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CURTAILING AUDITOR TAX SERVICES RAISES FIRMS' TAXES: STUDY

By [Jacob Wolinsky](#)

Companies that curtail auditors' tax services for sake of appearances pay stiff price in higher rates, study finds

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. As a new study in the journal ***Accounting Horizons*** observes, 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."

Is An Auditor's Independence Compromised By The Provision Of Tax Services?

Does provision of tax services in fact compromise auditors' independence – and thereby diminish the reliability of their client firms' financial reporting? As noted in the new paper in ***Accounting Horizons***, a peer-reviewed quarterly journal from the **American Accounting Association**, voluminous research on this question has yielded evidence that is mixed. Instead, the new research 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 amount owed and about \$7.65 million in what was actually paid.

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

Decreased Tax Avoidance

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 design/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 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."

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

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. The research covers two time spans, as follows:

- The period from enactment of the Sarbanes-Oxley act (SOX) on July 30, 2002 through 2005. Following the passage of this legislation, which represented Congress’ response to recent major corporate accounting scandals, the SEC required public companies to disclose tax-service fees paid to audit firms.
- The years 2006 through 2008, when SOX was further in the rear-view mirror and companies’ reasons for shifting away from audit firms as tax-service providers likely differed from those of the earlier period.

As the professors explain, in the years closely following the passage of SOX, the likely motivation for dropping or greatly curtailing auditors as tax providers was “promoting the appearance of auditor independence rather than obtaining higher-quality tax services.” In the later period, in contrast, “we conjecture that auditor independence was not a concern in these dismissal/decrease decisions.”

The upshot? In the later period, “companies did not experience the same unfavorable tax-avoidance results as companies in the earlier years...Differing motivations for terminating or substantially reducing auditor-provided tax services result in differing tax-avoidance outcomes between those periods.”

Indeed, in contrast to the earlier period, the relationship between auditor dismissal/decrease and company tax expense in was not statistically significant in the later time span.

The Effects Of This New Law In Europe

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 SEC and PCAOB 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**, a worldwide organization devoted to excellence in accounting education, research, and practice. Other journals published by the AAA and its specialty sections include *The Accounting Review*, *Auditing: A Journal of Practice and Theory*, *Issues in Accounting Education*, *Behavioral Research in Accounting*, *Journal of Management Accounting Research*, *Journal of Information Systems*, *Journal of Financial Reporting*, *The Journal of the American Taxation Association*, and *Journal of Forensic Accounting Research*.



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