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Deferred taxes, earnings management, and corporate governance: Malaysian evidence

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ABSTRACT

This study examines whether Malaysian public listed companies (PLCs) use deferred taxes to avoid an earnings decline. In addition, this study also examines whether corporate governance mechanisms attenuate the extent to which deferred taxes are used to manage earnings. Using a sample of 221 PLCs listed on the main and second boards of *Bursa Malaysia* in 2008 with a complete set of data available from 2005 to 2008, this study finds that Malaysian PLCs use both the accrual and valuation allowance components of net deferred tax liabilities to avoid a decline in earnings. The study also finds that ownership structure and board structure affect the extent to which earnings management is associated with a deferred tax component.

1. Introduction

Malaysia's financial reporting regime was reformed in 1997 to be based largely on the US model. Similar to the Financial Accounting Standards Board (FASB) in the US, the Malaysian Accounting Standards Board was established as an independent standard setter. It is under the oversight of the Financial Reporting Foundation and reports directly to the Securities Commission of Malaysia (referred to as SC). Further, Malaysia has been making efforts to harmonize its financial reporting practices with International Financial Reporting Standards (IFRS) since 1975. From 1 January 2012, Malaysia undertook full convergence, with two exceptions[1], of Malaysian accounting standards to IFRS. The convergence with IFRS takes the form of the Malaysian Financial Reporting Standard (MFRS) which is the name of the accounting standards in Malaysia. Thus, corporate Malaysia's adoption of IFRS has been grounded in a principles-based approach as compared to the predominately rules-based approach used in the US. Moreover, unlike the US, Malaysia has a large number of firms which are either owned by the government or are government-related institutions. Hence, Malaysia provides a unique setting to examine the interplay of the effects of institutional factors on accounting standard setting, and principles-based SC enforcement that influences financial reporting in a political economy (Adhikari et al., 2006; Gul, 2006). With regard to the reporting of deferred taxes, the Malaysian standard is aligned with IAS 12 (revised), which does not require the setting up of a valuation allowance adjustment account for deferred tax assets. In contrast, such a valuation allowance adjustment is required in the US if the deferred tax asset is impaired under Statement of Financial Accounting Standard (SFAS) 109. More importantly, the current effective Malaysian standard on deferred taxes, referred to as Financial Reporting Standard (FRS) 112, discourages the setting up of such a valuation allowance account. Thus, it would be interesting to examine whether Malaysian Public Listed Companies (PLCs) continue to use such

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[1] The adoption of two accounting standards that were deferred until a later date is: (i) Malaysian Financial Reporting Standard (MFRS) 141 Agriculture, and (ii) Interpretation 15 Agreements for the Construction of Real Estate (IFRIC 15).

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valuation allowance adjustments. In addition, we investigate whether the ownership structure and corporate governance mechanisms of PLCs make a difference in which of the deferred tax liability (DTL) components are used for earning management activities.[2]

Malaysia was among the top 10 countries in a sample of 34 countries with the highest earnings opacity as measured by earnings aggressiveness, loss avoidance and earnings smoothness (Bhattacharya et al., 2003). Our study replicates two US studies by Phillips et al. (2003a,b) using a sample of Malaysian PLCs to examine if deferred taxes are used for earnings management. These US studies found that firms use net deferred tax liabilities to avoid an earnings decline. We extend this literature to examine if the ownership structure and corporate governance mechanisms affect the use of the various components of DTLs to avoid an earnings decline to smooth earnings in Malaysian PLCs. An increasing credit balance in a DTL account means that the firm is reporting book-income that is higher than taxable income. This indicates that the firm is deferring its tax liabilities to future years. Mahenthiran and Kasipillai (2012) found evidence that Malaysian PLCs engaged in multi-year tax planning strategies when corporate tax rates were lowered from 35% to 25% over the period 1999–2009. This permanent reduction in rates suggests that Malaysian PLCs may have had an incentive to defer tax payments during this period by aggressively managing the various components of DTLs. Hence, the objectives for this study are threefold: First, to examine whether the net change in deferred tax liabilities (DTLs) can detect earnings management (EM) activities in Malaysian PLCs. Second, to investigate which components of net change in DTL are associated with EM activities in Malaysian PLCs? Third, to probe the influence of ownership concentration types and board structure in affecting the components of DTLs used to manage earnings.

FRS 112 became effective on July 1, 2007 and greatly enhanced the disclosure requirements for deferred taxes. Additionally, FRS 112 requires that all temporary differences between income tax reported on the financial statements and income tax reported on the tax returns be accounted for on the balance sheet using the liability method, rather than adjusting tax expenses without considering future tax liabilities. Temporary differences in tax expenses arise between the periods in which a transaction affects book-income and the periods in which it affects taxable income. For example, the difference between rates of depreciation used for financial reporting and capital allowances used for calculating statutory income can give rise to a difference in tax expense and tax payment. This choice of accounting treatment could create a DTL that would be paid in a future period. Thus, temporary differences originate in one period and reverse in subsequent periods (e.g., over the life of a depreciable asset the total amount of depreciation should be the same for both financial reporting and tax purposes). Temporary differences arise because items that are reflected on the income statement as expenses are not necessarily permitted as deductions on the income tax return, or vice versa. However, if any such differences are permanent (e.g., income is exempt from taxes or subject to lower tax rates), they should not affect the DTL.

In the EM literature, the assumption is that managers exercise discretion to manage book-income (before taxes) upward without increasing taxable income (Mills and Newberry, 2001) to get the benefit of aggressively reporting higher book-income without paying more taxes in the same period. Hence, a high deferred tax expense (DTE) means a greater magnitude of difference between book-income and taxable income. This difference suggests an increased probability of EM to avoid reporting an earnings decline that helps to smooth reported income. Phillips et al. (2003a) found that DTE is useful in detecting EM, and Phillips et al. (2003b) found that the net change in DTL is a good proxy for DTE. However, in a regime of declining statutory tax rates, one would expect there to be less use of certain components of DTL for EM because most timing differences are likely to be permanent. Thus, the Malaysian context where taxes have been gradually reduced provides a unique setting to study the preference of managers for temporary versus permanent timing differences, and to investigate which components of DTLs the Malaysian PLCs use for EM activities.

Phillips et al. (2003a) found that DTE was useful in detecting EM beyond total accruals and abnormal accruals in firms trying to meet earnings targets to avoid an earnings decline. Phillips et al. (2003b) found that changes to DTL that are related to differences in revenue or expense accruals are items used to manage earnings. Likewise, the requirement under FASB's SFAS 109 for an adjustment to the deferred tax valuation allowance when the firm's future expected profitability makes recovering the deferred tax asset questionable is also used to manage earnings. Our study finds that the net change in DTL is incrementally useful in detecting EM in Malaysian PLCs. These companies use DTL related to accruals, revenue and expense adjustments, and the revaluation of assets components of DTL to avoid an earnings decline. Additionally, we find that EM is more likely when concentrated ownership by the five largest shareholders of PLCs is high and boards have fewer independent directors.

The remainder of this paper is organized as follows: Section 2 presents seven hypotheses based on tax and corporate governance literature. Section 3 details the methodology used for the study. Section 4 examines the incremental usefulness of total changes in net DTL to detect EM. It also explains the usefulness of the components of the changes in net DTL to detect EM. Finally, Section 5 concludes our paper by highlighting how Malaysian PLCs may use the change in DTL related to revenue and expense accruals, and a revaluation allowance, to manage earnings.

[2] The six deferred tax liability (DTL) components are accruals components (ΔNDTL_ACC), depreciation component (ΔNDTL_DEP), inventory and other asset valuations component (ΔNDTL_OAV), carried forward losses and unrealized gains and losses component (ΔNDTL_CFW_UGL), valuation allowance component (ΔNDTL_VA) and tax rate component (ΔNDTL_TAX). The results are reported in Table 5.