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ORGANIZATIONAL DECOUPLING: THE CASE OF GOODWILL IMPAIRMENT

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ABSTRACT

This study explores types of resistance to institutional change through decoupling, caused by an implementation of IFRS 3 *Business Combinations*. Taking listed companies in Malaysia as a case study, the exploration is conducted through semi-structured interviews with four personnel and detailed analyses of selected annual reports throughout several years. The findings reveal two different decoupling strategies undertaken by companies. In both strategies, companies were perpetuating the old system, disguised as a new impairment system required by the IFRS 3. The decoupling strategies highlighted is hoped to help relevant regulatory bodies to take note of impairment test of goodwill conducted by companies, and hence to ensure the true and fair value of goodwill reported on the financial statement.

JEL Classifications: *L2, D2, M41*
Keywords: Organisational change; Goodwill; IFRS implementation
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INTRODUCTION

The implementation of International Financial Reporting Standards (IFRS) throughout the world represents a major change in the accounting regulation (Hong et al., 2014). To date, more than 100 countries require or permit the use of IFRS in their financial reporting system (Barth, 2008; Daske et al., 2013). In line with this implementation, there is a growing literature which examines costs and benefits of adopting the IFRS (e.g., Jermakowicz and Gornik-Tomaszewski, 2006; Tyrrall et al, 2007; Ramanna and Sletten, 2014) as well as consequences of the IFRS adoption (e.g., Ahmed et al., 2013; Daske et al., 2013; Hong et al., 2014).

Research problem

One of the reasons for the increasing adoption of IFRS is because of the supports offered by worldwide regulatory bodies, such as the International Organization of Securities Commissions (IOSCO), the Committee of European Securities Regulators (CESR), and the World Bank (Jermakowicz and Gornik-Tomaszewsk, 2006; Ding et al, 2007). With such supports, organisations might be pressured to adopt IFRS. Jermakowicz and Gornik-Tomaszewsk, (2006), for example, find that the majority of the European listed companies they interviewed would not adopt IFRS if they were not required by the CESR. As a result, there is a concerned that some organisations might adopt the IFRS in name only (Daske et al., 2006).

Although the literature on IFRS is growing, one area of investigation which receives little attention is how companies coped with institutional pressures for change, caused by the IFRS adoption. This study, therefore, aims to address this gap in the literature. Using an institutional theory, this study attempts to understand how an organisation copes with institutional pressures caused by the implementation of IFRS 3 through decoupling. Focusing on an accounting for goodwill impairment stipulated by IFRS 3 and taking listed companies in Malaysia as a case study, the exploration is conducted through semi-structured interviews and

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detailed analyses of annual reports throughout several years. Malaysia provides a unique setting because of its unregulated environment on an accounting for goodwill prior to the implementation of the IFRS 3 (Pillai, 2006).

REVIEW OF THE RELEVANT LITERATURE

The present study draws upon an institutional theory, in particular, decoupling, in explaining how companies cope with institutional pressure to implement IFRS 3 *Business Combinations*.

Resistance to institutional change through decoupling

Institutional theory explains decoupling as a form of resistance to change undertaken by organisations, which was caused by pressures from dominant external institution (Pitsakis et al., 2012). Through decoupling, an organisation develops visible symbolic compliance policies or programs that address the institutional pressures but do not implement them substantively in real practices (MacLean et al., 2010). The symbolic compliance programs could come in various forms, ranging from a complete non-implementation of the programs to subtle forms of decoupling (Westphal and Zajac, 2001).The later could occur when programs or policies are available but disconnected from on-going organisational functions (MacLean et al., 2010).

Organisations normally resist to institutional pressure for change by decoupling their policies from actual implementation when the external pressure conflicted with their internal targets (Westphal and Zajac, 2001). Reasons for decoupling include safeguarding companies' internal routines from external uncertainties while at the same time gaining legitimacy with external requirements (Westphal and Zajac, 2001). Prior studies demonstrate how organisations developed formal programs such as stock-repurchase programs, total quality management program, or long-term incentive programs without implementing them substantively in real practice, yet these programs help the organisations maintained or gained legitimacy from external institutions (MacLean et al., 2010). Westphal and Zajac (2001) illustrate how companies initiated a stock repurchase programs due to pressure for accountability without implementing these programs in real practices.

Regulatory change: IFRS 3 adoption

To gain a deeper insight into a company's decoupling strategy, we focus on the adoption of IFRS 3 *Business Combinations* and its consequential standard *IAS 36 Impairment of Assets* related to goodwill impairment. IFRS 3 *Business Combinations* is the result of a joint effort between the International Accounting Standards Board (IASB) and the United States of America (US) Financial Accounting Standards Board (FASB) to improve financial reporting and promote an international convergence of accounting standards (IASB, 2010a: IFRS 3). As Malaysia has a convergence policy with IFRS, its listed companies are required to fully comply with IFRS 3 and IAS 36 in their accounting treatment for goodwill. Nevertheless, in Malaysia, the effective dates for these two IFRS were January 1, 2006 (MASB, Undated), a year later than the effective dates for the European listed companies.

Prior to the implementation of IFRS 3, Malaysian listed companies do not have a specific accounting standard on goodwill. This unregulated environment has resulted in various accounting treatments for goodwill including capitalisation and amortisation of goodwill, treating goodwill as a permanent item, and an impairment review of goodwill whenever there is an indication (Abdullah et al., 2004). Thus, the implementation of IFRS 3 in 2006 provided listed companies in Malaysia with a specific accounting standard on goodwill, previously unavailable prior to 2006 (Pillai, 2006).

Two main regulatory changes imposed through the implementation of IFRS 3 are the prohibition of an amortisation of goodwill, and the requirement for companies to perform an impairment review of goodwill at least annually (IASB, 2006b: IFRS 3). The purpose of the impairment review is to ensure that the carrying amount of the goodwill reported on the balance sheet do not exceeds its recoverable amount (IASB, 2006a: IAS

36; Ernst and Young, 2008). The rationale for focusing on IFRS 3 and IAS 36 is that these standards afforded managers with discretion in performing an impairment test of goodwill. For example, Ramanna and Watts (2012) argue that the approach of relying exclusively on an impairment review of goodwill represents a major innovation in the accounting treatment for goodwill as it relies purely on the management judgement and estimation.

METHOD

The investigation of how companies cope with institutional pressures for change, caused by an implementation of IFRS 3, involves two stages. In the first stage, semi-structured interviews were conducted; in the second stage, detailed analysis of goodwill movement is performed.

Semi-structured interviews

The semi-structured interviews aim to gain an insight perspective on the implementation of the IFRS 3. Four groups of respondents were targeted: a finance manager, a senior auditor, a financial analyst, and a former standard-setter. A list of open ended interview questions was designed and ethical approval to conduct the interviews was obtained. The interviews focused on two key areas – companies' reactions to IFRS 3 implementation, and procedures involved in performing an impairment test of goodwill. All the interviews were tape-recorded and transcribed almost verbatim.

Detailed analysis of annual reports

IFRS 3 requires company to report an impairment loss of goodwill when the recoverable amount of cash-generating-units (CGU) containing goodwill is lower than the carrying amount of the unit. IAS 36 further specifies several indications of an impairment. One of the indications that can be observed by external users is a decline in the market capitalisation below the carrying amount of the net assets of the company (MASB, 2006: FRS 136, paragraph 12d). Thus, in the detailed analysis, we focus on four key items: (i) the ratio of the market capitalisation to the carrying amount of the net assets of the company, (ii) the financial performance of the company – i.e. net income pre-goodwill write-off available to equity holders, and basic earnings per share (EPS), (iii) the financial performance of the cash-generating-units containing the goodwill, and (iv) the movement of goodwill (MASB, 2006, AbuGhazaleh et al., 2011).

To perform the detailed analysis, we refer to companies' annual reports and financial data from Datastream. We then trace the goodwill impairment losses reported from the write-off year back to the acquisition year (i.e., the year the goodwill was acquired).

FINDINGS: SEMI-STRUCTURED INTERVIEWS

Four semi-structured interviews were conducted with four groups of respondents: a finance manager, an auditor, an analyst, and a former standard-setter, independently. For each respondent, the interview lasted on average around 1 hour. As noted in Section 4.1, two issues were explored - companies' reactions to IFRS 3 adoption, and procedures of an impairment test of goodwill undertaken by companies.

As for the reactions to IFRS 3 adoption, the financial analyst agreed on the prohibition of goodwill amortisation, as he viewed that the amortisation is subjective due to difficulty in determining the useful life of the goodwill. In addition, the analyst considered an amortisation of goodwill as merely a structure of the balance sheet and does not drive the business. The senior auditor seemed to share similar view with that of the analyst as he considered the implementation of IFRS 3 related to goodwill as not an issue in Malaysia since the IFRS 3 merely requires companies to stop amortising the goodwill. Further, the former standard setter informed that the Malaysian Accounting Standards Board (MASB) received little or not much complaints from Malaysian listed companies regarding this issue. He opined that it could be because the IFRS has became the law of the country.

Hence, listed companies do not have any option other than to abide by the law. Moreover, European listed companies have already implemented the standard.

In terms of the procedures of an impairment test of goodwill, the finance manager acknowledged that he was unable to make a decision in taking goodwill write-off merely based on his opinion. Thus, when there is a need to report the write-off, the company will appoint an independent valuer. However, as the appointment is costly, the valuer will be appointed once in every three years. In addition, the finance manager viewed that it is unnecessary for the company to incur such valuation annually as it is costly.

The findings of these interviews suggest that resistance to institutional change, caused by the IFRS 3 adoption, if any, might be carried out by companies to prevent excessive costs in appointing an independent valuer. Further, as IFRS 3 has the force of law and have been implemented worldwide, any resistance to the institutional change will be undertaken by companies in a subtle manner.

COPING WITH INSTITUTIONAL PRESSURES FOR CHANGE: PERPETUATING THE OLD SYSTEM

We present two cases of companies resisting to change by continuing with the old system of amortising their goodwill although the method was prohibited by the IFRS 3 and IAS 36. These are SL Limited and RB Limited[1].

SL Limited

Company background

SL Limited was incorporated in 1982 and it was converted to a public company in 1993. In 1994, its shares were listed on the main board of the Bursa Malaysia. The company involves primarily in trading of gasoline products throughout Malaysia.

Accounting policy related to goodwill impairment

In 2003, the company acquired several service stations, which led to an existence of goodwill on acquisition. Prior to the implementation of IFRS 3, the accounting policy on goodwill of SL Limited was to amortise its goodwill using a straight line method. Thus, under this accounting policy, the goodwill balance of SL Limited was reduced systematically annually.

As discussed in Section 3.2, IFRS 3 prohibits an amortisation of goodwill and instead requires companies to perform an impairment review of goodwill, at least annually. When SL Limited implemented IFRS 3 in 2006/7, the company disclosed in its Notes to the financial statement that it is complying with the requirements stipulated by the IFRS, as follows:

> With the adoption of (I)FRS 3 beginning 1 April 2006, goodwill represents the excess of the cost of the acquisition over the company's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities of the acquiree. Goodwill is measured at cost and is no longer amortised but tested for impairment at least annually or more frequently when there is objective evidence of impairment. Goodwill is allocated to cash-generating-units.
>
> (SL Limited, 2007)

[1] In this paper, names of the two companies are anonymised because of the critical comments made about it, which could be priced sensitive if quoted out of context of the study.

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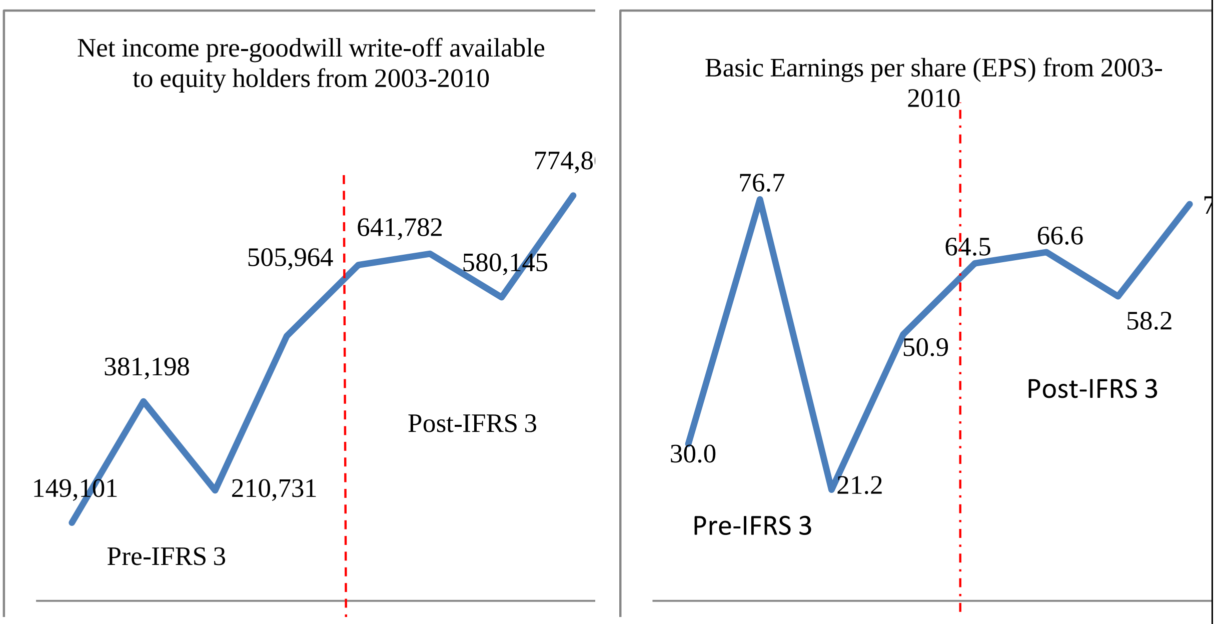
From 2007 to 2009, the company reported goodwill impairment losses, which reduced its operating profit and net income. Nevertheless, reasons or 'objective evidence' for taking the impairment losses were not disclosed in the annual reports. Further, in 2010, the goodwill balance was reduced to zero as the company fully impaired its goodwill. Again, there is no justification or 'objective evidence' for taking the goodwill write-off disclosed in the Notes to the financial statement.

Signs of decoupling

We examine signs of decoupling by focusing on four key items: (i) the ratio of the market capitalisation to the carrying amount of the net assets of the company, (ii) the financial performance of the company, (iii) the financial performance of the cash-generating-units containing the goodwill, and (iv) the movement of goodwill. Figure 1 presents the first two key items.

FİGURE 1. DETAİLED ANALYSİS OF THE FİNANCİAL PERFORMANCE OF THE COMPANY AND İTS MARKET-TO-BOOK RATİO FOR SL LİMİTED

Panel A: Financial performance of the company from 2003-2010



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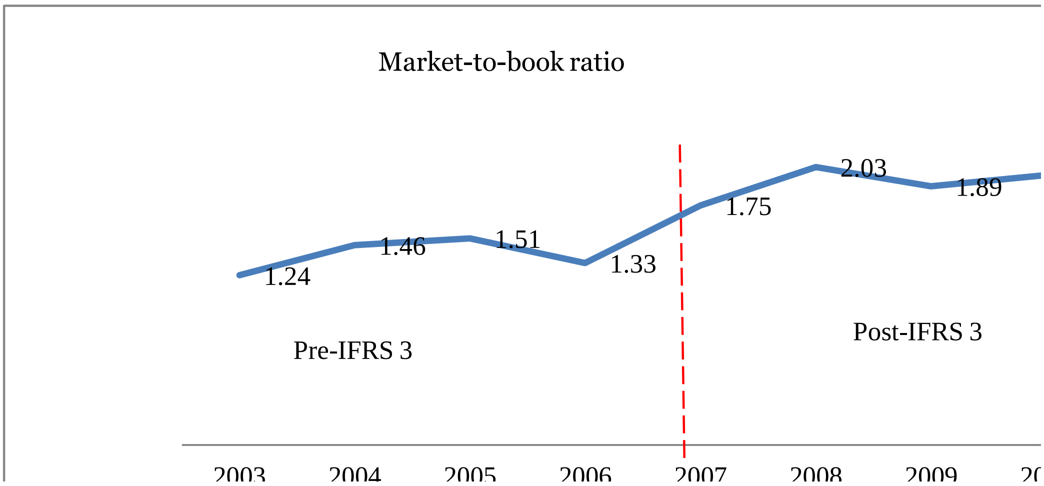
Panel B: The ratio of the market capitalisation to the carrying amount of the net assets of the company from 2003-2010



Panel A of Figure 1 shows that starting from the year of the acquisition of goodwill in 2003 until 2009, a year prior to the goodwill was being fully impaired, the company portrayed strong financial performances. This is reflected in the high net income pre-goodwill write-off and the basic earnings per share (EPS). Further, panel B portrayed that the market values of the company remained high above its book values of the net assets, suggesting that investors perceived the company to have more value than the equity reported on its balance sheet. Thus, from Figure 1, it is seen that there is no reason for the company to report goodwill impairment losses after the implementation of IFRS 3, i.e. from 2007 to 2009, as the company was experiencing good financial performances and strong market capitalisations.

As for the third key item, i.e. the financial performance of the cash-generating-units containing goodwill, no information is disclosed by the company. In the Notes to the Financial Statement, the company merely disclosed the movement of goodwill within the financial year and its comparison with the previous year. Information concerning the allocation of goodwill to cash-generating-units, the impairment test conducted, and reasons for reporting the impairment losses from 2007 to 2010 is not disclosed. The lack of detailed disclosure seems to suggest signs of decoupling of the accounting policy on goodwill impairment from the actual impairment test.

The last key item that we examined is the analysis of the movement of goodwill balance. Table 1 shows that the amount of goodwill impairment losses reported by the company is similar to the amount of goodwill amortisation previously reported. With the strong financial performance and market capitalisation, there is no reason for the company to report goodwill impairment losses. By observing the Notes to the financial statement within a single period or for a few periods, company's resistance to change by perpetuating the old system would not be obvious. However, when a comparative analysis was undertaken from the date the goodwill was acquired to the date the impairment loss was reported, it is apparent from Table 1 that the company is continuing the process of reducing its goodwill balance systematically. Instead of recording the amount as goodwill amortisation (see item c), which was prohibited by the IFRS 3, it was disguised as goodwill impairment loss (see item d). Hence, in this case, the company decoupled its accounting policy on an impairment review of goodwill from the actual implementation of the impairment test of goodwill.

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TABLE 1. ANALYSİS OF GOODWİLL MOVEMENT FOR SL LİMİTED FROM 31 MARCH 2003-2010

	Pre-FRS 3 (RM'000)				Post-FRS 3 (RM'000)			
	2003	2004	2005	2006	2007	2008	2009	2010
(a) Opening goodwill balance	-	21,902	29,297	27,823	26,349	24,874	23,400	
(b) Additions	22,166	8,536	-	-	-	-	-	
(c) Goodwill amortisation	(264)	(1,141)	(1,474)	(1,474)	-	-	-	
(d) Goodwill impairment	-	-	-	-	(1,475)	(1,474)	(1,474)	(21,926)
(e) Closing goodwill balance	21,902	29,297	27,823	26,349	24,874	23,400	21,926	
(f) Goodwill accounting policy	Goodwill is amortised from the date of initial recognition				Goodwill is reviewed for impairment annually or more frequently			

RB Limited

Company background

RB Limited was incorporated in 2003 and it shares were offered to the public in 2004. As of 2015, the company's shares are listed on the second board of the Bursa Malaysia. RB Limited primarily involves in the marketing and distributing of software products.

Accounting policy related to goodwill impairment

In 2004, the company acquired 100% equity interest in another company which led to an exisence of goodwill on acquisition. Prior to the implementation of IFRS 3, the accounting policy on goodwill of RB Limited was to amortise its goodwill over a period of 25 years. Thus, under this accounting policy, the goodwill balance of RB Limited was reduced systematically from year to year.

RB Limited implemented IFRS 3 in 2006 and disclosed in its Notes to the financial statement that the company is complying with the requirements stipulated by the IFRS, as follows:

> The adoption of FRS 3 and the revised FRS 136 has resulted in the Group ceasing annual goodwill amortisation. Goodwill is now carried at cost less accumulated impairment losses and is tested for impairment annually, or more frequently if events or changes in circumstances indicate that it might be impaired.
>
> (RB Limited, 2006)

RB Limited reported goodwill impairment losses in every single year from 2006 to 2008. Unlike SL Limited that does not disclosed reasons for the impairment losses reported, RB limited disclosed such reasons in its Notes to the financial statement. However, the reasons disclosed were not only generic in nature but they are also similar from year to year.

Signs of decoupling

To identify signs of decoupling, we focus on four key items: (i) the ratio of the market capitalisation to the carrying amount of the net assets of the company, (ii) the financial performance of the company, (iii) the financial performance of the cash-generating-units containing the goodwill, and (iv) the movement of goodwill. Figure 2 shows that the financial performances of the company is declining from year to year while the the market values of the company remained high above its book values of the net assets from 2004 to 2007. Only, in 2008, the market capitalisation started to decline. Thus, the results for the financial performancces are conflicting with the market capitalisation. We then search for the financial performance of the cash-generating-

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units (CGUs) containing goodwill. However, no detailed information concerning the financial performance of the CGUs was disclosed by the company. Further, reasons for reporting the impairment losses from 2006 to 2008 were disclosed but were more generic than specific in nature. The lack of detailed disclosure seems to suggest signs of decoupling of the accounting policy on goodwill impairment from the actual impairment test.

We further explore the signs of decoupling by analysing goodwill movement for RB Limited starting from the date the goodwill existed on acquisition. Table 2 shows that unlike SL Limited that reduced its goodwill balance by the same amount annually (i.e. using the straight-line method), RB Limited reduced its goodwill balance with the same percentage in 2006 and 2007 (i.e. using the reducing balance method). From the table, it is observed that both in 2006 and 2007, the company reduced 10% of its beginning goodwill balance (see Notes 3 and 4). In 2008, the company's financial performance declined further and its market value fell below the book value of the net assets, which led the company to reduce its beginning goodwill balance by a larger percentage (10% reduction of goodwill balance for the newly acquired goodwill and 20% reduction of beginning goodwill balance for the previously acquired goodwill) (see Note 5). The analyses of financial performance presented in Table 2 and goodwill movement portrayed in Figure 2 for RB Limited seems to imply that the managers who were accustomed to the amortisation of goodwill prior to the implementation of FRS 3 were perpetuating this old system by reporting goodwill impairment losses systematically perannum.

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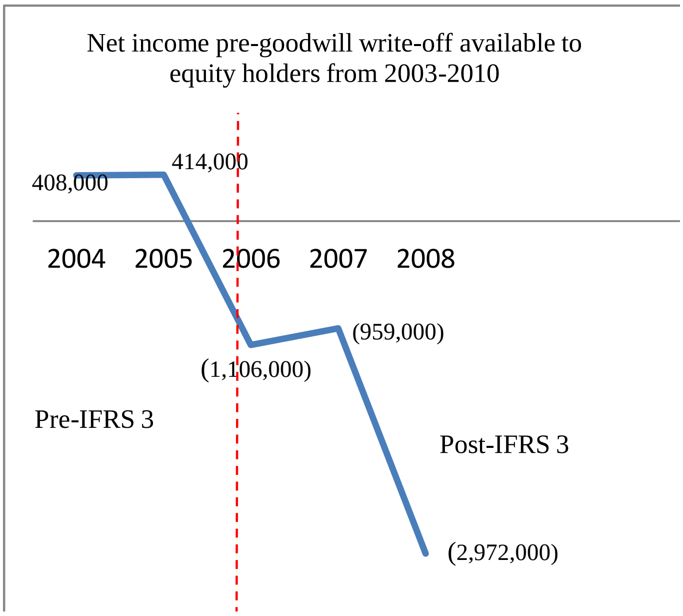
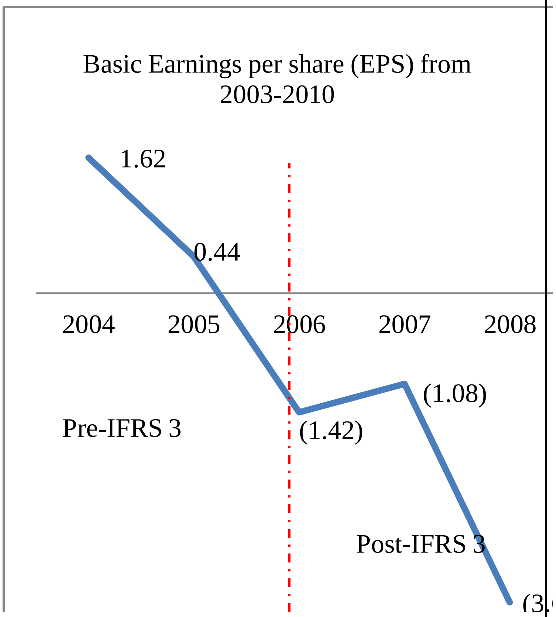
FİGURE 2. DETAİLED ANALYSİS OF THE FİNANCİAL PERFORMANCE OF THE COMPANY AND İTS MARKET-TO-BOOK RATİO FOR RB LİMİTED

Panel A: Financial performance of the company from 2003-2010





Panel B: The ratio of the market capitalisation to the carrying amount of the net assets of the company from 2004-2008

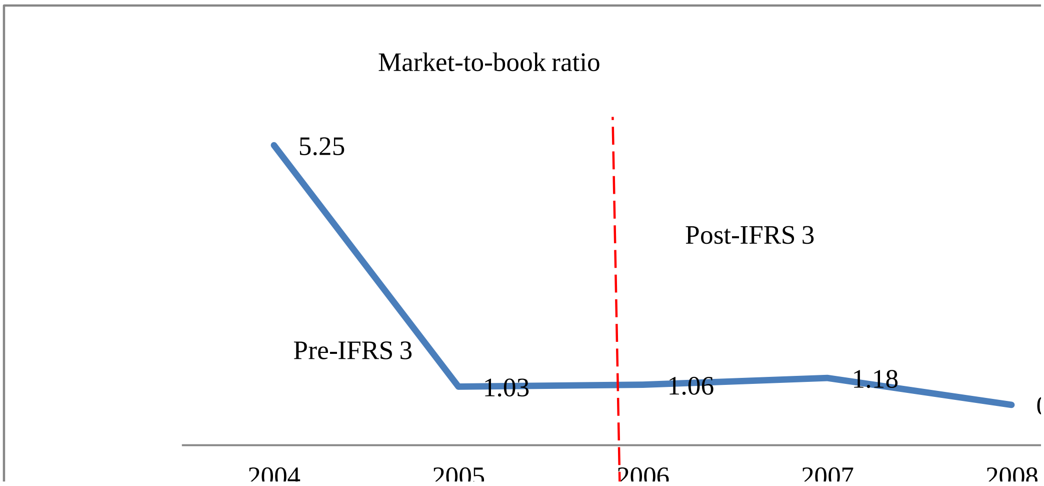


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TABLE 2. ANALYSİS OF GOODWİLL MOVEMENT FOR RB LİMİTED FROM 31 DECEMBER 2004-2008

	Pre-FRS 3 (RM'000)		Post-FRS 3 (RM'000)		
	2004	2005	2006	2007	2008
(a) Opening goodwill balance	2,269,870	2,247,171	2,156,375	1,940,738	1,746,664
(b) Additions	-	-	-	-	1,172,691
(c) Goodwill amortisation	22, 699[1]	90,796[2]	-	-	-
(d) Goodwill impairment	-	-	215,637[3]	194,074[4]	466,602[5]
(e) Closing goodwill balance	2,247,171	2,156,375	1,940,738	1,746,664	2,452,753
(f) Goodwill accounting policy	Goodwill is amortised from the date of initial recognition		Goodwill is reviewed for impairment annually or more frequently		

Notes:

1. 1% x Opening goodwill balance = 1% x 2,269,870 = 22, 699
2. 2,269,870/25 years = 90,796
3. 10% x Opening goodwill balance = 1o% x 2,156,375 = 215,637
4. 10% x Opening goodwill balance = 1o% x 1,940,738 =194,074
5. 10% x new goodwill balance + 20% x Opening goodwill balance = 1o% x 1,172,691 + 20% x 1,746,664 = 466,602

The detailed analyses of financial performances, market capitalisation and goodwill movement for both SL Limited and RB Limited reveal two different decoupling strategies undertaken by companies in order to resist changing from goodwill amortisation to goodwill impairment. The consequence of this resistance to change through decoupling is that company's earnings on the financial statement are under reported for several years. Further, the resistance to change undertaken by the company is visible and could be detected by both internal and external auditors through careful analysis of the annual reports, yet the auditors appear not to take any action.

DISCUSSION AND CONCLUSION

We began by suggesting that one area that has been overlooked by researchers in analysing the implementation of IFRS is how companies coped with institutional pressure for change, caused by the IFRS adoption. Our study has attempted to address this gap. Using an institutional theory, we proposed that companies might resist this institutional pressure, especially at the early years of the implementation. Our study revealed a decoupling strategy of perpetuating the old system, disguised as a new impairment system required by the IFRS 3. Further, we demonstrate that the consequence of this decoupling compliance is that earnings were under reported on the financial statements for the past several years, which would hamper the quality of the financial reporting.

The contribution of this study is that it attempts to explain the IFRS implementation from an institutional theory, a theoretical framework that has not been explored before by prior studies. In doing so, the study contributes to the literature by identifying a specific way in which a company may appear to adopt IFRS 3 related to goodwill impairment but do not apply the IFRS substantively in practise. Hence, the present study provides valuable insights into how organisations coped with institutional pressures for change by decoupling their accounting policy on goodwill impairment from the actual implementation of the impairment test of the goodwill.

While the findings of this study provide insights into how organisations address institutional pressures caused by the implementation of IFRS 3 through decoupling, they do not explain factors influencing this decoupling. Future studies could expand on this study by investigating, on a large scale, reasons for this decoupling of the goodwill accounting policy.

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ENDNOTES

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