Analysis of "Big Bath" under Tighter Regulation on Goodwill Impairment

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Abstract: "Big bath" is a subset of earnings management techniques. Previous studies demonstrate that goodwill impairment recognition can be used as a tool for big bath earnings management. Under circumstances that regulators have tightened regulation of goodwill impairment, goodwill write-downs surged, which indicates that Chinese listed firms with depressed earnings are still likely to overstate goodwill impairment losses by taking a bath. My study analyzes the representative case of Dalian Zeus Entertainment Co., Ltd. (Dalian Zeus) for the relationship between potential big bath reporting and goodwill impairment. My paper further discusses the combination of amortization and impairment test as an alternative treatment for subsequently measuring goodwill and proposes some guidance for the purpose of reducing big bath earnings management. The alternative measurement can decrease managerial discretion in impairment testing.

1. Introduction

Many scholars consider that earnings management is within accounting principles in which managers use discretion in financial reporting to obscure the actual financial performance. William R. Scott defines earnings management as "the choice by a manager of accounting of accounting policies, or actions affecting earnings, so as to achieve some specific reported earnings objective." William R. Scott outlines four earnings management genres: taking a bath, income minimization, income maximization, and income smoothing [1].

The term "big bath" has been used to refer to situations in which earnings are negative or much lower than previous years and target earnings will not be met under whichever accounting procedures, managements have incentives to take a bath by booking an extensive non-recurring loss in a year. Such big bath activities further decrease current earnings but reduce future expenses and rise future earnings [2-4].

Goodwill generates from a business combination. The goodwill impairment test is an international approach to measure goodwill after a business combination, and it is adopted by Statement of Financial Accounting Standards (SFAS) No.142, International Financial Reporting Standards (IFRS) 3, Accounting Standards for Business Enterprises (ASBEs) No. 8, Malaysian Financial Reporting

Standards (MFRS) 136 and so on. According to ASBEs No. 8, goodwill is subject to an impairment test at least at the end of each year. Marc F. Massoud and Cecily A. Raiborn argue that the impairment test gives enough spaces for management interpretation, judgment, and bias. And they also speculate that companies utilize this impairment calculation to manage earnings, including reporting large goodwill losses if earnings are depressed [5]. Plenty of researches support their argument. As stated by Naser M. AbuGhazaleh et al., managerial discretion is used in goodwill impairment recognition which is more likely to be associated with recent CEO changes, income smoothing, and big bath charges [6]. Charles E. Jordan et al. note that firms carry out big bath earnings management by goodwill impairment losses in the implementation year of SFAS No. 142 to enjoy the favorable below-the-line treatment. They also find evidence supporting that this big bath behavior continues in the subsequent years when companies are exposed to weak earnings [7].

Previous studies demonstrate goodwill impairment recognition can be used as a tool for big bath earnings management. A surge in write-downs on goodwill by listed A-share companies allows me to shed light on the potential big bath reporting activities of the goodwill impairment under the circumstance that regulators have tightened regulation of goodwill impairment. My study suggests Chinese listed firms with depressed earnings are still likely to overstate goodwill impairment losses by taking a bath. In order to reduce the chance of big bath earnings management via goodwill impairment, my study discusses the combination of amortization and impairment test as an alternative treatment for subsequently measuring goodwill, and proposes some guidance needed to be given to the goodwill impairment, including indication of impairment, the timeliness of impairment, key parameters used in the impairment test, and information disclosure.

2. Theoretical Analysis

During recent years, Chinese mergers & acquisitions (M&As) in the capital market remain bullish with rapid growth in both total value and volume of takeovers. Wind shows that the scale of goodwill for A-share listed companies has increased since 2013 and had reached to RMB1305 billion by the end of 2017, at a three-year compound annual growth rate of 57%. The proportion of goodwill impairment charges over goodwill was as stable as 1% from 2013 to 2016 and slightly rose to 3% in 2017. The vast amounts of goodwill sitting on the book of Chinese listed companies came into notice of China Securities Regulatory Commission (CSRC). In order to enhance accounting regulation of goodwill impairment and heighten the quality of accounting information disclosure in the capital market, CSRC has announced Accounting Regulatory Risk Alert No.8 – Goodwill Impairment (the Alert) on November 16, 2018. The Alert covers accounting regulatory concerns about common issues in accounting treatment and information disclosure, auditing, and asset appraisal with respect to goodwill impairment. Valuation adjustment mechanism (VAM) plays a distinctly supporting role for a high valuation of takeover targets, which drives the excessively high premium paid by acquiring companies and generates high goodwill [8, 9]. Given the slow economic development, lots of takeover targets fell short of the targeted financial performance (e.g.net income) for 2018 required by VAM agreements. Thus the basis supporting high goodwill no longer exists, and acquiring companies probably need to make goodwill write-offs after taking goodwill impairment test. The Alert tightened disclosure rules around goodwill, urging listed companies to conduct timely impairment test at least at the end of each fiscal year. Then Chinese listed companies rushed to issue profit warnings for the 2018 fiscal year, and goodwill impairment losses played an important role in the sudden and significant decrease of earnings. Some companies even turned gain into loss after taking goodwill impairment into consideration. For 2018, audited goodwill impairment losses of A-share listed companies are about RMB167 billion. In 2018, among 476 Chinese A-share listed companies with negative profits, 265 of which report goodwill write-offs with an astonishing number while 45 of which record more than RMB1 billion. In the hope of reporting better numbers going forward, Chinese A-share listed companies with depressed earnings may opt to manage earnings by taking a big bath. To be specific, managers were likely to record a large amount of overstated goodwill impairment charges for the 2018 fiscal year.

3. Case Analysis

As an A-share listed company, Dalian Zeus Entertainment Co., Ltd. (Dalian Zeus), a gaming firm reporting the largest goodwill impairment charges, probably engages in big bath earnings management. In 2014, Dalian Zeus went public through a reverse merger. Since 2015, Dalian Zeus has expanded rapidly by virtue of several M&A deals which integrated the game and entertainment industry. These M&As transactions resulted in original goodwill amounting to RMB 6.71 billion on 31 December 2018. After conducting the impairment test, Dalian Zeus reported goodwill impairment charges of RMB 4.06 billion on goodwill for the year 2018, representing 61% of the original value of goodwill (As shown in Table 1).

Table 1 Goodwill and Goodwill Impairment of Dalian Zeus

Company	Acquisition Year	Goodwill Identified on Acquisition (RMB million)	Accumulate Goodwill Impairment Losses at the end of 2017 (RMB million)	Goodwill Impairment Losses for 2018 (RMB million)	Carrying Value of Goodwill at the end of 2018 (RMB million)
Shenzhen Yihua Technology Co., Ltd	2016	901.96	-	900.13	1.83
Leishan (Beijing) Technology Co., Ltd	2015	782.62	-	782.62	-
Beijing Interesting Network Technology Co., Ltd	2015	503.65	30.38	426.65	46.61
Shenzhen Weiepu Information Technology Co., Ltd	2015	493.04	-	-	493.04
Beijing Fantasy Yueyou Network Technology Co., Ltd	2017	2,927.91	-	1,702.05	1,225.86
Beijing Herun Detang Cultural Media Co., Ltd.	2017	520.16	-	195.33	324.83
Jiaxing Happy Play Network Technology Co., Ltd	2017	436.17	-	-	436.17
Shenzhen Taiyue Investment Center (Limited Partnership)	2018	43.15	-	-	43.15
Shanghai Kaiyi Investment Center (Limited Partnership)	2018	99.52	-	52.83	46.69
Total		6,708.18	30.38	4,059.62	2,618.18

Source: 2018 Annual Report of Dalian Zeus, Dalian Zeus's reply to concern letter from Shenzhen Stock Exchange

Since 2018, the Chinese game industry has begun to grow significantly slowly, and sector regulatory policy has tightened. Moreover, the pipeline of some games did not meet the research and development expectation and several games failed to launch on time. In this case, the earnings of several subsidiaries declined dramatically in 2018 and failed to complete the performance commitment required by VAM agreements. Hence, the basis supporting the original calculation of goodwill no longer existed, which led to goodwill write-offs. However, in the announcement of the results for three quarters ended 30 September 2018 disclosed by Dalian Zeus, it was indicated that whether goodwill impairment took place was still uncertain and the estimated net profit attributable to Dalian Zeus' shareholders for 2018 was between 0 and RMB510 million without taking goodwill impairment into account. After CSRC issued the Alert, Dalian Zeus released the profit warning and estimated that its losses for the 2018 fiscal year would be between RMB 7.3 billion and RMB 7.8 billion. Dalian Zeus claimed that in line with ASBEs No. 8 – Asset Impairment and the Alert, approximately RMB 4.9 billion of goodwill impairment provision was measured after the company carried out the impairment testing for goodwill. Dalian Zeus would be able to achieve RMB 377 million net profit attributable to Dalian Zeus' shareholders for 2018 if the factor of asset impairments was not considered, which was consistent with the earnings forecast disclosed in the previous quarterly result. Finally, Dalian Zeus reported that audited net income attributable to Dalian Zeus' shareholders for 2018 was RMB -7.15 billion, an enormous decline compared with the results for the previous year(As shown in Table 2), and that RMB 4.06 billion of the goodwill impairment charges were recorded. The earnings reversal implies that Dalian Zeus was likely to take a bath by calculating a huge asset impairment to digest the goodwill generated by excessive M&As premium, paving the way for the great performance in the following years.

Table 2 Financial Performance Highlight of Dalian Zeus

Item	2017	2018
Total Revenue (RMB million)	3,101.37	2,598.81
Net Income attributable to Dalian Zeus' shareholders (RMB million)	1,016.40	-7,150.59
Total Assets (RMB million)	14,608.44	8,569.92
Goodwill/Total Assets (RMB million)	45%	31%
Total Equity (RMB million)	9,546.59	2,343.74

Source: 2018 Annual Report of Dalian Zeus

After Dalian Zeus warned their investors for the first time, Shenzhen Stock Exchange sent concern letter to Dalian Zeus, requiring the explanation for the specific reasons and rationality of goodwill impairment. Although Dalian Zeus denied that the company used goodwill impairment losses to take a bath and disclosed earnings performance, earnings forecast and completion status of performance commitments for takeover targets, the company did not disclose key parameters used for goodwill impairment (such as growth rates of the expected present value of future cash for projection periods, estimated terminal growth rate, discount rates and years of projection period). The disclosure of Dalian Zeus lacks substantial content, which is unconvincing to investors.

4. Conclusion and Suggestion

Previous studies demonstrate goodwill impairment recognition can be used as a tool for earnings management. My study suggests that under the circumstance that regulators have tightened regulation of goodwill impairment, Chinese listed firms with depressed earnings are still likely to overstate goodwill impairment losses by taking a bath, thus to clear the assets bubble arising from M&As and enhance future earnings performance. Future research could test my notion by designing and doing empirical research.

The wave of goodwill write-downs by the large scale of Chinese listed companies provokes great repercussions in Chinese society, following by stocks price falling to the maximum daily limit. The relationship between the wave of goodwill impairment and stock price can also be considered by future research.

The wave of goodwill write-downs also reveals that regulators, rule makers and scholars need to do more to prevent the big bath earnings management relative to goodwill write-offs. First of all, amend the goodwill accounting standard. Recently, the majority of advisors of the China Accounting Standards Committee articulated that the amortization approach is a better accounting treatment for writing down the carrying value of goodwill to zero than the impairment approach. The reintroduction of the amortization method puts the subsequent measurement of goodwill in the teeth of the storm. The proper measurement methods for the value of goodwill after the business combination have aroused heated debate. The author supports the combination of amortization and impairment test as an alternative treatment for subsequently measuring goodwill. Under the amortization method, the cost of goodwill is systematically amortized over the periods expected to deplete the combination interests. Rule makers can set maximum amortization periods for different industries. The amortization approach could decrease managerial discretion in goodwill impairment and reduce the chance of earnings management. Next, provide more guidance. More guidance should be given to the goodwill impairment, including the indication of impairment, the timeliness of impairment, key parameters used in the impairment test, and information disclosure. ASBEs No. 8 stipulates different disclosure standards on the basis of whether the proportion of the carrying value of goodwill distributed to the asset group is significant. If the proportion is significant, the enterprise is required to further disclose the method to determine the recoverable amounts of the asset group. Now how to determine a significant proportion lacks further guidance, which decreases the quality and transparency of goodwill impairment disclosure. The author holds that a significant proportion can quantify as above 20%. Finally, strengthen the regulation. After the wave of goodwill write-offs, regulators sent concern letters and annual report inquiry letters to many companies. Accounting firms and regulators not only should keep a watchful eye on the listed companies when large goodwill impairment losses take place but also need to pay attention to listed companies when they record massive goodwill.

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