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The Effect of Audit Quality on Goodwill Disclosure among Malaysian Listed Firms under the MFRS 136

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Abstract: Accounting for goodwill is again controversial as International Accounting Standard Board adopts the impairment regime in 2004. Indeed, the adoption of impairment regime regarding Goodwill in accordance with IFRS makes the annual reports of companies more credible and transparent. However, the new treatment continues to receive criticism from the academics and practitioners, because they see the impairment regime is based on the discretion of management, and there is subjectivity inherent in the application of the impairment regime besides the conceptual move toward fair-value accounting. Hence, there is non-compliance with this standard in many companies around the world. However, the problem of agency and information asymmetry, which happen between companies' management and shareholders, can be decreased by external audit. This paper investigates the factors that may affect companies' compliance with the MFRS 136 *Impairment of Assets* among the Malaysian listed companies. Based on a review of the prior literature, this paper proposes a conceptual framework to investigate the impact of audit quality (audit firm size, audit tenure and audit fees) on the level of goodwill disclosure compliance with the MFRS 136 among Malaysian listed companies. Evidence from previous studies suggested that the audit quality proxy namely audit firm size, audit tenure and audit fees positively impact the companies' compliance with the MFRS 136.

Keywords: IFRS; IAS 36; MFRS 136; Impairment of Asset; Audit Quality; Goodwill Disclosure.

I. Introduction

After corporate accounting scandals across the United States, Europe and East Asia (e.g. Enron, HealthSouth, Parmalat, Tyco, WorldCom, and Xerox), there is growing concern regarding accuracy of financial statements globally. According to Glaum et al. (2004) and Fearnley et al. (2004) these accounting scandals were investigated into the quality of financial disclosure as well as transparency and credibility in protecting companies' stakeholders.

Indeed, the relevant information which is disclosed by companies plays an important role in the decision making process by stakeholders (Ferrer & Ferrer, 2011). Audited annual reports represent major inputs used by stakeholders, to evaluate firm's financial performance and to make proper business decisions. The quality of auditing and its ability to ensure credible financial reporting plays an important role in minimizing information asymmetry and boosting shareholders confidence in any stock market (Khlif & Samaha, 2013).

With the adoption of a new goodwill accounting regime by IFRS, goodwill is no longer amortized, but instead tested at least annually for impairment. As known, goodwill is a controversial asset and the new treatment continues to receive criticism from the academics and practitioners, because they see the impairment regime based on the discretion of management (Abu Ghazaleh et al., 2011).

Further, the new IAS36 demands many requirements, and requires companies to provide more disclosure (ESMA, 2013). Thus, it is considered as a complex standard (Linda & LeMaster, 2007), as well as has some ambiguous requirements (Bepari & Mollik, 2015). Hence, many companies around the world failed to comply with the IAS 36 requirement of disclosure regarding goodwill (Khairi et al., 2013; Glaum et al., 2013; Carlin et al., 2009a; Carlin et al., 2009b). Previous studies attributed those non-compliances to the lack of established "best practices" for IFRS, the complexity and the apparent inherent managerial discretion in the new treatment of goodwill. Furthermore, others attributed that to the subjectivity that inherent in the application of the impairment approach (Jarva, 2012; Lee & Yoon, 2012).

This means auditors have to rely more on their own judgment and interpretation of the standards (Zhang, 2011). In other words, auditors are required to exercise professional judgment when investigating management assumptions and valuations (Al-Hiyari *et al.*, 2016). This may affect the overall audit quality. However, Hope (2003) suggested that audit quality is a better execution of accounting standards. According to Arrunada (2004) audit quality is a vital factor influencing the credibility of financial statements. If quality work is performed, then the audited financial statement would give an appropriate report, rendering the financial statement useful to users for decision making. External auditors ensure integrity in the financial reporting process through independent audits of financial statements. Thus, audited financial statements are deemed more credible than unaudited ones by virtue of the assurance given by an independent expert, the external auditor (Ismail & Mustapha, 2015).

This paper proposes a conceptual framework to investigate if the Audit quality (Audit firm size, Audit fees and Audit tenure) has an impact on goodwill disclosure complying with the paragraph 134 requirements according to the MFRS 136 *Impairment of Assets* among the Malaysian companies listed on Bursa Malaysia. The remainder of the paper is organized as follows: Section 2 introduces the background of the study; Section 3 highlights the literature review; Section 4 presents the conceptual framework and hypothesis development and Section 5 summarizes and concludes this paper.

II. Background

The Malaysian Accounting Standard Board (MASB) adopted the IFRSs and became effective in 2006. Hence, the Malaysian companies were forced to prepare and present their annual reports according to the IFRS (Carlin et al., 2009). Before that the treatment of goodwill accounting remained different among Malaysian companies until 2006, and this is attributed to the absence of a true standard which governs goodwill accounting (Carlin et al., 2009). In particular, some companies used capitalized goodwill and amortization, while some companies used capitalization but the goodwill was subjected to impairment review, where as another group used capitalized goodwill and kept it as a permanent asset (Susela, 1999).

On January 1st 2006, Malaysian listed firms have been requested to prepare and present the financial statements in accordance with Financial Reporting Standards (FRSs) adopted by the Malaysian Accounting Standard Board (MASB) (Carlin et al., 2009a). As a result of the adoption of IFRSs, firms must account for goodwill in according of FRS 136, *Impairment of Assets*. The FRS 136 is equivalent to the IAS 36 Impairment of Assets. According to the new treatment, the amortization against goodwill was abolished, and goodwill has been subjected to an annual impairment test or more if there were any indicators implying that there is any impairment in goodwill value took place, as well as, the impairment loss will not be retrieved (MFRS 136, 2012).

On 1st August 2008, the MASB published a statement on their plan for full convergence of the MFRSs and IFRSs as issued by IASB by 1 January 2012 (Deloitte, 2015). Subsequently, the MASB released the approved MFRS Framework, which was known as the Malaysian Financial Reporting Standards (MFRSs) on 19 November 2011. The accounting standards issued by the MASB were literally word-for-word identical to those of the IFRSs (KPMG, 2011), and all firms were required to apply the MFRS framework at the beginning of 2012, except for private ones (MASB, 2015).

Thus, In view of the fact that the MASB recently adopted the MFRS 136, and because of the lack of studies about goodwill disclosure compliance in Malaysia, this study intends to investigate the impact of the audit quality in constraining goodwill disclosure.

III. Literature Review

According to Godfrey et al. (2010), financial information basically demands for two intentions: steward and decision making. With respect to the agency theory, it focused on the steward intention because the separation between ownership and management leads to a divergence of interests between managers and shareholders, thus, the agency conflict will increase (Jensen & Meckling, 1976). As such, monitoring managerial decisions becomes essential for shareholders to assure that their interests are protected (Fama & Jensen, 1983), as well as for ensuring credible and reliable financial reporting. Therefore, financial disclosures will reduce the agency problems which arise from the conflict between shareholders as principals and managers as agents (Abe & Chung, 2009).

Recently, most global countries have adopted the International Financial Reporting Standards (IFRS), and as reported by Bova and Pereira (2012) and Khairi et al. (2013), more than100 countries have changed their domestic standards to the IFRS. Indeed the IFRS have superior merits when compared to same domestic standards of accounting (Hail et al., 2010). Aside from that, the IFRS offer more convergence and harmonization in accounting treatment around the world (Ferrer & Ferrer, 2011). Furthermore the standards increase financial information in local and foreign corporations (Chen et al., 2013). Thus, the companies' financial statement could achieve more transparency and credibility (Godfrey et al., 2009). Therefore, these benefits will decrease the information asymmetry between the companies' management and shareholders (Eiler, 2009). Hence, the company's investment efficiency will also be improved (Chen et al., 2013).

Financial disclosure is the information released by companies to the public and may be financial or non-financial, numerical or qualitative, mandatory or voluntary, and through formal or informal methods (Gibbins et al., 1990). Meanwhile, mandatory disclosure is the information released by companies in order to meet the standards' requirements (Hassan & Marston, 2010), the voluntary disclosure is the information released by companies exceeding the mandatory requirements and it is considered as optional to provide this relevant information for users of annual report (Al-Janadi et al., 2011).

Previous literatures have seen that financial disclosure is an effective way to decrease the agency cost (Abe & Chung, 2009), and decrease the information asymmetry between managers and shareholders, as well as among shareholders themselves. Additionally, it is considered as a basic source for decision making (Ferrer & Ferrer, 2011; Bova & Pereira, 2012). However, previous studies identified the external auditors as an interesting area attributed to the external auditors ensuring the integrity in the financial reporting process through independent audits of financial statements. The audit quality of external audit is supposed to act effectively for monitoring and mitigating managerial opportunistic behaviour, thereby ameliorating agency conflicts and protecting the interests of shareholders (Fama & Jensen, 1983). Hence, the audit quality is an effective way to decrease the agency conflict and information asymmetry (Xiao *et al*., 2004; Watts & Zimmerman, 1983). As such, in the quality of financial statements, auditors play a pivotal role.

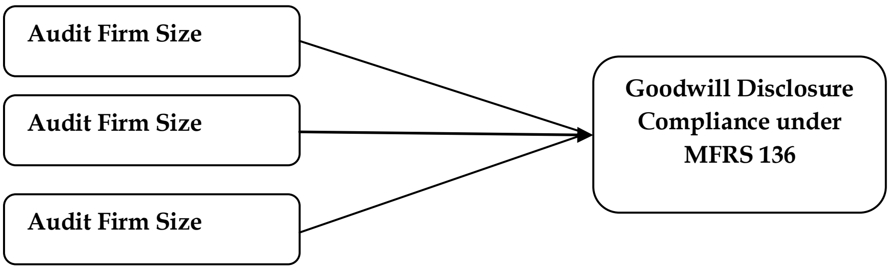
Thus it is reasonable to hypothesize that audit quality will enhance the goodwill disclosure compliance under the MFRS 136 among the Malaysian listed companies.

In the following section, audit quality proxies such as audit firm size, audit tenure and audit fees are discussed for their impacts on financial disclosure in literature review.

IV. The Conceptual Framework and Hypothesis Development

The audit quality and their relation with goodwill disclosure are integrated in one conceptual framework. Figure (4.1) explains the proposed framework. In this conceptual framework, audit quality dimensions are the independent variables and goodwill disclosure is the dependent variable. The current study thus attempts to bridge the gap by providing the basis for discerning the impact of audit quality on goodwill disclosure compliance under MFRS 136. Then, sections 4.1- 4.3 will discuss the hypotheses that are developed from the conceptual framework.

Figure (4.1): Audit Quality and Goodwill Disclosure.



4.1 Audit Firm Size

According to the agency theory, the conflicts that arise between investors and company managers regarding their interest can be decreased via an external audit (Xiao *et al*., 2004; Watts & Zimmerman, 1983). As such, in the quality of financial statements, auditors play a pivotal role. Prior research suggests that large, globally operating 'Big 4' audit firms provide audits of a higher quality level than smaller, regionally oriented auditors (De Angelo, 1981). Large audit firms produce more quality audits as compared to smaller firms as well as, large audit firms are expected to be more independent (Haniffa & Cooke, 2002).

Higher quality audit services are provided by Big 4 firms, and this has been proven by stricter audit procedures (Francis & Krishnan, 1999) and international evidence (Palmrose, 1988; Feroz *et al*., 1991). According to Watts and Zimmerman (1986), a higher audit quality is possible among large audit firms because they possess a superior monitoring capability. Unsurprisingly, the creditors and investors prefer companies to engage with large audit firms with international affiliation in order to audit the financial statements of companies (Whiting &Woodcock, 2011).

A positive association between compliance and being audited by the Big N firms has been found in prior studies (Bepari *et al.*, 2014; Glaum *et al*., 2013; Glaum & Street 2003; Street & Gray 2001). Glaum *et al*. (2013) and Bepari *et al*. (2014) found audit quality to be a significant determinant of firms' compliance with IFRS for goodwill impairment testing. Glaum and Street (2003) and Street and Gray (2001) found that firms' compliance with IFRS is positively associated with the audit quality, with the audit quality being defined in terms of Big-N versus non-Big-N auditors. Nurunnabi and Monirul (2012), Whiting and Woodcock (2011), Chu and Mathieu (2009), Naser *et al.* (2002), Raffoni (1995), and Craswell and Taylor (1992) found a significant association between big audit firms and level of disclosure. Chu and Mathieu (2009) stated that companies disclose more information in their statement notes if they are audited by the Big 4.

Thus, based on the agency theory and aforementioned discussion, it is argued that there is a potential relationship between audit firm size and goodwill disclosure. Thus, the following hypothesis is developed as follows:

H1: Audit firm size has a significant positive impact on the level of goodwill disclosure compliance under the MFRS 136 *Impairment of Assets* among the Malaysian listed companies.

4.2 Audit Tenure

According to the agency theory, the auditor has an important role in monitoring the doubtful action of a company's management by serving to reduce agency cost (Watts & Zimmerman, 1986) and information asymmetry (Aboody & Lev, 2000). Therefore, the manager will be forced to disclose more credible information in financial statements. Indeed, the relationship between auditors and their clients, in case of long engagement, is controversial. Proponents of audit tenure argue that audit quality impacted positively in the case of audit tenure (Almutairi *et al*., 2008). According to Beck *et al*. (1988), when the auditor first starts to audit his/her client for the first time, he/she needs to build knowledge about the company. Hence, the auditor will likely face some challenges early on in the contract to discover any fraud and material error or misstatement. Consequently, the auditor may produce a lower quality of audit. However, over time, the auditor may gain more knowledge and experience. Hence, the audit quality will improve.

Meanwhile, the supporters of auditor rotation contend that long audit tenure will more likely affect the independency of the auditor and impair his/her objectivity (Almutairi *et al*., 2008). The involvement of a personal relationship between the auditor and the client will lead to the loss of auditor independence (Flint, 1988). A lengthy tenure is one such threats, as it may bring about a relationship that is less rigid and formal in nature and develop a sense of loyalty or emotional relationships which may influence the auditor's attitude and opinion. As a consequence, a decline in the competence and quality of the auditors' work may be witnessed (Flint, 1988).

Empirical evidence supports the notion that audit tenure is better for audit quality, compliance with accounting standards, and the quality of financial statements (Chung & Kallapur, 2003; Carcello & Nagy, 2004; Stanley & DeZoort, 2007; Chiang & Lin, 2012).. Chung and Kallapur (2003) proposed that the length of auditor tenure is negatively associated to abnormal accruals**.** According to Carcello and Nagy (2004), the likelihood of fraudulent reporting is higher in the initial years of audit engagement. Stanley and DeZoort (2007), indicated that a short audit tenure is negatively related to the likelihood of restatement. Chiang and Lin (2012) verified the impact of the auditor-client relationship on the disclosure of SFAS 34 *Financial Instruments*. Their results show that when financial statements are audited by auditors with market knowledge, the level of information disclosure is higher.

Thus, based on the agency theory and aforementioned discussion, it is expected that there is a potential relationship between audit tenure and goodwill disclosure. Thus, the following hypothesis is developed as follows:

H2: Audit tenure has a significant positive impact on the level of goodwill disclosure compliance under the MFRS 136 *Impairment of Assets* among the Malaysian listed companies.

4.3 Audit Fees

Prior researches had been using audit fees as proxy for audit quality. This is because audit fees reflect the magnitude of audit effort. Higher audit fees are expected to indicate more auditing work, which is expected to enhance audit quality. Factors that are common across different clients tend to determine audit fees. These factors include client-specific size, complexity, and risk (Choi *et al*., 2010). Hay *et al.* (2008), confirm that the demand for auditing is a function of the set of risks faced by individual stakeholders to an organization and the set of control mechanisms available for mitigating these risks. Hence, the more reliability and validity in annual reports the more likely lead to reduce the auditor's risk evaluates and less audit efforts are required, thus, leading to charge less audit fees (Yatim *et al*., 2006).

Beatty (1989), argued that the nature and extent of agency costs vary across organisations and this variation may lead audit firms to differentiate the quality of their services. Beatty (1989) further proposed that a more precise financial statement is produced by high reputation firms in the firms' attempt to protect its standing in the market. Therefore, it is reasonable for audit fees to reflect differences in audit quality. An independent-audit consumer will be required to pay a premium price when seeking an audit service of higher quality (Copley, 1992). Similarly, Wahab *et al*. (201) contended that because companies demand higher audit quality, they incur higher audit fees.

However, the adoption of IFRSs adds a new burden on the auditors. For example, in an impairment test, auditors are required to exercise professional judgment when investigating management assumptions and valuations (Al-Hiyari *et al.*, 2016). In addition, the fair value reporting introduces substantial discretion into management estimates (Watts, 2006; Ramanna & Watts, 2010). This increased discretion can compound agency costs, leading auditors to increase their assessment of reputation and/or litigation risk and, consequently, their efforts to verify fair value estimates (Goncharov*et al.,* 2014).

Prior empirical evidence reinforces and supports that the recent transition to the new IFRS has a significant link to the level of audit fees. Griffin *et al.* (2009) suggested that the increase in audit fees is associated with the adoption year and in the following IFRS adoption years in New Zealand. Ding *et al.* (2008) indicated that the transformation from IAS to IFRS is regarded as a major accounting event in the auditing arena that is supposed to affect audit fees. This is because the changes in standards and regulations have increased the difficulties in the audit process.

Thus, based on the agency theory and aforementioned discussion, it is argued that there is a potential relationship between Audit fees and goodwill disclosure. Thus, the following hypothesis is developed as follows:

H3: Audit fee has a significant positive impact on the level of goodwill disclosure compliance under the MFRS 136 *Impairment of Assets* among the Malaysian listed companies.

V. Summary and Conclusions

Importance of financial disclosure appears as a consequence of the information asymmetry between the managers and shareholders and on the other hand, among shareholders themselves. Hence, the adoption of the IFRSs makes the annual report of companies more credible and transparent, and they offer a lot of information to different users. However, with the adoption of a new goodwill accounting regime by IFRS which has some ambiguous requirements (Bepari & Mollik, 2015). Besides, the lack of established "best practices" for IFRS means auditors are required to exercise professional judgment when investigating management assumptions and valuations (Al-Hiyari *et al.,* 2016). Hence, the audit quality is a vital factor influencing the credibility of financial statements (Arrunada, 2004).

Therefore, this study aimed to investigate the factors that influence the Malaysian listed companies to comply with the MFRS 136 by proposing a model that includes three proxy of audit quality that might affect the Malaysian listed companies in complying with the paragraph 134 requirements according to the MFRS 136. These proposed three proxy of audit quality which are audit firm size, audit tenure and audit fees. In turn, three hypotheses are developed and to validate the hypothesis, a survey research will be undertaken. Based on previous literature, the proposed model shows that audit quality plays an important role in improving the goodwill disclosure among Malaysian listed companies under MFRS 136 *Impairment of Assets*, where the audit firm size, audit tenure and audit fees positively impact the level of compliance with MFRS 136.

The present research paper is limited to Malaysian companies' compliance under MFRS 136 *Impairment of Assets* due to the lack of studies that have been carried out on compliance with MFRS 136. The results of this research paper may be generalized to all companies listed in Bursa Malaysia.

The proposed model concludes and gathers the important factors that influence the goodwill disclosure compliance with MFRS 136 *Impairment of Assets*, which will help future researchers to conduct further studies on disclosure compliance with accounting standards.

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