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Family and Government Influence on Goodwill Impairment: Evidence from Malaysia

Noraini Omar[1] and Norman Mohd-Saleh[1]

[1]Universiti Kebangsaan Malaysia

Abstract. Prior studies suggest that managers have the tendency to recognize goodwill impairment loss to signal future decline in performance or as a means of earnings management. Since prior studies suggest that corporate ownership could influence reporting quality, this paper argues that the family and government ownership, which are common in Malaysia could have some influence on the recognition of goodwill impairment loss. Evidence shows that family controlled firms are more likely to record impairment of goodwill than non-family controlled firm. The effect is however not significant for government controlled firm. In addition, firms that are expected to engage in income smoothing behavior significantly report higher magnitude of goodwill impairment loss than firms that are not expected to engage in income smoothing behavior. Additional analysis suggests that firms are more likely to recognize and record higher goodwill impairment loss in the first year of impairment standard adoption than in the years afterwards. The result of this study contributes to current literature by providing the evidence that managers in family controlled firm has significant influence on goodwill impairment.

Keywords: Goodwill impairment, family controlled firm, government controlled firm

1. Introduction

Studies in the U.S., U.K., Australia and the European countries provide evidence that managers have the tendency to recognize goodwill impairment loss while they were experiencing a decline in profitability (Haman and Jubb, 2008), to engage in income decreasing incentives (Poel et al., 2009) and to avoid debt covenant violation (Beatty and Weber, 2006). This issue may become severe in a country like Malaysia since this country had never had any proper standard on goodwill. There have been practices to write off goodwill against reserve or capitalize and amortize goodwill over its useful economic life (following the other jurisdictions' accounting standards). The introduction of Financial Reporting Standard (FRS) 136 *Impairment of Assets* which is more complex, may give greater challenges for the management to fully comply with the standard particularly when it involves goodwill (Wines et al., 2007). In addition, businesses in Malaysia, being part of the Asia, are highly concentrated (Claessens et al., 2000) and largely influenced by the government (Ball, Robin and Wu 2003) and families (Claessens et al., 2000). Against this background, it is an empirical question whether these impairment charges fully reflect the economic value of goodwill or rather the effect of manager's manipulation over accounting numbers. Therefore, the objective of this paper is to investigate the effect of two types of highly concentrated ownership structure; family controlled firms and government controlled firm on the recognition of goodwill impairment loss in the transition year of the new impairment standard in Malaysia.

Some unique characteristics of Malaysian businesses i.e. involvement of government and families in firms though share ownership provides an opportunity for this paper to contribute to the literature by investigating the issue of goodwill impairment. Thus far, prior studies on goodwill impairment do not concentrate the discussion on the specific incentives that may come from the government or families. It is hoped that this paper could shade some light into this issue since the government and family ownerships are common in Asian countries. An additional insight is given by an investigation of the management behaviour, with respect to goodwill impairment, in the transition year of new accounting standards.

The remainder of the paper is structured as follows. Section 2 discusses the literature review. Section 3 presents the development of hypotheses and research methodology followed by results in Section 4. Section 5 provides the statistical result and section 6 discusses the findings and conclusion of this paper.

2. Background, literature and hypotheses

2.1. Background

Internationally, there are different practices to record goodwill. Consistent with the International Accounting Standards (IAS) 22, some countries allow acquired goodwill to be either recognized as an asset and amortized or immediately adjusted against shareholders' interest. There was some debate on the amortization period since the benefit is not tangible and cannot be assured. Some jurisdiction suggested 40 years (in the US since 1970) or 20 years (requirements in the US after 1999, Australia and New Zealand). In 1998, International Accounting Standard Committee (IASC) revised IAS 22 and proposed that useful economic life of goodwill may exceed 20 years but is subjected to impairment review.

Goodwill acquired in a business combination should be tested for impairment annually or if there is circumstances[1] that raised the need for impairment loss to be recognized (para 7, FRS 3). In Malaysia, due to lack of liquid active market, the use of value-in-use method (that requires estimation of future cash flows and a discount rate) is common in the determination of recoverable amount i.e. an amount to be compared with the book value (Carlin et al., 2009). Another difficulty is in determining appropriate cash generating units (CGU[2]). This introduces difficulty for management and auditors' to assess the reasonableness of the assumptions that is use on current cash flow projections (Wines et al., 2007). During the transition year from amortization method to impairment, companies may have the tendency to record larger impairment in the year of adoption as the effect is regarded non-recurring.

In terms of the direction of earnings management in the goodwill context, prior studies focus on two perspectives i.e whether the behaviour is consistent with "big bath" theory or income smoothing (Poel et al., 2009). Managers who have the incentives to increase their reported profit (income increasing incentives) will have the tendency to reduce their reported expenses by not recognizing impairment loss on goodwill. Whereby, managers with the incentives to reduce their reported profit (income decreasing incentives) will have the tendency to record larger impairment loss on goodwill. These issues are investigated in this paper.

2.2. Family and Government Controlled Firms

Malaysia is identified as a country with high political connection and high concentrated shareholding that may reduce the level of financial reporting quality (Ball et al., 2003). Therefore as the controlling owner oversees the accounting report, they have a strong opportunistic behavior and the market perceive them as they will not report high quality accounting information (Fan and Wong, 2002). In Malaysia, the types of concentrated ownership structure are dominated by two groups of firms which are family controlled firms and government controlled firm. Since most of the large firms in Malaysia are very much influenced by government agencies due to substantial government shareholdings while some other firms are mostly run by families, the likelihood of these managers to use goodwill as a tool to manage earnings is quite high.

The effect of family controlled firm on earnings management is mixed due to two opposing views; entrenchment (agency cost type II) versus alignment effect (agency cost type I). Anderson, Mansi and Reeb (2003) mentioned that family controlled firm has a better knowledge of their business activities which enabled them to detect manipulation of accounting numbers. Founding families firms will limit managers' ability to manage earnings (Jiraporn and Dadalt, 2007) but there is also a likelihood that the controlling families engage in expropriation of minority shareholders' interest that would result in lower performance (Fan and Wong 2002). Due to high level of concentration, ineffective communication of information (Fan and Wong, 2002), and weak shareholders protection, the second incentive may dominate i.e. controlling

[1] The circumstances are when there is significant underperformance relative to historical or projected future operating result, significant changes in the manner the company use of underlying assets, and significant adverse industry or market economic trends.

[2] A cash generating unit is defined in International Financial Reporting Standard (IFRS) 136 as the smallest identifiable group of assets that generates cash flows that are largely independent of the cash inflows from other assets or groups of assets

family may engage in expropriation of minority shareholders wealth. Thus, value damaging expropriation activities may results in lower recoverable CGU amount and, goodwill impairment loss is unavoidable.

Thus,

H1 :The occurrence of goodwill impairment loss is greater in family controlled firms than non-family controlled firms.

On the other hand, government controlled firm in Malaysia is comprised of the Government Linked Firms (GLCs), their subsidiaries and affiliates and state-owned firms.[3] Malaysia is known with the close linkage between many large corporations and conglomerates with the government. This close connection may resulted in an exclusive business relationship with state owned enterprises and thus have a preferential access to major government contracts (Gomez and Jomo, 1999). Prior studies found that the extent of government intervention on firm's performance is mixed due to two different perspectives. Some firms with government intervention performed better as they are under the "watchful eyes of the public" and thus more concerned to maximize the shareholders' value (Ang and Ding, 2006). The other firms with high government ownership are restricted on their innovation and more focus on public service which resulted in poor performance (Wei and Varela, 2003). At the same time, government controlled firm has conflict to maintain a good reputation by reporting high performance as they are managing the capital of the society through government agencies.

This leads to the second hypothesis;

H2: The occurrence of goodwill impairment loss is lower in government controlled firms than non-government controlled firms.

3. Research Method

To measure family controlled firm, this paper use a dichotomous variable. If the firm's largest shareholders are an unlisted private firm and the owner of the private firm is identified as belongs to one of the directors, it is also included as a family controlled firm (Faccio and Lang, 2002). In addition, if the total shareholdings of the family members sitting on the board are more than 20%, the firms are also categorized as family controlled firm. This information is provided in the Director's Profile section of the annual report. Meanwhile, all firms that are listed as GLCs, subsidiaries of GLCs, and state owned firms in government reports are categorised as government controlled firms. A cut off point of 20% is used to indicate the controlling power of the GLICs or other government agencies in those particular firms. All other variables are as described in the equation.

We include control variables to control for other effects on the propensity to record goodwill impairment loss and this is described in Table 1. Following Poel et. al. (2009), the direction of earnings management used a proxy for big bath using indicator variable of one if the change in firms' pre-impaired earnings in prior year divided by prior year total asset is below the median of non-zero negative values, and a proxy for smoothing effect indicator variable of one if the change in firms' pre-impaired earnings in prior year divided by prior year total asset is below the median of non-zero positive values.

The sample firms must also satisfy the goodwill balance selection criteria i.e. (1) the firms must have positive goodwill balance at least in one of the three years prior to FRS 3 adoption, and (2) the firms must either have positive goodwill balance in at least one year after FRS 3 adoption, or have positive beginning goodwill in their year of adoption.

The sample from OSIRIS that has all data required (and after deleting outliers with very large standardized Z-scores) contains 579 observations from year 2006, 2007 or 2008. This research utilized binary-logistic regression model.

4. Results and discussions

[3] Government linked firms (GLCs) are defined as firms that have a primary commercial objective and in which the Malaysian Government has a direct controlling stake (PCG, 2006). GLC are controlled by the Malaysian Government via Federal Government-Linked Investment Co (GLICs) (Lau and Tong, 2008).

The data shows that the mean for variable FAM is lower (0.67) in firms that do not impair goodwill compared to firm that impair goodwill (0.77). Examination of the correlation matrix indicates that there is no correlation greater than 0.80. The highest correlation is between ROACHG and BATH and SMOOTH at 0.66 and 0.65 respectively.

Table 1: Binary-Logistic Regression

$IMP_{it} = \beta_{it} + \beta_1 FAM_{it} + \beta_2 GOV_{it} + \beta_3 BATH_{it} + \beta_4 SMOOTH_{it} + \beta_5 CEOCHG_{it} + \beta_6 CEOTEN_{it} + \beta_7 CEODUAL + \beta_8 INDPAC + \beta_9 INDPBOAD_{it} + \beta_{10} BIG4_{it} + \beta_{11} MEANAMORT_{it} + \beta_{12} FOREIGN_{it} + \beta_{13} LEV_{it} + \beta_{14} ROA_{it} + \beta_{15} \Delta ROA_{it} + + \beta_{16} EXPIMP\_GWB_{it} + \beta_{17} FIRMSIZE_{it} + \beta_{18} GW\_BEGTA_{it} + \beta_{19} ADOPT_{it} + e_{it}$... Equation 1

Variable	*Coefficient*	*z-Stat*	*Variable*	*Coefficient*	*z-Stat*
Test variables			*Control variables*		
FAM (+)	0.6404**	1.9806	MEANAMORT (-)	-0.0109*	-1.5238
GOV(-)	0.2735	0.6265	FOREIGN (?)	-0.0098	-1.2664
BATH (+)	0.3484	1.2614	LEV (-)	-0.0077*	-1.3515
SMOOTH (+)	0.3275	1.1275	ROA (-)	-0.0565***	-3.8082
			ROACHG (-)	-0.0399***	-2.2828
Corporate governance variables			EXPIMP_GWB (+)	-0.1946	-0.8011
CEOCHG (+)	0.6099**	1.6554	FIRMSIZE (+)	0.6190***	3.0958
CEOTEN (+)	0.0288**	2.0993	GWB_BEGTA (+)	-0.0168	-1.2958
CEODUAL (+)	0.4119*	1.6113	ADOPT (+)	0.4039**	1.8724
INDPAC (?)	0.0055	0.7444	C	-5.2285***	-4.2992
INDPBOD (?)	-0.0050	-0.5026			
BIG4 (?)	0.0401	0.1800			
McFadden R-squared 0.0859					

,,***significant at 1%, 5% and 10 % significance levels.* Tests are one-tailed if directional prediction, two-tailed otherwise. Z-statistics are based on robust standard errors

Where IMP is an indicator variable equal to one if impairment loss is recorded and zero otherwise, FAM is a dichotomous variable equal to one if the firm is a family controlled firm and zero otherwise, GOV is a dichotomous variable equal to one if the firm is a government controlled firm and zero otherwise, BATH - dichotomous variable of one if the pre-impaired earnings is below the median non-zero negative values, otherwise zero, SMOOTH - dichotomous variable of one if the pre-impaired earnings is above the median non-zero positive values, otherwise zero, MEANAMORT- percentage of mean of amortization in last three years prior to adoption of FRS3, FOREIGN- percentage of foreign shareholdings, LEV- prior year total liability to prior year total asset ratio, ROA- return on asset measured as earnings before tax over beginning total asset, ROACHG- changes in return on asset, CEOCHG- dichotomous variable of 1 if there is a change in CEO, otherwise zero, CEOTEN- number of years of service by CEO, ADOPT- dummy variable of one if the firm is in the year of transition to FRS 3, otherwise zero, EXPIMP_GWB- percentage of amount expected to be impaired measured by the amount of difference between the book value of equity and market value of equity(if this amount is not greater than the amount of goodwill or equal to zero if market value exceeds the book value) divided by the opening balance of goodwill, FIRMSIZE - natural logarithm of total asset, GWB_BEGTA- percentage of beginning goodwill over beginning total assets, CEODUAL- dummy variable of one if the CEO is also the chairman of the firm, otherwise zero, INDPAC- proportion of independent directors on the audit committee, INDPBOD- proportion of independent directors on the board of directors, BIG4 - dichotomous variable equal to one if the firm audited by a big four audit firm and zero otherwise.

It appears from Table 1 that hypothesis 1 is accepted i.e. that family controlled firms are more likely to recognize goodwill impairment loss compared to non-family controlled firm. However, there is a non-significant positive relationship between independent variable GOV and the likelihood to impair goodwill. Therefore, hypothesis is 2 rejected. It is also evident from the table that firms do not have the big bath or smoothing incentives in managing their earnings through goodwill impairment loss. Consistent with prior literature MEANAMORT, ROA, ROACHG, CEOTEN, CEOCHG, ADOPT, CEODUAL and FIRMSIZE are interestingly, significant factors determining goodwill impairment loss in Malaysia. However, in contrast to our expectation, the sign for CEOTEN is positive suggests the longer the CEO, the more likely they will impair goodwill. The analysis as in Table 1 is repeated using Tobit regression and using dependent variable of value of impairment over beginning total asset following Lapointe (2005). The result (not reported) is qualitatively similar to the ones reported above. In addition, variable FOREIGN and LEVERAGE are also significant at 10% and 5% level respectively with negative relationship with the magnitude of impairment. Consistent with Poel et. al. (2009), SMOOTH is positively associated with the magnitude of goodwill impairment at 5% significance level. However, BATH remains insignificant.

5. Conclusion

The unique element in Malaysia setting provides an opportunity to investigate the effect of family and government controlled firms on managers' decision to manage earnings through goodwill impairment. Given the issue of expropriation of minority shareholders, family controlled firm are identified as more likely to impair goodwill rather than non-family controlled firm. The findings of this study suggest that a stricter guideline should be imposed on family controlled firm especially in appointing different CEO and Chairman and controlling the length of CEO in the office since these factors are significantly associated with the likelihood to impair goodwill which is not associated with a decline in their performance. By this way, an independent decision making can be made along with the ability to control managerial incentives from engaging in earnings management through goodwill policy.

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