

The Usefulness of Deffered Tax Expense in Detecting Earnings Management

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Abstract : *The aim of this research is to examine the usefulness of deferred tax expense as compared to various accrual measures employed in prior research in detecting earnings management in two settings where earnings management likely occurs: to avoid loss and to avoid earnings decline. Manufacturing companies are listed at Indonesia Stock Exchange as sample in period 2010-2012 by purposive method. Our results provide evidence that deferred tax expense, total accruals, and discretionary accrual of the Jones Model have no significant influence to detecting earnings management to avoid loss. Deferred tax expense has no incrementally useful beyond accruals measures with regard to detecting earnings management to avoid loss. The result of the second setting empirically show that deferred tax expense has no significant influence to detecting earnings management to avoid earnings decline. Meanwhile, the total accrual and discretionary accruals of Jones Model have significant influence to detecting earnings management to avoid earnings decline.*

Keywords: *Earnings Management; Deferred Tax Expense; Accruals*

I. Introduction

Earning has been used as a target in the process of assessing the business achievement of a department and or the company [6][23][28][29]. Earnings consist of income in cash and accruals components, both of which are discretionary or non-discretionary [20][27]. Awareness of management, particularly for managers whose performance is measured based on income information, encourage deviant behavior, one of which is a form of earnings management.

Various empirical studies have been done in finding a relationship between discretionary accruals with earnings management. [8] Suggests there are at least five models for detecting earnings management through the calculation of discretionary accruals, among others (1) Healy Model, (2) The De Angelo Model, (3) The Jones Model, (4) The Modified Jones Model, and (5) The Industry Model. Based on research. [8] note that the Modified Jones Model showed better ability in detecting earnings management, so that this model is often used as a proxy for earnings management in a variety of research related to earnings management.

Tax purposes can be one way of earnings management because in addition to making the financial statements, companies also required to prepare fiscal statements [25]. Both of these financial statements have differences in determining the amount of reported earnings. [24] Stated that it was incurred as a result of differences between the provisions of tax laws with Indonesian's statement of financial accounting standards (PSAK 46) in recognizing the revenues and expenses. The existence of these differences cause the necessary corrections to the financial statements, which called fiscal correction that has two types: permanent differences and temporary (time) differences.

Revsine, *et al* (2001) as quoted by [34] argued that the temporary differences can be sourced from depreciation expenses, allowances of bad debt expenses, prepaid expenses, pension costs, the purchase of goodwill, the construction long-term contract, advanced payment/prepaid income, and undistributed profits to investors.

[14] in their study proves that there is a systematic difference between the actual deferred tax and deferred tax provisions in the Statement of Standard Accounting Practice 15 (SAP 15) on Accounting for Deferred Tax. The difference occurs because the manager is allowed to create the authority in determining the limit on the amount of deferred tax. The results showed a significant relationship between deferred tax provisions with earnings management practices in 1991 and 1992 in 58 sample companies. [34] showed that the deferred tax expense have better capabilities than discretionary accruals in detecting earnings management in the amount of a company's reported EPS. The calculation of deferred tax expense by [34] only focused on depreciation expense, allowances of bad debt expenses, and prepaid expenses.

[23] revealed to his research that there is a positive and significant correlation between deferred tax expenses with earnings management. In that study, the deferred tax expense is treated as one measurement of accruals together with the Modified Jones Model [8] and forward-Looking Jones Model [8]. [32] demonstrated the ability of deferred tax expense in detecting earnings management showed a positive and significant relationship between deferred tax expenses with the possibility of earnings management's company to avoid losses. The study used a sample of the companies listed in the Jakarta Stock Exchange in the period 1999-2002.

Based on various studies that have been done in finding a relationship between deferred tax expenses with earnings management, this research is conduct as an empirical study to test a predictive ability of deferred tax expense to detect earnings management. The main research problems are:

1. Is deferred tax expense has incrementally useful to total accrual as a predictive ability to detect earnings management to avoid loss?
2. Is deferred tax expense has incrementally useful to discretionary accruals based on Modified Jones Model as a predictive ability to detect earnings management to avoid loss?
3. Is deferred tax expense has incrementally useful to total accrual as a predictive ability to detect earnings management to avoid earnings decline?
4. Is deferred tax expense has incrementally useful to discretionary accruals based on Modified Jones Model as a predictive ability to detect earnings management to avoid earnings decline?

1.1 Deferred Tax

Deferred tax assets and deferred tax liabilities arise from temporary differences. Temporary differences arise when income or expense is recognized in the calculation of accounting profit that is different from the current year income or expense is recognized in the calculation of taxable income. Under [13], the measurement of deferred tax assets and liabilities as follows:

1. Current tax liabilities (assets) for the current year and the previous year are recognized at the amount of tax payable, which is calculated using tax rates that have been enacted or substantively enacted at the balance sheet date.
2. Deferred tax liabilities (assets) shall be measured at the tax rates that will apply when the liability is settled or the asset is realized, the tax rates that have been enacted or substantively enacted at the balance sheet date.
3. Deferred tax assets and liabilities should reflect the tax consequences for the recovery of the carrying value of assets or settlement of liabilities expected the company at the balance sheet date.
4. Deferred tax assets and liabilities should not be discounted (discounted).
5. The carrying amount of deferred tax asset should be reviewed (at the balance sheet date).

1.2 Earnings Management

[6][13] stated that earnings management occurs when managers use judgment in financial reporting and in the structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers. [25] suggested four pattern made by managers in performing earnings management, among others:

1. Taking a bath
Taking a bath pattern emerged in the concept of Bonus Scheme proposed by [12]. This pattern is associated with the Bonus Plan Hypothesis in a positive accounting theory. Taking a bath can occur when companies are in crisis or at the time of the reorganization, including at the time of hiring a new CEO.
2. Income minimization
This pattern is done in the years in which the company experienced a substantial profit. The goal is to "hold" the large number of reported earnings to be allocated to the following year. This pattern is closely related to the payment of corporate income tax, where the number of tax payments increase along with the number of reported earnings.
3. Income maximization
In this pattern, the manager inflate reported earnings for the purpose of getting a big bonus and the achievement of certain performance appraisal management. This pattern can be implemented by the recognition of revenue and the recognition of expense accruals basis cash basis.
4. Income Smoothing
According to [12], managers have an incentive to perform income smoothing, so the number of reported earnings is always in the region between the bogey and cap. In this pattern, the manager tried to "hold" the amount of reported earnings that lies between certain limits, the lower limit (bogey) and the upper limit (cap) which is believed to be appreciated by shareholders. Another reason to do income smoothing by management, among others, to reduce the volatility of reported earnings for purposes of covenants, lowering the possibility of being fired for being able to generate profits in accordance with the expectations of shareholders, and to describe the company's ability to generate profits in the context of reporting to the public.

1.3 Earnings Threshold

[7] hypothesize that managers have strong incentives to avoid reporting an earnings decrease and to avoid reporting a loss. They provide evidence of earnings management by documenting a higher frequency of

zero or small increases in earnings than expected in cross-sectional distributions of annual scaled earnings changes. They find similar results for zero and slightly positive earnings levels.

This study has two conditions to proxy earnings threshold in detecting earnings management: (1) earnings management to avoid loss (EM1) and, (2) earnings management to avoid earnings decline (EM2). At companies that perform earnings management to avoid loss divided into two categories, namely EM1 = 1 for profit firms and EM1 = 0 for loss firms. Meanwhile, the companies that perform earnings management to avoid earnings decline divided into two categories, where EM2 = 1 for the increase of firms and EM2 = 0 for decrease firms.

II. Research Method

2.1 Variable Measurement

The dependent variable in this study are earnings management (EM) using categorical data. Measurement of study variables are based on formulas that are used by [1][2][3][23], as follows:

Earnings management to avoid loss (EM1)

$$\text{Earnings levels} = \frac{\text{NI}_{it}}{\text{MVE}_{i,t-1}}$$

NI_{it} = net income of firm i in year t

MVE_{i, t-2} = Market value of equity of firm i in year t-2

- EM1 = 1, if the value of net income in the year (t) divided by the market value of equity in the year (t-1) is greater equal to zero (0).
- EM1 = 0, if the value of net income in the year (t) divided by the market value of equity in the year (t-1) is smaller than zero (0).

Earnings management to avoid earnings decline (EM2)

$$\text{Earnings changes} = \frac{\text{NI}_{i,t-1} - \text{NI}_{it}}{\text{MVE}_{i,t-2}}$$

NI_{i,t-1} = net income of firm i in year t-1

- EM2 = 1, if the difference between net income (NI) in the year (t-1) and net income in the year (t) divided by the market value of equity (MVE) in the year (t-2) is greater equal to zero (0)
- EM2 = 0, if the difference between the net income in the year (t-1) and net income in the year (t) divided by the market value of equity in the year (t-2) is smaller than zero (0).

The independent variable in this study is a deferred tax expense (DTE), the total variable accrual (TACC), and discretionary accruals (DACC) is based on Modified Jones Model.

1) Deferred Tax Expense (DTE)
$$\text{DTE}_{it} = \frac{\text{DTE}_i}{\text{TA}_{i,t-1}}$$

2) Total Accrual (TACC) calculation using cash flow approach as follows:

$$\text{TACC}_{it} = \text{EBE}_{it} - (\text{CFO}_{it} - \text{EIDO}_{it})$$

TACC_{it} = Total Accrual firm i for year t

EBE_{it} = Income before extraordinary items of firm i for year t

CFO_{it} = Cash Flow from Operations of firm i for year t

EIDO_{it} = Extraordinary items and discontinued operations of the company's cash flow statement of firm i for year t

3) Discretionary Accrual (DACC)

Jones model differentiates total accruals into discretionary accruals (DACC) and non-discretionary accruals (NDA). The difference between the TACC is NDA DACC.

The formula for calculating the NDA by Modified Jones Model:

$$\text{NDA}_{it} = \alpha + \beta_1 (\Delta \text{REV}_{it} - \Delta \text{REC}_{it}) + \beta_2 (\text{PPE}_{it})$$

NDA_{it} = Non Discretionary Accruals firm i in year t

TA_{i,t-1} = Total Asset firm i for year t-1

ΔREV_{it} = Revenues from sales of firm i in year t minus revenues in year t-1

ΔREC_{it} = Accounts Receivables firm i in year t minus account receivables in year t-1

PPE_{it} = Property, Plant & Equipment company i in year t

E_{it} = Error term

All of the above variables measured in the scale of Total Assets at year t-1.

Discretionary accruals (DACC) is obtained from a reduction in the total accruals and the NDA, such as the following formula: $\text{DACC}_{it} = \text{TACC}_{it} - \text{NDA}_{it}$

The control variable in this study is the change and the level of cash flow from operations. Determination of the variable formula is based on the formulas used by [23].

In detecting earnings management to avoid loss (EM1), used a variable level of cash flow from operations, as follows: $\text{CFO}_{it} = \text{CFO}_{it}$

$$TA_{i,t-1}$$

In detecting earnings management to avoid earnings decline (EM2), used variables change from cash flow from operations, as follows: $DCFO_{it} = \frac{CFO_{i,t-1} - CFO_{it}}{TA_{i,t-1}}$

2.2 Research Design

- For hypothesis 1a, the research model: $EM_{1a} = \alpha + \beta_1 DTE + \beta_2 TACC + \beta_3 CFO + \epsilon$
- For hypothesis 1b, the research model: $EM_{1b} = \alpha + \beta_1 DTE + \beta_2 DACC + \beta_3 CFO + \epsilon$
- For hypothesis 2a, the research model: $EM_{2a} = \alpha + \beta_1 DTE + \beta_2 TACC + \beta_3 DCFO + \epsilon$
- For hypothesis 2b, the research model: $EM_{2b} = \alpha + \beta_1 DTE + \beta_2 DACC + \beta_3 DCFO + \epsilon$

2.3 Samples

This study using a secondary data, in the form of financial statements of companies listed on the Indonesian Stock Exchange for the year 2010-2012. The population is focused on the manufacturing industry. The sampling criteria: (1) the company is listed on the Indonesian Stock Exchange December 31, 2008 and was registered by December 31, 2012 as the time horizon used in this study is 2010-2012. 2008 data is used to find the value of the market value of equity in the (t-2), while the 2009 data used in the calculation of total assets and net income computed in the previous year (t-1), and (2) the company elected to have all the necessary components in the study.

III. Result And Discussion

This study is to see the predictive ability of the DTE as incremental use of accruals in influencing the earnings management, both for the purpose to avoid loss and to avoid earnings decline. CFO and DCFO variables used as control variables. Results and discussion will be based on the research hypothesis. Based on the results of data processing by using binary logistic regression analysis is known to all models descriptive statistics also shown in table2.

Table 1 Case Processing Summary

Unweighted Cases ^a		N	Percent
Selected Cases	Included in Analysis	90	100.00
	Missing Cases	0	.00
	Total	90	100.00
Unselected Cases		0	.00
Total		90	100.00

Table 2 Descriptive Statistics

	N	Range	Minimum	Maximum	Mean	Std. Deviation
EM1	90	1	0	1	.87	.342
EM2	90	1	0	1	.30	.461
DTE	90	.05101	-.01100	.04001	.0027956	.00772255
TACC	90	26.35165	-.34128	26.01037	.3146779	2.74088136
DACC	90	5.20320	-5.30391	-1.0071	-1.4781874	.79567409
CFO	90	15.99916	-.19137	15.80779	.2556937	1.66328353
DCFO	90	17.40721	-.52645	16.88076	.1878302	1.78522975
Valid (listwise)	N 90					

Logistics coefficient interpretation of test results for each variable is done in the form of odds ratios. The conversion result called the odds or the possibility, which is the ratio between the probability of occurrence of an event with a probability of non-occurrence of an event [22]. The significance of the effect of each independent variable on the dependent variable used p-value with a confidence level of 90% and 95%. If the probability (p-value) is greater than 0.10 or 0.05 means that the independent variable has no effect on the dependent variable.

3.1 The Testing Hypothesis

1. Testing the predictive ability of deferred tax expense and total accruals in detecting earnings management for the purpose to avoid loss (EM1a)

Table 3 Defered Tax Expense and Total Accrul in Detecting EM

Description	Coefficient	S.E.	Wald	Sig	Exp(B)
Constant	1.548	.483	10.288	.001	4.704
DTE	-157.475	81.225	3.759	.053	.000
TACC	11.474	5.274	4.733	.030	96211.160

CFO	15.869	5.854	7.350	.007	7798106.701
Chi-square	14,382				
-2LogL	43.401				
Cox & Snell R ²	.261				
Nagelkerke R ²	.481				
Sig Hosmer and Lemeshow Test	.072				
Percent Correct					

Hosmer and Lemeshow testing was used as a test of goodness of fit that can be known from the p-value (sig. In the table) is greater than α (0.05). Table 3 shows that the p-value of $0.072 > 0.05$ means that the model is able to explain the relationship between the deferred tax expense and the total accrual with earnings management for the purpose to avoid loss. Table 3 shows the value Nagelkerke R Square amounting to 0.481, which means that the three independent variables (DTE, TACC, and CFO) was able to explain 48.10% the variance of earnings management practices for the purpose to avoid loss. The smaller the -2 log likelihood, the better the ability of independent variables in predicting the dependent variable. Table 3 shown variable DTE partially does not provide a significant effect in detecting the earnings management to avoid losses due to the Sig $0.053 > 0.05$. While variable TACC and CFO partially provide significant effect in detecting the earnings management to avoid losses. Magnitude of the effect of influence is indicated with Exp (B) or also called ODDS RATIO (OR). Variable DTE, TACC, and CFO with OR 0.000; 99.211; and 7,798,106 show DTE, TACC, and CFO has a predictive influence as much as 0,000 times; 99.211 times; and 7,798,106 times in detecting earnings management to avoid losses. Based on the B values in Table 3, then the model equations are formed as follows:
 $\ln P/1-P = 1.548 - 157.475 \text{ DTE} + 11.474 \text{ TACC} + 15.869 \text{ CFO}$

2. Testing the predictive ability of deferred tax expense and discretionary accruals based on Modified Jones Model in detecting earnings management to avoid loss (EM1b)

Table 4 Detecting EM to Avoid Loss

Description	Coefficient	S.E.	Wald	Sig	Exp(B)
Constant	-.399	.916	.190	.663	.671
DTE	-246.979	88.698	7.753	.005	.000
DACC	-2.289	.916	6.248	.012	.101
CFO	9.947	4.238	5.509	.019	20897.761
Chi-square	7.908				
-2LogL	41.922				
Cox & Snell R ²	.274				
Nagelkerke R ²	.503				
Sig Hosmer and Lemeshow Test	.443				
Percent Correct					

Table 4 shows that the p-value of $0.443 > 0.05$ means that the model is able to explain the relationship between the deferred tax expense and discretionary accruals based on Modified Jones Model in detecting earnings management to avoid loss. Table 4 shows the value Nagelkerke R Square amounting to 0.503, which means that the three independent variables (DTE, DACC, and CFO) was able to explain 50.30% the variance of earnings management practices for the purpose to avoid loss. Table 4 shown variable DTE, DACC, and CFO partially has a significant effect in detecting the earnings management to avoid losses due to the Sig < 0.05 . Variable DTE, DACC, and CFO with OR 0.000; 0.101; and 20,897 show DTE, DACC, and CFO has a predictive ability as much as 0,000 times; 0.101 times; and 20,897 times in detecting earnings management to avoid losses. The model equations: $\ln P/1-P = -0.399 - 246.797 \text{ DTE} - 2.289 \text{ DACC} + 9.947 \text{ CFO}$

3. Testing the predictive ability of deferred tax expense and total accruals in detecting earnings management for the purpose to avoid earnings decline (EM2a)

Table 5 DTE and TAIN Detecting EM to Avoid Earnings Decline

Description	Coefficient	S.E.	Wald	Sig	Exp(B)
Constant	-.744	.272	7.469	.006	.475
DTE	-17.285	34.120	.257	.612	.000
TACC	-4.107	3.191	1.657	.198	.016
DCFO	-5.191	2.590	4.017	.045	.006
Chi-square	13.036				
-2LogL	102.323				
Cox & Snell R ²	.081				
Nagelkerke R ²	.115				
Sig Hosmer and Lemeshow Test	.111				
Percent Correct					

Table 5 shows that the p-value of $0.111 > 0.05$ means that the model is able to explain the relationship between the deferred tax expense and the total accrual with earnings management for the purpose to avoid

earnings decline. Table 5 shows the value Nagelkerke R Square amounting to 0.115, which means that the three independent variables (DTE, TACC, and DCFO) was able to explain 11.50% the variance of earnings management practices for the purpose to avoid earnings decline. Table 5 shown variable DTE and TACC partially does not provide a significant effect in detecting the earnings management to avoid earnings decline due to the Sig > 0.05. While variable DCFO partially provide significant effect in detecting the earnings management to avoid earnings decline. Variable DTE, TACC, and DCFO with OR 0.000; 0.016; and 0.006 show DTE, TACC, and DCFO has a predictive ability as much as 0,000 times; 0.016 times; and 0.006 times in detecting earnings management to avoid earnings decline. The model equations: $\ln P/1-P = -0.744 - 17.285 \text{ DTE} - 4.107 \text{ TACC} - 5.191 \text{ DCFO}$

4. Testing the predictive ability of deferred tax expense and discretionary accruals based on Modified Jones Model in detecting earnings management to avoid earnings decline (EM2b)

Table 6 DTE and DA in Detecting EM to Avoid Earnings Decline

Description	Coefficient	S.E.	Wald	Sig	Exp(B)
Constant	-.872	.509	2.938	.086	.418
DTE	-5.132	32.826	.024	.876	.006
DACC	-.003	.295	.000	.993	.997
DCFO	-3.813	1.932	3.893	.048	.022
Chi-square	11.886				
-2LogL	104.281				
Cox & Snell R ²	.061				
Nagelkerke R ²	.087				
Sig Hosmer and Lemeshow Test	.156				
Percent Correct					

Table 6 shows that the p-value of 0.156 > 0.05 means that the model is able to explain the relationship between the deferred tax expense and discretionary accruals based on Modified Jones Model in detecting earnings management to avoid earnings decline. Table 6 shows the value Nagelkerke R Square amounting to 0.087, which means that the three independent variables (DTE, DACC, and DCFO) was able to explain 8.70% the variance of earnings management practices for the purpose to avoid earnings decline. Table 6 shown variable DTE and DACC partially does not provide a significant effect in detecting the earnings management to avoid earnings decline due to the Sig > 0.05. While variable DCFO partially provide significant effect in detecting the earnings management to avoid earnings decline due to Sig 0.048 < 0.05. Variable DTE, DACC, and DCFO with OR 0.006; 0.997; and 0.022 show that DTE, DACC, and DCFO has a predictive ability as much as 0,006 times; 0.997 times; and 0.022 times in detecting earnings management to avoid earnings decline. The model equations: $\ln P/1-P = -0.872 - 5.132 \text{ DTE} - 0.003 \text{ DACC} - 3.813 \text{ DCFO}$

IV. Conclusion

This study aimed to test the predictive ability of deferred tax expense (DTE) in detecting earnings management, both for the purpose of avoid losses and earnings decline, which is carried out by companies in the manufacturing industry are listed in the Jakarta Stock Exchange 2010-2012. The conclusion that can be obtained based on the results are as follows:

1. There is no significant effect of deferred tax expense to detect the earnings management to avoid losses, while total accrual has a significant effect to detect the earnings management to avoid losses. Deferred tax expense has lower predictive ability than total accrual in detecting earnings management to avoid losses.
2. There is a significant effect of deferred tax expense and discretionary accruals based on Modified Jones Model to detect the earnings management to avoid losses. Deferred tax expense has lower predictive ability than discretionary accruals based on Modified Jones Model in detecting earnings management to avoid losses.
3. There is no significant effect of deferred tax expense and total accrual to detect the earnings management to avoid earnings decline. Deferred tax expense has lower predictive ability than total accrual in detecting earnings management to avoid earnings decline.

There is no significant effect of deferred tax expense and discretionary accruals based on Modified Jones Model to detect the earnings management to avoid earnings decline. Deferred tax expense has lower predictive ability than discretionary accruals based on Modified Jones Model in detecting earnings management to avoid losses.

Limitation

There are several limitations in this study: first, limitations in the amount of research data also affects the range of profit firms and loss firms, where the selection is at range ≥ 0 for profit firms and < 0 for loss firms. The selection of range intended to prevent the amount of data is diminishing, so the ability of data to detect

earnings management, both for the purpose of preventing reporting loss or decline in earnings, could be better. Second, variable measurement of deferred tax expense which assumes that all deferred tax expense as a discretionary component. In fact there may be some component in the deferred tax expense are non-discretionary or are the result of the company's operational activities.

V. Recommendation

1. The use of the model distributions of profits and distribution of earnings changes in detecting earnings management by the company around the reporting cut-off point (zero point) should use longer time span, so can obtained more data and has a better predictive ability to detect earnings management, also can improve the validity research result.
2. Using detail components of deferred tax expense, which it discretion or not, for future studies to improve the ability of deferred tax expense in predicting earnings management by companies in Indonesia.
3. Using other accrual model, such as Kaznik Model, for future studies so it can compare the ability among accrual model in detecting earnings management.

VI. Implication

This research implied the using of deferred tax expense as a variable to detect earnings management beside the accrual models that has been used by previous studies. Analysis of deferred tax expense can be an alternative for external users of financial statements to measure either a company doing an earnings management or not.

From the accounting standards' standpoint, the results showed that the change in accounting standards governing the accounting of income tax [15], in which companies are required to record deferred tax expense (income) could provide additional information for users of financial statements to analyze company performance. It may be a consideration in the development of [15], for example in the case of the determination of the rules of disclosure components of deferred tax expense can be more detailed, so it can be identified components of discretionary or non-discretionary deferred tax expense.

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