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THE RELEVANCE OF GOODWILL REPORTING IN AN ISLAMIC CONTEXT

Empirical studies

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Abstract

In recent years global finance has seen the emergence of Islamic finance as an alternative to the western secular system. While the two systems posses largely similar concepts of social equity and well-being the major divide between them rests in the distinction between divine and natural law as a source of protection for the downtrodden. As communication barriers between the Arabic and Anglo-European accounting systems start to blur, the question posed for the practitioners as to what constitutes a source of equity becomes more and more relevant. Considering the case of Islamic countries, besides internally-generated and acquired goodwill Islamic sources of social equity such as zakat also provide a source of social equity. For the purpose of this paper, two models pertaining to value relevance are tested for a sample of 56 companies in 6 accounting jurisdictions with the purpose of identifying the underlying sources of social equity revealing that zakat disclosures marginally improve the accuracy of the model.

Introduction

As an innovation of the Anglo-European Judeo-Christian company law, goodwill as a form of equity has for long been a reliable metric for inclusion in the financial statements of both public companies and SME's alike. The underlying framework which allows the inclusion of this metric into the financial statements of a company are not the fitness-oriented secular framework, but one which is deep-routed into the biblical framework of the 17th century England.

One of the bases for the recognition of goodwill as an asset rather than an expense can be found in the King James Bible 2 Corinthians 9:7 „Each one must give as he has decided in his heart, not reluctantly or under compulsion, for God loves a cheerful giver". By this paragraph the Bible clearly states that impulsive acts of charity and benevolence do improve the fate of the providers of charity, which as an act is separated from that of an economic transaction in which two assets of a comparable value are traded in a mutually beneficial manner allow the parties to reach their disparate economic goals.

The purpose of financial statements is to play a role in shaping the financial decisions of stakeholders in the context of the enterprise as well as protect the interest of the enterprise within the network of contracts. . As an immaterial right, goodwill can satisfy multiple demands from the different stakeholders and thus fulfill a role in ensuring the growth and development of the enterprise as defined by network effects (Lev, 2001).

A fair amount of skepticism must be mentained however in accruing the different amounts of expenses incurred during the financial year, as these play a role in the case of future mergers and acquisitions. For instance expenses incurred for the purpose of penetrating the marketplace can be recorded off-balance sheet for the purpose of negotiating a better deal with a would-be buyer. In fact the 1952 French chart of accounts included such items as establishment expenses (market research, initial advertising) into the amounts on the balance sheet (Canibano, 1972). Considering the detailed French Chart of Accounts we must consider the role played by these expenses on the social and financial clout of the enterprise within its particular framework.

By recognizing goodwill as an asset on the balance sheet, shareholders not only improve their credit scores, but also enhance the possibility of a favorable price for the trading of their company, while fulfilling a social role for the implementation of tax brackets.

There are many value relevance studies conducted for the purpose of examining value relevance have been proposed, inspired by the work of Feltham and Ohlson (1995). These studies are mostly conducted in a low-context Anglo-European setting such as the case of Damash et al (2009) who examine the value relevance and reliability of reported goodwill in the Australian context, Craig et al (2010)who examine the relevance of reported goodwill in the context of the Portughese stock exchange (2010), Beisland&Hamberg (2014) monitor the effects of impairment-only goodwill decisions on stock prices as reported by companies on the Stockholm stock exchange. The conclusions of such studies are limited to low-context accounting systems. Other studies fail to disclose the sample entirely, such as Xu, Anandarajan, & Curatola (2011) and at best provide a judgement for a general framework.

Islamic countries are generally not classified as developed markets. Pakistan, Malaysia and Indonesia are classified as emerging markets by the International Monetary Fund. Quatar, Egypt, Malaysia, Indonesia and the United Arab Emirates are awknoledged by MSCI Barra as emerging markets within their respective classifications.Goldman Sachs as part of its Next Eleven sample includes also Iran and Nigeria. These markets provide a window into a loosely regulated environment which can either endorse the legal secular developments of developed markets or provide the world with an innovative local frameworks, based on an Islamic cultural framework.

Regarding research in islamic countries the literature is vast and focuses mainly on moral and ethical aspects. Kamla et al (2006) find that Western transnational corporations have sought to promote their particular brand of corporate social (and environmental) responsibility accounting in Arab countries, variously influenced by Islam, with little to no mention of a notion of accounting for the environment integral to and deeply rooted in Islam. Building on Islamic teachings such as holism, social justice and knowledge development constitutes a platform for Islamic banking and accounting to go beyond emphasis on interest prohibition and ethical rhetoric that in practice bears little resemblance to operations. (Kamla R. , 2009, p. 929)Karim (2001) states that supervisory authorities in countries in which Islamic banks operate have taken various approaches to regulate Islamic banking.

Such variations appear to have resulted in Islamic banks adopting different accounting treatments for investment accounts, although most of the countries in which Islamic banks operate either look directly to international accounting standards as their national standards or develop national standards based primarily on international accounting standards. This rendered the financial statements of Islamic banks noncomparable. It also implies that the calls for worldwide adherence to international accounting standards to achieve harmonization in financial reporting, regardless of cultural differences that affect the way in which business transactions are carried out (in substance as well as in form), should not go unchallenged.

Research conducted within Islamic countries proper such as those conducted for the Tehran Stock Exchange emphasize legal distinctions between various categories of rights which are subject to classification as intangible assets, mainly focusing two different concepts, the right to goodwill and the right to business vocation (Sha'bani Nashtaei & Shahroudbari, 2012).

For the present paper, the emphasis shifts towards the social aspects of goodwill accounting, by focusing on a relevance model which incorporate Islamic metrics of social performance as internally-generated goodwill.

Goodwill accounting under an Islamic framework

In order to draw a link between accounting and the religion of Islam we must first accept that religion and finance represent a set of contracts. Religion is a contract between God and disparate individuals, linking subjects through social norms such as Shariah or the Talmud while finance represents a contract between individuals which is regulated by secular authorities. Both company law and religious codes share a mixture of positive and subjective norms, which either favour Will Theory or Theory of Interests which focus on a mixture of positive and subjective law, finance mainly draws from subjective law.

The world is rapidly becoming a multicultural landscape which does not favour segregation of ethnic and religious groups. While the Christian population is for the most part in favour of a secular landscape, religious influences law-making and attitudes towards laws and customs. Inevitably, research efforts must focus on the informational needs of the rapidly growing Muslim communities. European nations are accepting substantial immigrant populations chiefly drawn from Africa and Asia, so that today, Muslims constitute around 4 or 5 percent of the European population (Jenkins, 2006).

Such communities are rapidly gaining clout and demanding appropriate information from the CEO’s regarding the social performance of their funds, as well as the traditional financial performance. As revealed in Table 1, the numbers of jurisdictions which endorse Islamic guidance are significant, with over 10% of the UN member states supporting a legal system which in some way or another exposes Shariah principles for company or fiscal law. Over sixty percent of jurisdictions with an Islamic percentage greater than 90% have thus far adopted or permitted the adoption of IFRS guidelines for public enterprises or SME, including those pertaining to goodwill accounting. Some of those jurisdictions like Nigeria or Malaysia have even endorsed parts of the British common law framework, responsible for the emergence and development of goodwill accounting through the world.

Financial reporting practices pertaining to goodwill are converging. In the case of Saudi Arabia, one of the most conservative Islamic regimes, which has adopted IFRS the policies relating to goodwill are identical to those expressed in IFRS 3.The excess of consideration paid over the fair value of net assets acquired is recorded as goodwill. Goodwill is annually re-measured and reported in the consolidated financial statements at carrying value after adjustment or impairment, if any. If, after reassessment, the net amounts of the identifiable net assets acquired at the acquisition date exceed the sum of the consideration paid, the excess is recognized immediately in the consolidated statement of income as a gain.

Likewise in the case of Cairo and Jakarta Stock Exchanges which do not apply IFRS. In the case of Indonesia in particular, the entire carrying amount of the investment (including goodwill) is tested for impairment in accordance with PSAK 48 (Revised 2009),Impairment of Assets, which is similar in respect with the requirements set forth by the International Financial Reporting Standards (IFRS).

As we can observe in Table 2, the tax benefits incurred by companies which acquire goodwill are mixed, with some jurisdictions allowing goodwill amortization, while some do not recognize goodwill amortization as a deductible. As such, there are a few issues with deferred tax which would affect the comparison between the various accounting jurisdictions at a local level.

While, the degree of context certainly plays a part in the relevance of goodwill accounting numbers it is an established concept for the Islamic accounting establishment.

Zakat in Muslim countries: a cornerstone for accounting and social responsibility

Zakat is an element specific for Muslim countries. In the majority of Muslim countries, Islamic law covers all aspects of life, such as economics, ethical, political and religious. It is interesting the fact that there are different types of Muslim countries, when referring to constitutional recognition of state religion (Salim, 2008). Some states, including Saudi Arabia declare themselves as being Islamic states, while states like Egypt consider Islam as being their state religion.

Zakat is a mandatory tax, but means purification, prosperity, goodness. All Muslims have the obligation to renounce at a part of their assets and wealth, when it is exceeded a threshold, called al-nisab, being a minimum basis (Mohsin, 2013). Moreover, it is considered that zakat is a form of equitable distribution of wealth.

Zakat is viewed as a catalyst for extermination of poverty. The Islamic precepts highlight the importance of this religious tax, the Holy Coran referring to this word 82 times. Consequently, the premise could be that respecting the teaching of Islam, including here the payment of zakat is the guarantee for the lack of poverty.

In the literature is presented the eccentric explanation of the lack of disadvantages of registering the religious tax, zakat. An obvious inconvenient of paying this tax is the decrease in the total assets. However, Muhammad prophet stated that company's assets will not have a lower value, the zakat being the most profitable investment, because the return is 700 times higher than the initial investment (Adnan & Bakar, 2009).

The routes of this tax are in the year 624, when zakat was introduced and organized. This can be considered as a starting point for Islamic accounting, because it was the instrument for computing and determining the value of zakat. Ten years later, there were introduced the accounting concepts and procedures, in the period 634-644 (Kamla, Gallhofer, & Haslam, Islam, nature and accounting: Islamic principles and the notion of accounting for the environment, 2006).

Zakat represents basis for the differences between Islamic and traditional accounting. Accordingly, while traditional accounting was monetary value based, Islamic accounting is quantity based and monetary based (Saufi & Mustapha, 2012).

It is considered that the act of zakat embodies not only spiritual purposes, but also political and economic aims.

Islamic economic perspective is different from the Western economic perspective. While in western perspective individuals' main aim is to maximize their wealth and profit and to minimize the losses, according to Islamic approach individuals and also entities cannot consume their wealth in a wastefully manner. Moreover, they are bound to give to others under to the form of social contribution or zakat, because, according to Islamic beliefs, others have right to another person's wealth. Islamic version contrasts with western perspective where persons and companies can exert absolute and unconditional rights over their wealth and can benefit from it as is pleased. In Islamic world, according to Quran, individuals do not have absolute right over their wealth; they are only administrators of the received resources (Saufi & Mustapha, 2012).

Zakat seems to be considered a cornerstone and landmark for accounting. Although according to Islamic approach only the Allah will exist indefinitely, it is said that, if Allah wishes, business organization will continue indefinitely, this being an Islamic version of going concern principle of accounting. In the literature, is highlighted the idea that Islam religion tolerates business continuity, because they are a source of Zakat. The payment of zakat is linked to the continuity of its activity, being paid every year (Saufi & Mustapha, 2012).

Computation of zakat and implications on accounting

Zakat is related to fairness, justice and accountability. In order to compute Zakat in a fair and equitable manner, assets are recorded at the current market value, so not at cost, although the cost amount is verifiable and more objective. The current market value is considered to be able to capture the fair and real picture of the companies, while the historical is criticised for its inaccuracy and lack of relevance. (Saufi & Mustapha, 2012).

At international level, the accounting treatment for zakat is presented according to the Financial Accounting Standard (FAS) 9. This standard was issued by the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI), an independent international organization (Bakar, 2007).

The liability generated from zakat is determined by income level, the type of resources used by the company and the utilization of these resources. The resources a company can use are related to long term and short term financing and equity (PricewaterhouseCoopers, 2013).

The basis for zakat computation does not include unlawful or prohibited wealth, coming from stolen assets, income from interest, or having an illicit and prohibited source (Mohsin, 2013).

There are some methods for zakat calculation, namely the adjusted working capital method and adjusted growth method.

According to the adjusted working capital method, the base for zakat is the Net Current Assets (NCA), from which are deducted the items that do not fulfil the conditions for zakat assets and liabilities. As a parallel, the adjusted growth method considers as base for zakat long-term liabilities and owners' equity deducted for non-current assets and property, plant and equipment. As if in adjusted working capital method, items from the balance sheet are subtracted due to lack of productivity, lack of utility as well as additional items that do not respect the shariah law.

After the zakat base is established, a percentage of 2.5% is applied to the base in order to compute the zakat payable. (Ibrahim, Abdullah, Kadir, & AdwamWafa, 2012)

Considering the importance of this tax, companies should understand the importance of disclosing the major components of zakat and the method used for determining the base for this religious tax. This could be possible through presenting the payment, expense and liability related to zakat. Also, the recorded adjustments that influence the value of zakat should be mentioned in the financial statements of the companies (Ibrahim, Abdullah, Kadir, & AdwamWafa, 2012).

Methodology, sample and results

After developing the case for goodwill accounting in the case of Islamic countries we compare two models for determining its relevance in the Islamic context, based on the work performed by Feltham & Ohlson (1995).

The sample was selected from the Thomson Reuters DataStream library. Shariah-compliant companies ware considered. The second criterion for inclusion was the compliance with IFRS guidelines in respect to goodwill accounting (impairment-only, no pooling option, mandatory annual impairment tests). Next the results ware we filtered from the companies which had goodwill and ware listed major African or Asian Stock Exchanges only (Shariah-compliant equities listed in the EU or USA ware ignored for the purpose of the study since these jurisdictions are more secular than Asian or African firms). The data was compiled from the 2013 fiscal year.

The sample thus consists of 56 equities listed on the Abu Dhabi, Lagos, Cairo, Jakarta and Tadawul. The stock exchanges selected provide meaningful results not only for their diverse sample of quality equities but also for their pious Muslim communities. Of these only 8 companies (about 14% of the total sample) had experienced goodwill impairment and thus goodwill accounting had to be factored into net goodwill for a more robust statistical significance. Of these 25 are from the Jakarta Stock Exchange, 15 from Tadawul, 2 from Lagos, 4 from Abu Dhabi, 5 from Dubai, 5 from Cairo. The average free float from the sample is about 52% and thus the equities are more volatile in a market setting.

The variables factored in for the tests are the closing price for the equity at the day of the publishing of their annual financial statements as a dependent variable, net equity minus net goodwill (NE), net income (NI) and net goodwill (GWSH) adjusted by the number of ordinary shares as independent variables.

For the second model net goodwill was merged with outstanding zakat as an internally generated asset of the company as if the expenses been capitalized on the balance sheet. Zakat plays on the financial performance of the company by attracting Muslim customers.

The correlation coefficients between the dependent variable and independent ones are 0.45 for goodwill per share, 0.89 for net equity per share 0.85 for the net income of the company.

Both models contain an intercept and ware tested for the predicted sign to match against the correlation matrix. No Simpsons' effect was detected which would require the sub-sampling of the 56 companies.

Hypothesis 1 states that goodwill is more relevant when disclosed with Zakat.

Hypothesis 0 states that Zakat does not play a significant role in enhancing goodwill disclosures

The hypotheses are tested by judging the performance of the models. In case Zakat would not be recognized as an asset of the company by the investors, the corresponding model would have a lesser performance than the standard model.

Both models perform at 80% adjusted R squared, however the performance of the model which accounts for zakat as an internally-recognized asset of the company is slightly superior, thus signifying that Zakat would help improve the social performance of the companies. Since both models are valid the one who offers a better performance is superior. The first model, as seen in the Table 4 fulfills these demands.

Conclusions

In Muslim countries, the focus on profit maximization is transformed into maximizing the value of zakat, this religious tax being a proxy for the focus on the welfare of the society on the whole; the emphasis is not on the individual interest.

With Islamic civilizations encounter Anglo-European models, derivative metrics must be considered for the improvement of the financial reporting environment. The factoring of religious duties into this environment can bridge this gap.

Both internally-generated goodwill factored in Islamic accounting and acquired goodwill measured in respect to international accounting standards can be the missing links of integrated reporting in the new millennium.

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Appendices

Appendix A

Table No.1

The types of legal systems by percentage of jurisdictions

Type of legal system	Percentage of jurisdictions
Secular Civil Law	60.93
Secular Common Law	27.08
Mixed and Pure Religious Law	11.99

Source (http://www.juriglobe.ca/eng/syst-demo/tableau-dcivil-claw.php)

Appendix B

Table No.2

The types of legal systems by percentage of jurisdictions

Jurisdiction	Accounting treatment	Fiscal treatment
Saudi Arabia	Impairment of goodwill	Amortization of goodwill is deductible
Nigeria	Impairment of goodwill	Amortization of goodwill is non-deductible
United Arab Emirates	Impairment of goodwill	No definitive answer
Indonesia	Impairment of goodwill	Amortization of goodwill is deductible
Egypt	Impairment of goodwill	Amortization of goodwill is deductible

Source (http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/cross-border-mergers-acquisitions)

Appendix C

Table No.3

The metrics relating to the relevance of the legal source material

Statistics	Adjusted R^2	Standard Error	Intercept	GWSH (t-stat/p/coeff)	EN (t-stat/p/coeff)	NI (t-stat/p/coeff)
Model 1	80.5	2.33	0.269	(3.55/0.01/3.62)	(2.48/0.01/1.19)	(2.27/0.02/5.00)
Model 2	80.4	2.34	0.265	(3.42/0.01/3.56)	(2.20/0.01/1.25)	(2.20/0.03/4.85)