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Companies that Cut Back Auditors' Tax Services for Appearances Had Higher Tax Rates, Study Finds

By Soyoung Ho

A study found that companies that pull back using their audit firms for tax services just for appearances may end up costing them more. These companies had higher tax rates.

Researchers hypothesized that tax services from a new firm can result in decreased tax avoidance because the new firm lacks familiarity with a client's existing tax planning or does not have the expertise in general new tax-avoidance opportunities.

"Consistent with our hypothesis, our results reveal that sample companies' book (cash) effective tax rates increased by economically significant 1.36 (1.63) percentage points in the year after terminating or substantially decreasing purchases of tax services from their audit firms, and discretionary permanent book-tax differences declined significantly," Kirsten Cook of Texas Tech University, Kevin Kim of the University of Memphis, and Thomas Omer of the University of Nebraska in Lincoln, wrote in a study which appears in the June/August 2020 issue of **Accounting Horizons**, published quarterly by the **American Accounting Association**.

"We find that decreases in tax avoidance were larger for companies whose outgoing tax-service providers were tax-specific industry experts," the authors wrote.

The researchers analyzed data from thousands of public companies, including taxes owed and paid, and fees paid for tax services.

They looked at two different periods: one from 2002 to 2005, which includes the period when the SEC required companies to disclose tax-service fees; the other time period was for years 2006 to 2008 when the reasons for companies shifting away from using their audit firms for tax services likely differed from those of the earlier timeframe.

The study found that in 419 cases where tax service auditors were dismissed or their tax services sharply curtailed, tax rate increases amounted to an average tax increase of about $6.4 million in amount owed per company and $7.65 million in what was actually paid.

After the accounting scandals at companies like Enron and WorldCom, Congress passed Sarbanes-Oxley in 2002 to promote the integrity of financial reporting and impose regulations on auditors of public companies.

Section 201 of Sarbanes-Oxley states that audit firms can perform non-audit services including tax compliance and planning work for their audit clients, the clients' audit committees must approve these services beforehand. The 2002 law also requires companies to disclose non-audit service fees, including a separate tax-fee disclosure. A year later, the SEC revised its audit independence rules that banned accounting firms from representing their audit clients on tax matters in court.

Moreover, investor protection advocates have been paying attention to firms that provide non-audit services.

All these led some companies to reduce or eliminate tax fees paid to their auditors to show they are independent.

The study finds, however, the higher tax bill was only temporary—it was limited to about one year.

Earlier research has provided "survey evidence from corporate tax directors that nearly 70 percent of corporate tax plans are alterable within one year and 40 percent are alterable within six months. If tax avoidance is alterable in such a short period, it is not surprising…that tax avoidance rebounded relatively quickly following the hiring of a new tax advisor," the researchers wrote.

The professors believe that in the aftermath of the passage of Sarbanes-Oxley, companies likely dropped or greatly curtailed their auditors providing tax services to promote "the appearance of auditor independence rather than obtaining higher-quality tax services."

In the later period, by contrast, "we conjecture that auditor independence was not a concern in these dismissal/decrease decisions," they said.

In the meantime, they said their findings should be of interest to the SEC and the PCAOB. In 2016, the European Union passed legislation that prohibit audit firms from providing tax services to audit clients.

"U.S. regulators have adopted a wait-and-see attitude, monitoring whether the benefits of the mandate in Europe outweigh the costs," Professor Cook said. "Meanwhile, the Big Four accounting firms have issued implementation guidance for potentially affected clients, in case a similar regulatory regime is enacted over here."