

Earnings Management and Impairment Loss

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Corporate Governance, Income Growth, and Incentives to Report Impairment Loss – China Publicly Listed Companies

Introduction

The advent of SFAS 142 and IAS 36 regarding handling of asset impairment has spawned research into how these standards are being implemented. When a company records an impairment loss, the loss reduces net income on the financial statements, but the loss is not deductible for tax purposes. This creates a deferred tax asset. Our research has to do with how Chinese companies are handling the asset impairment standards. We start with a brief discussion of deferred tax items in China. Deferred tax items in China have three major components: tax and financial reporting of temporary differences in depreciation; impairment losses; and previous losses, which can be carried forward for five years. While the temporary differences in depreciation typically create deferred tax liabilities (DTLs) that defer taxes to a future period, impairment losses and previous losses create deferred tax assets (DTAs). A deferred tax asset is created when a firm has overpaid its taxes and is due some form of tax relief. DTAs are viewed as less desirable than DTLs since DTLs result in lower taxable income in the current period, while DTAs cause taxable income, and income tax actually paid, to be higher in the current period and lower in some future period. Of course, it is more desirable to delay paying taxes. In our previous research (Wang et al., 2016), we documented that the median GAAP effective income tax rate for publicly listed Chinese companies is 13%, while the median cash effective income tax rate is 26%. This is less than optimal from a cash flow management standpoint. Many factors contribute to this result. In this research, we investigate some of the incentives of companies reporting impairment losses and thus creating deferred tax assets, which lower accounting net income and do not necessarily lower the taxable income.

Specifically, we attempt to determine whether impairment loss recognition is motivated by earnings management, and/or big bath behavior, and/or is a reflection of improved corporate governance. Our process includes examination of many variables that could impact impairment loss decisions, including firm size, asset mix, leverage, ownership percentages of top shareholders, Board of Director and Board of Supervisor size and composition, duality of CEO and BOD Chair, income growth, previous year loss, and industry. We include all companies listed on the Shenzhen and Shanghai stock exchanges for the period 2011-2016. Our study greatly expands current research on impairment, which typically has been limited to addressing only goodwill impairment. Our study analyzes impairment as a whole, instead of focusing only on goodwill impairment.

Chinese Accounting Standard No. 8 (CAS No. 8) prohibits the reversal of long-lived asset impairments to constrain managerial opportunism with respect to previously recognized impairment loss. CAS No. 8 forbids the reversal of long-lived asset impairment losses only, while allowing the reversal of short-term asset impairment losses. Our analysis shows the influence of this differential treatment on firm impairment loss taking behavior.

Literature Review

Extensive research has been done regarding corporate governance and earnings management. Whether earnings management and/or goodwill impairment reflect big bath behavior forms another stream of study.

Corporate governance and earnings management

Large investors as a mechanism of corporate governance has been documented by many, while disproved by others. Gillan & Starks (2003) study the role and impact of institutional investors on corporate governance. Institutional investors may influence management's activities directly through their ownership, and indirectly by trading their shares, and sometimes more significantly by acting as a group. The specific ownership structures and governance characteristics vary by market and country. Based on their research, Gillan & Starks (2003) believe that institutional investors tend to increase the liquidity, volatility, and price informativeness of the markets in which they invest. The increased information generated by institutional investors should result in better monitoring of corporations and in better corporate governance structures. Li (2010) concludes that the primary governance mechanism in China is the state and informal networks. Sueyoshi et al. (2010) conclude that stable shareholding is an important aspect of traditional Japanese corporate governance, although stable shareholding enhances operational performance only when the ratio of shares held by stable shareholders is more than 61.21%. Chung et al. (2002) find that managers who have an incentive to increase or decrease reported profit use income-increasing or decreasing accruals. They also find that institutional investors with large shareholdings inhibit managers from using these discretionary accounting accruals opportunistically. However, Leuz et al. (2003) find that earnings management appears to be lower in economies with large stock markets, dispersed ownership, strong investor rights, and strong legal enforcement. Schmid & Zimmermann (2008) find strong evidence supporting the hypothesis that corporate governance index is positively related to firm value and neither the presence of a controlling shareholder nor large outside block-holders have a significant valuation impact. Leuz et al. (2003) and Schmid & Zimmermann (2008) contradict Gillan & Starks (2003), Li (2010), Sueyoshi et al. (2010), and Chung et al. (2002) finding that large/state shareholding an important governance mechanism.

Shlifer & Vishny (1989) believe that there is ample evidence to support the notion that entrenched managers make specific investments to increase their value to shareholders, to reduce the probability of being replaced, extract higher wages and larger perquisites from shareholders and obtain greater latitude in determining corporate strategy.

Elyasiani & Zhang (2015) investigate the relationship between corporate liquidity $[(- \text{cash} + \text{LCs})/\text{assets}]$ (lines of credit LC) and CEO entrenchment and find that corporate liquidity, including lines of credit, is positively related to management entrenchment. They believe that CEOs prefer greater than necessary liquidity (which is costly to shareholders) because it makes their jobs less stressful and they can lobby more effectively for luxury personal perks.

Davidson et al. (2005) find a significant positive relationship between having a board of directors comprised of a majority of non-executive directors and minimizing the amount of earnings management. They define a non-executive director as a director who is not employed in the company's business activities and whose role is to provide an outsider's contribution and

oversight to the board of directors. Their findings also support an association between an audit committee comprising a majority of non-executives and a reduction in earnings management.

Extensive research has been done on the impact of board size and outside directors. Beasley (1996) studied 150 firms, 75 with no instances of fraud and 75 with fraud. He finds that no-fraud firms have significantly higher percentages of outside members on their boards. He also finds that as outside director ownership interest in the firm and outside director tenure increase, the likelihood of financial statement fraud decreases. Xie, Davidson, and DaDalt (2003) study 110 S & P 500 firms for years 1992, 1994 and 1996. They find that earnings management is less likely to occur or occurs less often in companies whose boards include both more independent outside directors and directors with corporate experience. They also find that the composition of the audit committee (and to a lesser extent the executive committee) is associated with the level of earnings management. Musteen et al. (2010) find that firms with a greater proportion of outside directors and those with larger boards exhibit better reputations than those with smaller boards and a higher proportion of insiders using 2000 Fortune List of America's Most Admired Corporations. Alves (2013) also finds less earnings management when board size is large. Duchin et al. (2010) conclude that the effectiveness of outside directors depends on the cost of acquiring information about the firm. When the cost of information acquisition is low, performance increases when outsiders are added to the board. When the information acquisition cost is high, performance worsens when outsiders are added to the board. As we discuss later, AbuGhazaleh, Al-Hares, and Roberts (2011) find that goodwill impairments are strongly associated with effective governance mechanisms.

Smaili & Labelle (2016) study the extent to which corporate governance acts as an efficient means of protecting investors in Canadian companies against accounting irregularities. They find that level of noncompliance with financial reporting regulations is indeed, higher when firms: (1) have fewer independent and financial expert directors on their boards and audit committees and no block holders or individuals owning a significant portion of company shares; (2) have recently changed auditors; and (3) have a CEO who is also the Chair of the Board of Directors. These firms also appear to fulfill their financing requirements through private placements rather than public funds, which is consistent with the fact that firms with accounting irregularities, are less likely to be in a position to go to the public market to fulfill financing needs.

Earnings management, impairment, and big bath behavior

The big bath or cookie jar approach is refers to firms that take big losses in one period to avoid a steady stream of annual losses or decreased earnings. Using a sample of 33 Portuguese nonfinancial firms from the Euro next Lisbon stock exchange, Alves (2013) finds that the goodwill impairment amount is significantly positively related to earnings management, suggesting that IAS 36 under IFRS provides managers with discretion for goodwill write-offs. Alves also finds less earnings management when board size is large and cash flows are high and more earnings management when firms are highly leveraged and political costs are high.

Giner and Pardo (2015) study Spanish firms to analyze the ethical behavior of managers who make decisions on recognizing impairment of goodwill. They find that managers decisions about whether or not to impair goodwill and about the magnitude of the impairment are influenced by

big bath and smoothing strategies. Firm size and macroeconomic environment influence appear significant in the analysis.

Duh, Lee and Lin (2009) study Taiwanese companies subject to the IAS 36, which allows reversal of asset impairment losses. They match 55 reversal firms with 55 similar non-reversal firms. They find that firms recognizing more impairment losses are more likely to reverse impairment losses when reversal will avoid an earnings decline in a subsequent period, which is consistent with big bath approach. They also find that this behavior is more pronounced for firms with higher debt ratios and consistent with earnings management being used to avoid violation of debt covenants.

Lee, Lev and Yeo (2015) study the connection between big bath accounting and recognition of impairment losses in the telecommunication industry in Europe. They find a co-occurrence of goodwill impairments and big bath indicators and believe it shows a pattern of earnings management.

Hassine and Jilani (2017) study how reporting incentives influence firms' accounting choices under IAS 36 to account for goodwill impairment. They examine whether earnings management motives are associated with the decision to record asset impairment and the magnitude of annual goodwill impairment losses reported. The study includes a sample of 720 observations from 134 French firms. They find that firms that have a change in CEO are significantly more likely to record goodwill impairment losses and that managers overstate annual goodwill impairment losses in order to meet earnings management incentives related not only to CEO change and financial crisis but also to earnings smoothing and big bath accounting.

Cheng, Peterson & Sherrill (2017) study US firms to examine investor reaction to impairment write-offs. Previous studies find a negative stock price reaction after goodwill impairment write-offs both in the short term and in the long term. In 2002, the Financial Accounting Standards Board rules for accounting for goodwill changed. Cheng, Peterson & Sherrill (2017) examine data from after the rule change requiring goodwill to be reviewed for impairment and find that investors continue to perceive goodwill write-offs as negative events in the short term, but contrary to previous studies, that investors perceive goodwill write-offs as positive news in the long term. They also find that firms tend to incorporate all foreseeable future non-recurring charges into the good-will impairment. Decreased non-recurring charges in the years subsequent to the write-off result in improvement in overall firm performance after the write-off. However, firm operating performance improves only slightly.

Watts (2003a, 2003b) and Beatty & Weber (2006) both conclude that managerial incentives do affect accounting choices including decisions to accelerate or delay expense recognition. Ramanna and Watts (2009) investigate how managers are implementing SFAS 142 that requires annual unverifiable fair-value estimates of value of goodwill and other intangible assets with indefinite useful lives. Their results are consistent with the contention that managers are exploiting unverifiable fair value based discretion in SFAS 142 to avoid timely goodwill write-offs in circumstances where they have motives to do so as predicted by Watts (2003). The results do not confirm standard setters' arguments that unverifiable fair-value-based discretion in SFAS 142 will be used to convey more helpful private information on future cash flows.

Giacomino & Akers (2009) state that the findings of several research studies, along with their own findings show that goodwill write-offs increased during 2008 and are likely continue into 2009. Giacomino & Akers (2009) question whether goodwill write-offs provide the financial statement users with useful information for analyzing investments as the FASB intended. They note that many firms carry substantial amounts of goodwill on their 2008 balance sheets. Because of the uncertainty of the economy and the financial markets, they believe the potential for big bath earnings management through the use of goodwill impairments exists for 2009 and that these goodwill impairments will significantly impact the quality of earnings.

Caruso et al. (2016) study goodwill impairments by Italian firms. The authors find income smoothing cases, as well as income maximization and big baths, almost equally distributed. It seems that every firm pursues its own "strategy", and even those who seem not to have a clear strategy can be enticed by the chance of a big bath under certain conditions. Overall, this study indicates that managerial behavior regarding goodwill impairment in Italian firms very likely includes efforts to manage earnings due to the discretion offered by IAS 36 and IFRS accounting standards. The authors end by questioning whether it is still appropriate to rely on financial reports as the main document of corporate communication to stakeholders.

Filp, Jeanjean and Paugam (2015) study US firms and find that the recognition of impairment loss is associated with big bath accounting among firms that record impairments of goodwill that exhibit large and negative (income-decreasing) abnormal accruals (excluding the impairment loss) during the year of impairment. They show that firms that do not record impairments even though they are likely to carry impaired goodwill, have lower future stock returns and tend to exhibit smaller change in future operating performance than impairers.

AbuGhazaleh, Al-Hares, and Roberts (2011) study managers' use of discretion in determining goodwill impairment losses in the top 500 UK firms during 2005 and 2006 following the mandatory adoption of IFRS 3 "Business Combinations," and whether this discretion reflects opportunistic reporting by managers or the provision of their private information. IFRS 3 has been criticized because of the managerial discretion inherent in impairment testing. The authors find that managers are exercising discretion in the reporting of goodwill impairments following the adoption of IFRS 3. Goodwill impairments are more likely to be associated with recent CEO changes, income smoothing and big bath reporting behaviors. However, the results also indicate that goodwill impairments are strongly associated with effective governance mechanisms which suggests that managers may be exercising their accounting discretion to convey their private information about the underlying performance of the firm rather than acting opportunistically. Given these results, the authors believe that IFRS 3 has provided managers with a framework to reliably convey their private information about future cash flows consistent with the IASB's objectives in developing the impairment standard.

Zang (2008) examines managers' behavior and market reaction to initial impairment losses recorded by US firms after adoption of SFAS No. 142. Zang finds that managers do use discretion in determining the transitional goodwill impairment loss in a strategic manner. He also finds that firms that have had recent management changes report greater impairment charges, which supports the idea that new managers may take a big bath so that they can report higher

earnings in the future.

Sevin & Schroeder (2005) use a random sample of US firms. The results suggest that SFAS No. 142 adoption does allow companies to engage in earnings management. Findings indicate that small firms experienced a significantly greater negative impact and were much more likely than large firms to take big bath losses.

Zhou & Habib (2013) cite previous research, which documents that managers use impairment losses strategically to manage company earnings. They find that managers use fewer current asset write-downs and more reversals in the post CAS No. 8 period, but that these practices do not seem to be motivated by the desire to avoid losses or to report big bath losses. The international standard IAS No. 36 allows for the reversal of impairment losses on long-term assets if the asset value recovers.

Stenheim & Madsen (2016) study the extent to which goodwill impairment losses reported under IFRS are associated with proxies of economic impairment, earnings management incentives and corporate governance. The findings suggest that goodwill impairment losses do seem to reflect economic impairment. The evidence of associations between proxies for earnings management incentives and impairment losses are weaker, but there are associations consistent with big bath proxies and impairment losses. Firms paying CFO cash-bonus payments are found to be more likely to report fewer and smaller impairment losses. Corporate governance mechanisms do not seem to play a significant role in the accounting for impairment losses in goodwill. However, in firms where the COB and CEO positions are held by the same individual there are generally fewer and smaller impairment losses. There are also some indications that firms with more audit committee meetings report more and larger impairment losses.

Methodology

Hypothesis development

Impairment loss recognition has long been associated with earnings management (Stenheim & Madsen, 2016; Giner & Pardo, 2015; Duh, Lee, & Lin, 2009). Reversal of impairment loss to avoid earnings decline is documented by Duh, Lee, & Lin (2009). Earnings management is generally understood to mean attempts by company insiders to protect their positions and benefits by manipulating the financial information provided to outsiders. This often takes the form of income smoothing or income manipulation. We use the method defined by Leuz et al. (2003) to quantify earnings management. Recognizing an impairment loss can be an effective income manipulation technique, known as big bath, which results in lower net income in the current period, but higher net income in the following years (Sevin & Schroeder, 2005). Chinese Accounting Standard No. 8 (CAS No. 8) prohibits the reversal of long-lived asset impairments in order to constrain managerial opportunism with respect to previously recognized impairment loss. CAS No. 8 forbids the reversal of long-lived asset impairment losses only, while allowing the reversal of short-term asset impairment losses. Zhou & Habib (2013) find that Chinese managers do use short-term asset impairment reversals, but do not find strong evidence that such behavior is motivated by managerial propensity to avoid losses and/or engage in big bath accounting. Although previous research is not in consensus on this issue, we hypothesize that impairment loss recognition is positively associated with earnings management and following year income growth.

There are various related studies. Some show that institutional owners can improve corporate governance (Gillan & Starks, 2003 ; Cervantes, 1999; Li, 2010; Sueyoshi et al., 2010; Chung et al. 2002) while others disagree (Leuz et al., 2003; Schmid & Zimmermann, 2008). Empirical evidence on the impact of managerial entrenchment on financial reporting is mixed (Beasley et al., 2000; Beasley, 1996; Shlifer & Vishny, 1989; Elyasiani & Zhang, 2015; Stenheim & Madsen, 2016). We hypothesize that improved corporate governance will encourage proper impairment loss taking. Bigger BOD and BOS sizes, higher percentage of independent BOD members, and higher percentage of institutional ownership are all indicators of improved corporate governance. Management entrenchment is an indicator of compromised corporate governance, and we hypothesize that it will inhibit timely impairment loss taking. Since impairment loss can be reversed in later years, we exclude companies that have impairment loss reversals for this analysis.

- H1: Ceteris paribus, there is a positive association between impairment loss and earnings management.
- H2: Ceteris paribus, there is a positive association between impairment loss and the following year's net income growth.
- H3: Ceteris paribus, there is a positive association between impairment loss and improved corporate governance.
- H4: Ceteris paribus, there is a negative association between impairment loss and management entrenchment.

$$\text{Model 1: Impairment} = \beta_0 + \beta_1 \text{TopShareholderOwnership\%} + \beta_2 \text{Top}_{2-10} \text{ShareholderOwnership\%} + \beta_3 \text{DualityCEOBODChair} + \beta_4 \text{BODSize} + \beta_5 \text{IndependentBOD\%} + \beta_6 \text{BOSSize} + \beta_7 \text{IncomeGrowth} + \beta_8 \text{IncomeGrowth}_{(t+1)} + \beta_9 \text{EarningsManagement} + \beta_{10} \text{Financial} + \beta_{11} \text{Utilities} + \beta_{12} \text{RealEstate} + \beta_{13} \text{Wholesale\&Retail} + \beta_{14} \text{Size} + \beta_{15} \text{AssetMix} + \beta_{16} \text{Leverage} + \beta_{17} \text{PreviousYearLoss} + \varepsilon$$

Where:

Impairment is the natural log of impairment loss if impairment loss is taken, 0 otherwise.

TopShareholderOwnership% is the top shareholder's ownership percentage.

Top₂₋₁₀ShareholderOwnership% is the total of the top 2 to 10 shareholders' ownership percentage.

DualityCEOBODChair is 1 if CEO also serves as BOD chair and 0 otherwise.

BODSize=BOD size scaled by log of sales.

IndependentBOD%=Percentage of independent BOD members.

BOSSize=Board of Supervisors size scaled by natural log of sales.

IncomeGrowth is the income growth percentage the year impairment loss is taken.

IncomeGrowth_(t+1) is the income growth percentage the year following impairment loss being taken.

EarningsManagement is the earnings management measure quantified using Leuz et al. (2003) method.

Financial, Utilities, RealEstate, and Wholesale&Retail are different industries. The baseline are manufacturing and complex industries.

Size is the natural log of sales.

AssetMix is capital asset scaled by total asset.

Leverage= $\text{beginning total debt} / \text{beginning total asset}$

Previous year loss=1 if previous year has a loss, 0 otherwise.

Data is separated into two groups, companies that have no impairment loss and companies who took impairment loss are in one group. Companies that reversed their impairment losses are separately analyzed. In Table 1, only companies without impairment loss reversals are included.

Conclusion

We do not find support that impairment loss taking is associated with big bath behavior. Although the magnitude of impairment loss is not significantly associated with earnings management, the decision to take impairment loss is associated with earnings management behavior. Impairment loss amount is higher with improved corporate governance, such as bigger BOD and bigger independent BOD percentage. Institutional ownership, if viewed as an improvement of corporate governance, functions differently from other corporate governance measures. It reduces both impairment loss and impairment loss reversal amount.

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