objectives mentioned above, the present dissertation seeks to provide answers to the following research questions:

1. Is there any relationship between managers' incentives and the magnitude of goodwill impairment losses reported by public listed companies in Malaysia?
2. Is there any association between "big bath" reporting behaviour and the magnitude of goodwill impairment losses reported by public listed companies in Malaysia?
3. Is the effect of managerial incentives on reported goodwill impairment losses influenced by the ownership structures of public listed companies in Malaysia?

1.4 MOTIVATION OF THE STUDY

It is generally believed that managerial incentives are motivated from agency problem that exists due to the conflict of interests between agents and principals. Prior literature suggests that the type of agency problems vary according to different business environment. For example, when ownership is diffused, as in the case of developed countries, agency problems arise due to conflicts of interest between outside shareholders and the managers of the firms (Jensen and Meckling, 1976). However, when ownership is concentrated, as in the case of East Asia, the nature of the agency problem shifted from manager–shareholder conflicts to conflicts between the controlling owners and minority shareholders (Fan and Wong, 2002).

A number of studies have investigated the issue of managerial incentives in relation to the goodwill impairment in developed countries, where the traditional perspective of agency conflict exist between managers and shareholders (Beatty and Weber, 2006; Lapointe-Antunes, Cormier and Magnan, 2008; AbuGhazaleh, et al., 2011; Onesti and Romano, 2012; Siggelkow and Zülch, 2013). However, evidence from other contexts, especially the developing countries is very limited. Motivated by the dearth of literature on this issue in relation to developing countries, this study seeks to fill this gap by investigating the relationship between managerial incentives and the magnitude of goodwill impairment losses reported by public listed companies in Malaysia from the alternative perspective of agency theory i.e. the conflict between majority and minority shareholders. Malaysia is chosen because of its highly concentrated business environment as well as the availability of data that is readily offered on the Bursa Malaysia website.

1.5 SIGNIFICANCE OF THE DISSERTATION

This dissertation aims to contribute to the body of knowledge and understanding about the influence of managerial incentives on the magnitude of reported goodwill impairment losses, particularly among public listed companies in Malaysia. The empirical findings of the dissertation are expected to contribute to extant literatures related to the relevance of the traditional agency theory in explaining managers' behaviour for the case of emerging economies with specific focus on Malaysia.

In addition, the results of this dissertation might be useful to stakeholders, particularly the potential investors, and managers, and both financial statements' preparers and accounting analysts to enhance their understanding of managerial incentives in relation to goodwill impairment. In addition, it is expected that the findings of the present study would shed some light in understanding the effect of ownership structure on the relationship between managerial incentives and the magnitude of goodwill impairment losses. This could also help the authorities in evaluating the role of the existing ownership structure in Malaysian companies in relation to managerial incentives and goodwill impairment losses. Moreover, Malaysian Accounting Standards Board (MASB) could benefit from the findings of this study by becoming more aware of whether or not the existing requirements imposed by the new accounting standards of goodwill impairment are heading in the right direction. In addition, results from this dissertation provide useful information for regulators in term of assessing or considering changing accounting regulation related to goodwill impairment under IFRS.

1.6 ORGANIZATION OF THE DISSERTATION

The dissertation consists of six chapters. Chapter one provides an overview of the dissertation and explains its significance. The motivation for undertaking the dissertation, the objectives and contributions are also discussed in this chapter. Chapter two explains the theoretical concepts relating to goodwill and the impairment of goodwill as well as the accounting treatments of goodwill in Malaysia. Chapter three explains the theoretical framework that provides the rational for the conflicts that potentially influence managerial incentives and goodwill impairment reporting and reviews prior researches. Chapter four presents the hypotheses developed for explaining the relationship between managers' incentives and the magnitude of reported goodwill impairment losses, as well as the research design, which describes the sample selection, data collection, variables and statistical measurement used for data analyses. Chapter five presents the results of the dissertation. Chapter six concludes this dissertation by summarizing the key findings of the dissertation. In addition, it provides the limitations of the dissertation, as well as suggestions for future research. It also discusses the implications and contribution of the dissertation. The next chapter will provide an introduction of the concepts of goodwill and the impairment of goodwill as well as the accounting treatments of goodwill in Malaysia.

CHAPTER TWO

CONCEPT OF GOODWILL IMPAIRMENT AND ACCOUNTING FOR GOODWILL IN MALAYSIA

2.1 INTRODUCTION

This chapter explains the theoretical concepts relating to goodwill and the impairment of goodwill as well as the accounting treatments of goodwill in Malaysia. The chapter is organized as follows: First, it explains the concepts of goodwill and goodwill impairment. Second, it presents the accounting for goodwill prior to IFRS in Malaysia. Thirdly, it presents accounting for goodwill under IFRS in Malaysia. Lastly, the chapter ends with a summary and conclusion.

2.2 CONCEPTS OF GOODWILL AND IMPAIRMENT OF GOODWILL

The concept of goodwill has been a debatable topic for decades. In accounting literature, goodwill can be defined based on two different approaches, namely the excess profit approach and residuum approach (Johnson, 1993). According to the excess profit approach, goodwill is defined as the present value of a number of years of abnormal expected returns for the type of business concerned. Thus, in this view the total value of a business is the sum of the present values of the normal returns from the identifiable net assets, and the present value of the super-normal returns (Bryer, 1995). The residuum approach on the other hand describes goodwill as the difference between the purchase price and the fair market value of an acquired company's assets. As such, goodwill is a leftover amount that cannot be determined, after a thorough investigation, as any other tangible or intangible assets (Johnson and Tearney, 1993).

The accounting treatment of goodwill has been a controversial subject over the years. Prior to IFRS, three different approaches were used in treatment of goodwill. One view was in favour of writing the goodwill off immediately against reserves. While opposing view was to amortize goodwill to earnings over its useful economic life. A third view was to capitalize goodwill as a permanent item with no full write-off or amortization.

In relation to accounting standards, two standards dominated the accounting treatments for goodwill prior to IFRS. The two standards are APB Opinion no. 17, Intangible Assets in the United States, and IAS 22 Business Combinations in Europe. Both standards required goodwill to be reported as an asset and amortized on a straight-line basis above its useful life (IASC 22.50, 1983; AICPA, 1970). However, APB Opinion 17 required any goodwill to be reported following an acquisition to be amortized over a period not exceeding 40 years, while IAS 22 considered the amortization period to be only 20 years.

In the early of 1990, the amortization approach for goodwill under APB 17 and IAS 22 were criticized as investors felt that these methods failed to reflect the true value of goodwill and the firms' intangible assets (e.g., Jennings, Robinson and Thomson, 1996; Lhaopadchan, 2010). More adequate information and proper ways to identify, measure and recognize goodwill were suggested (Jerman and Manzin, 2008).

In 2001, the Financial Accounting Standard Board (FASB) issued the Statement of Financial Accounting Standards (SFAS) 141-Business combinations and 142-Goodwill and Other Intangibles. The Statements adopt a different way on how the goodwill has to be subsequently treated for its first recognition and eliminates the amortization of goodwill. According to the new accounting standard (SFAS 141), goodwill is defined as the excess of the cost of an acquisition price over the fair value of acquired net assets (FASB, 2001).

In 2004 International Accounting Standard Board (IASB) released the International Financial Reporting Standard (IFRS) 3-Business Combinations and the revised International Accounting Standard (IAS) 36-Impairment of Assets and (IAS) 38-Intangible Assets, which provided a significant change in the accounting treatment of goodwill. It introduced a more relevant approach for goodwill to be properly identified, measured and recognized. According to these standards, goodwill is defined as the difference between the cost of the acquisition over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities. Goodwill recognition requires the valuation of fair value of all identifiable intangible and tangible assets (IFRS, 2007). Therefore, goodwill is defined as an asset representing the future economic benefits arising from other assets acquired which are not individually identified and cannot be recognized separately (IFRS, 2007). Hence, the concept of goodwill under IFRS becomes more efficient as it is related to firms' future growth and economic benefits, hence reflecting proper information about intangibles assets of the firm.

On the other hand, after the initial recognition of goodwill, test for annual impairment is required by IFRS or more frequently if circumstances indicate that it might be impaired. An impairment of goodwill was defined as verifying whether any changes in the value of goodwill have occurred (Lemans, 2009, pp22). In other words, when the carrying value of the goodwill exceeds the fair value, then it is considered to be impaired. FASB (2001) and IFRS (2007) claim that goodwill impairment is better to reflect the underlying economic value of goodwill than amortization. Donnelly and Keys (2002) noted that, different to goodwill amortization, goodwill impairment