



JUNE 30, 2020

[Auditing](#)

## Curtailing Auditors' Tax Services For Appearances Brings Higher Rates

*The pursuit of perceived auditor independence turns out to be an expensive proposition, a new study reveals*



Heightened by notorious accounting scandals two decades ago involving Enron, WorldCom, Arthur Andersen accountancy, and others, suspicions have persistently dogged firms whose auditors perform consulting services for them in addition to core accounting functions. And perhaps no extra services have evoked more concern than those related to taxes.

Indeed, regulatory actions have likely created an atmosphere that motivated companies to reduce or eliminate tax fees paid to audit firms to bolster the appearance of independence in their auditor-client relationship, according to a new study in **Accounting Horizons**. But the evidence is mixed on whether the provision of tax services in fact compromises auditors' independence — and thereby diminishes the reliability of their client firms' financial reporting.

The new study investigates a related question that has received sparse attention: What is the financial impact on companies that drop or greatly reduce tax-counseling by auditors for appearances' sake — that is, to forestall suspicion among regulators and investors about the reliability of their financial reporting?

The pursuit of perceived auditor independence turns out to be an expensive proposition, the study reveals.

“Companies dismissing or substantially reducing reliance on their audit firms as tax-service providers ... incurred substantial [tax] costs to avoid the perception of impaired auditor independence,” conclude the paper's co-authors, Kirsten A. Cook of Texas Tech University, Kevin Kim of the University of Memphis, and Thomas C. Omer of the University of Nebraska-Lincoln.

More precisely, those companies saw their effective tax rate, as reported on their financial statements, increase by a mean of 1.36 percentage points in the following year and their actual cash payment of taxes swell by 1.64 percentage points. In the 419 instances where tax-counseling auditors were dismissed or their tax services sharply curtailed (as revealed in a large corporate database), these rate increases amounted to an average tax boost per company of about \$6.4 million in the amount owed and about \$7.65 million in what was actually paid.

Perhaps unsurprisingly, the biggest losers were client firms that curtailed auditors that have tax expertise (with high market share in this specialty); those companies' next-year tax payouts swelled by an average of 4.53 percentage points.

Fortunately, for the client companies involved, this extra tax burden proved to be only temporary, limited to about a year.

As the researchers explain, “decoupling audit and tax-service provision and subsequently obtaining tax services from a new provider can result in decreased tax avoidance because the new service provider lacks familiarity with the client's existing tax planning or does not have the expertise to generate new tax-avoidance opportunities. Even if the outgoing and incoming tax-service providers possess equal tax expertise, the incoming provider requires time to ascertain

the client's current tax planning and to [design and implement] tax-avoidance activities to capitalize on any additional tax-avoidance opportunities.”

Fortunately, for the client companies involved, this extra tax burden proved to be only temporary, limited to about a year.

Earlier academic research, the professors write, has provided “survey evidence from corporate tax directors that nearly 70% of corporate tax plans are alterable within one year and 40% 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 adviser.”

Does the temporary nature of the phenomenon vitiate its importance? Comments Texas Tech's Prof. Cook:

“While the costs are short-lived, they are large in magnitude, both statistically and economically. Moreover, if foregoing auditor tax services does not enhance audit independence, as some highly regarded research has concluded it does not, the disruption firms experience in switching tax consultants plus the resultant increased tax costs they sustain amount to deadweight losses — financial sacrifice with no compensating gain in accounting quality.”

The study's findings are based on analysis of information from large databases covering thousands of U.S. public companies, including taxes owed and paid, fees paid for tax services, and basic data on corporate finances and governance.

Taking note of the fact that in 2016 the European Union enacted legislation that prohibits audit firms from providing tax services to audit clients, the professors write: “Our findings should be of interest to U.S. regulators such as the [Securities and Exchange Commission] and the [Public Company Accounting Oversight Board] as they monitor the effects of this new law in Europe and consider implementing additional reforms to limit the scope of auditor-provided tax services here in the U.S.”

As for the prospects of a similar prohibition crossing the Atlantic, Prof. Cook surmises that “U.S. regulators have adopted a wait-and-see attitude, monitoring whether the benefits of the mandate in Europe outweigh the costs. Meanwhile, the Big-4 accounting firms have issued implementation guidance for potentially affected clients, in case a similar regulatory regime is enacted over here.”

The paper, “The Cost of Independence: Evidence from Companies’ Decisions to Dismiss Audit Firms as Tax-Service Providers,” is in the June/August issue of **Accounting Horizons** a peer-reviewed journal published quarterly by the **American Accounting Association**.