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Reporting incentives, ownership concentration by the largest outside shareholder, and reported goodwill impairment losses

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A R T I C L E I N F O

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A B S T R A C T

This paper examines the determinants of reported goodwill impairment losses by Malaysian listed companies from 2006 to 2010. The results show managers' reporting incentives are significantly associated with the reported impairment losses. The results also show that the effect of "big bath" reporting on the reported impairment losses was moderated by the largest outside shareholder ownership concentration. Further analyses reveal that "big bath" reporting is not found in companies with a controlling outside shareholder. These findings suggest that increased ownership by the largest outside shareholder is associated with increased shareholder monitoring of the managers' "big bath" reporting.

1. Introduction

This paper examines the determinants of reported goodwill impairment losses by Malaysian listed companies from 2006 to 2010, following the implementation of an impairment-only approach to accounting for acquired goodwill. The impairment-only approach was required by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board of the US (FASB) as part of their joint initiative on accounting for business combinations.[1] Since its implementation, the impairment-only approach has attracted considerable attention from practitioners, standard-setters, and academics (e.g., AbuGhazaleh et al., 2011; Beatty and Weber, 2006; Godfrey and Koh, 2009; Mohd-Saleh and Omar, 2014; Ramanna and Watts, 2012). Initiatives have also been advanced by standard-setters to ensure consistent implementation of the approach and to understand any unintended consequences arising from its implementation. One recent initiative was the discussion surrounding the Post-implementation review of International Financial Reporting Standard 3 *Business Combinations* (IFRS 3) by the IASB in February 2015 (IASB, 2015).

Much attention on goodwill impairment focuses on the element of managerial discretion inherent in the impairment test of goodwill and on whether managers use that discretion to manipulate the write-off when they have incentives to do so (AbuGhazaleh et al., 2011; Chalmers et al., 2011; Ramanna and Watts, 2012). Although prior studies agree on the existence

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[1] The joint initiative resulted in the issuance of IFRS 3 and SFAS 142 by the IASB and FASB, respectively. Although both of the standards require companies to perform an impairment review of goodwill, they differ concerning the method of determining the impairment, the allocation of goodwill, and the calculation of the impairment loss (Ernst & Young, 2009).

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of managerial discretion in the impairment test of goodwill, their findings on the motives for reporting impairment losses are inconclusive. One stream of research (e.g., Beatty and Weber, 2006; Ramanna and Watts, 2012) finds that reporting incentives influences the reporting of the impairment losses, whereas another stream of research (e.g., AbuGhazaleh et al., 2011; Godfrey and Koh, 2009) shows that the reporting of goodwill impairment losses reflects the underlying economic attributes of goodwill. The inconclusive evidence documented by prior studies suggests that further study is required in this area.

This paper extends the literature on accounting discretion related to goodwill impairment by testing four main hypotheses. The first two hypotheses are similar to those of prior studies; thus, the present study examines the influence of companies' economic factors (Hypothesis 1) and reporting incentives (Hypothesis 2) on the reporting of goodwill impairment losses by Malaysian listed companies. The last two hypotheses test features that are specific to listed companies with concentrated ownership. In the third hypothesis, this study tests the influence of inside ownership concentration, using managerial ownership as a proxy variable. In the fourth hypothesis, it tests the influence of the largest outside shareholder ownership concentration. This is done in three ways. First, I test whether the largest outside shareholder performs an important monitoring function by ensuring that the reported goodwill impairment losses reflect the underlying economic value of goodwill. Second, I test whether the largest outside shareholder plays a governance role by mitigating managers' reporting incentives. Third, I ran two separate multivariate Tobit regressions: one for companies with a controlling outside shareholder (the largest outside shareholder who owns 50% or more of the shares) and another for companies with a non-controlling outside shareholder.

This study is important for the following reasons. First, studies by Claessens et al. (2000) and Faccio and Lang (2002) show that ownership concentration is a common feature in many public corporations in Asia and Continental Europe. However, to the best of my knowledge, few comprehensive studies have been conducted analyzing the link between ownership concentration and managers' decisions in reporting goodwill impairment losses. Second, La Porta et al. (1998) and Gilson (2006) highlight that some concentrations of ownership might be efficient for companies because those concentrations provide incentives for managers to work and for large investors to monitor managers. Lins (2003) suggests that large external shareholders play a role in restraining managerial agency costs. Therefore, understanding the role of the largest outside shareholder concerning reporting goodwill impairment losses is essential in enhancing our understanding of managers' accounting choices, particularly in the case of goodwill impairment, in which managers are afforded discretion when performing the impairment test, and the reporting of impairment losses directly affects reported earnings.

This study uses Malaysian data for three main reasons. First, Malaysian listed companies, akin to listed companies in other emerging markets, are reported to have concentrated ownership (La Porta et al., 1998; Leuz et al., 2003). Leuz et al. (2003) report that in 1990–1999, the median shareholding of the largest three shareholders of listed companies in Malaysia was 52%, whereas for the UK and the US, the corresponding percentages were 15% and 12%, respectively. Likewise, Claessens et al. (2000) reveal that approximately 40% of the Malaysian listed companies they examined in 1998 were controlled by a single shareholder. The high ownership concentration of Malaysian listed companies not only allows the present study to examine the influence of the ownership concentration on the reporting of goodwill impairment losses but also provides the study with an opportunity to examine whether the largest outside shareholder plays a governance role.

Second, goodwill impairment deserves special attention in Malaysia because, prior to the implementation of the impairment-only approach, the country had no specific accounting standard on goodwill (Pillai, 2006) because the standard-setter faced resistance from large corporations and the business community in developing the standard (Susela, 1999). The history of companies resisting an accounting standard on goodwill based on its suitability provides a unique setting to examine the motives of Malaysian listed companies in reporting goodwill impairment losses following implementation of IFRS 3.

Third, prior studies on goodwill impairment tend to focus on listed companies in developed economies (e.g., AbuGhazaleh et al., 2011; Beatty and Weber, 2006; Godfrey and Koh, 2009; Ramanna and Watts, 2012). These economies not only have a history of regulated accounting for goodwill (e.g., Li et al., 2011) but also have stronger mechanisms to enforce higher quality financial reporting than is currently practiced in the emerging economy of Malaysia (Ball et al., 2003). In Malaysia, regulatory attention on enforcing goodwill accounting following the implementation of IFRS 3 seems lacking relative to developed countries. There are neither compliance programs nor enforcement intensity focusing on goodwill accounting on an annual basis. This relatively weak enforcement in Malaysia provides an interesting setting to investigate how goodwill accounting regulation, which arises from conforming to the IASB, is likely to affect managerial decisions concerning reporting impairment losses.

With the aforementioned reasons, what should one expect to observe in the data? First, I would expect that the history of companies resisting an accounting standard on goodwill based on its suitability pre-IFRS 3 is likely to affect how managers behave concerning reporting goodwill impairment losses following the implementation of IFRS 3. Realizing the lack of regulatory attention in Malaysia on enforcing goodwill accounting post-IFRS 3, managers might exercise the discretion inherent in the impairment test of goodwill to influence reported earnings when they have incentives to do so. Second, if the largest outside shareholder performs effective monitoring, I would expect the reporting of goodwill impairment losses to reflect the underlying economic values of goodwill. With this governance role, I also would anticipate the increased ownership concentration to be associated with increased shareholder monitoring of management and thus weaken managers' reporting incentives.

Consistent with the above expectations, empirical results show a significant association between reported goodwill impairment losses and reporting incentive variables after controlling for company-specific factors. Similar to prior studies (e.g.,