Should Auditors of Nonpublic Companies be allowed to provide Tax Services to their Audit Clients?

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ABSTRACT: This study examines the question of whether auditors should be allowed to perform tax services for clients that they also provide the audit. The question was examined by looking at bankers' perceptions of auditor independence, objectivity and reliability of the report on the financial statements when the auditor also performs tax compliance services for (1) the audit client and (2) company executives. We randomly selected bank loan officers from a commercial prepared list and mailed a questionnaire to each participant. Questionnaire results, based on 181 participants, indicate that bank loan officers believe attest auditors should be allowed to provide tax compliances services to the client even though they may be auditing some of their own work. Results also indicate that bank loan officers think that independence and objectivity would be impaired and reliability of the auditor's report would not be enhanced if the auditor provides tax compliance services to the client and the client's executives they also audit.

Keywords: auditor independence, objectivity and reliability; tax compliance services

I. INTRODUCTION

Much debate has taken place concerning the issue of whether independence is impaired when the attest auditor also provides tax compliance services to public audit clients. However the SEC, PCAOB and the AICPA have all continued to allow attest auditors to provide tax services to their audit client. How did this debate get started- the auditors have been doing tax services for their attest clients for many years? Over time the auditing environment changed with new tax services and other services being added to the auditor's list of fee paying services. These new services required new regulations to keep pace with the changing environment. It took enormous financial fraud scandals to get us to this point. This call for regulatory change produced the SOX (Hart, 2009). The act made several significant changes including creating the PCAOB, adding stringent internal control requirements, and strengthening the auditor independence rule. Furthermore, the SEC noted the possibility of auditor independence impairment from the provision of auditor-provided tax services and approved the rules of the Public Company Accounting Oversight Board to further limit the provision of such service (SEC, 2006).

Auditor provision of tax services and other non-audit service combined with an audit of the client continues to be an important question. It is well known that independence of external auditors is important to investors (Robinson, 2008). One report stated that credible financial reports are vital to confidence in the capital markets (Van Der Plaats, 2000). Investors need to believe what they are told about the investee companies by the auditor, as such auditor independence is a key source that gives the auditor's work its value. Because Independence gives the auditor's work value, it is the core of the profession (SEC, 2000). "For investors to have confidence in the quality of the audit, the public must perceive the accountant as independent" (SEC, 2000). The concern is important enough that the PCAOB and SEC stated that they will hold a round-table discussion to address the issue of audit firms providing non-audit and consulting services to audit clients (Tysiac, 2013). Since regulators in the nonpublic environment continue to allow attest auditors to provide tax service to their audit clients, this paper provides some empirical information to help regulators evaluate if changes are needed with respect to non-audit services in a nonpublic environment. The remainder of this article includes the following sections: (1) A review of the professional literature on NASs, (2) Research questions, (3) Methodology, (4) Findings, (5) Summary, (6) Recommendations and (7) Conclusions.

II. Non-audit Services-The Professional Literature

For public companies, the guiding principles for auditor provided tax services to audit clients come from the Public Company Accounting Reform and investor Protection Act of 2002. This act states that an auditor who performs non-audit services to audit clients must not (1) Act in the role of management, (2) Audit its own work, (3) Act as an advocate of the client (U.S. Senate, 2002). In addition, section 202 of SOX requires that non-audited services including tax services be approved by the audit committee and disclosed in the annual report of the public company (U.S. House of Representatives, 2002). The GAO states that when performing non-audit services for an audit client, the auditor must (a) consider the auditor's ability to perform an audit without being affected by influences that compromise professional judgment, (b) exposure of the auditor or audit organization to circumstances that would cause a reasonable and informed third party to conclude that the integrity, objectivity, or professional skepticism of the audit organization, or a member of the audit team, had been compromised (U.S. Congress, 2011).

The fact that Public Company firms are reducing the amount of fees paid to their audit clients for tax services indicates a concern for auditor independence real or perceived (Lassila, et al, 2010). Still another study investigating Tax Avoidance states that clients purchasing tax services from their audit firm engage in greater tax avoidance when their external audit firm is a tax expert (McGuire, Omer, Wang, 2012). However, the important finding in this study that supports our motivation is the statement that "While prior research suggest that the use of auditor-provided tax services declined after the passage of the Sarbanes-Oxley Act (Krishnan, Visvanathan and Yu, 2013) find that approximately two-thirds of the corporation in their sample continue to purchase at least a portion of their tax consulting and compliance services from their external audit firm (McGuire, Omer, Wang, 2012).

Another reason that firms are decoupling their tax services for audit service is the fact that although the SEC permits the auditor to provide tax services there are some significant restrictions like having to disclose fees paid for tax services separately in the company's annual proxy statements (Lassila, et al, 2010). A study conducted by Seetharaman, Sun and Wang (2011) supports the decline in auditors providing tax services to their clients. The study found that for companies that purchased non-audited tax service from their auditors for the period 2003 to 2006, average tax fees declined by 23% whereas average audit fees increased by 113%. Additionally, a study to test the relationship between auditor-provided tax fees and audits fees concluded, "Tests on the cross-selling of services show that firms that employ their incumbent auditors also for tax service are likely to pay higher audit fees than in the case when they only employ their auditors for audit service. Similarly, firms that do not use tax service of auditors are likely to pay lower audit fees than in the case had they had used incumbent auditors' tax service" (Halperin, R., & Lai, K., 2015). Again these studies support the need for additional studies on auditor provided tax services because audit firms are continuing to provide these services to their clients. At the same time, these firms are recognizing that stakeholders may perceive them as not being independent when they couple the two services together.

Because of these stated studies and the importance of auditor independence, this study provides much needed empirical research that can help firms, regulators, and stakeholders to make better decisions concerning auditors provided tax service. The AICPA's position is that the auditor should follow the codified rules of 101-3 (AICPA, 2014) in the performance of all non-audit functions. These rules require the auditor to acquire the proper approvals, not act in the role of management, and not take possession of entity assets. However, the GAO general standards state that non-audit services may create several threats to audit independence. These threats include self-review threat and management participation threat. Both threats are examined in this article (U.S Congress, 2007).

III. Research Question

Recurring tax services are the only NAS negatively associated with restatements. One study stated that the negative association is consistent with recurring tax services providing auditors with knowledge spillovers that improve audit quality (Peterson and Valencia, 2011). Another study concluded that auditor provided tax services have an insignificant impact on audit quality (Krauss, Zulch, 2013). However, a GAO study concluded that accounting restatements increased 145 percent and cost investors $100 billion during 1997-2000, and that restatements continued to increase from 2002 to 2005 (U.S. Congress, 2002,2006). These studies show that more information is needed to continue addressing issues that may contribute to these misstatements.

Significant controversy remains regarding the auditor providing tax services. Furthermore, major differences exist between SEC and AICPA independence rules regarding the independent auditors (1) providing tax services to their audited clients and (2) providing tax services to executives of their audit clients. Should the independent auditor be allowed to provide these additional services? Should auditors of nonpublic entities be afforded the flexibility to provide services which are limited and must be provided under more stringent circumstances in the public environment? We investigate these issues for users for financial statements in the nonpublic company context. We also include the related concepts of auditor objectivity and perceptions of financial statement reliability.

Our research questions are (1) should auditors be allowed to provide tax services to their non- public audit clients, (2) should auditors be allowed to provide tax service to executives of their non-public audit clients?

IV. Methodology

To obtain the necessary information required for this study, bank loan officers were used as the participants. The researcher chose bank loan officers as participants in the survey because they are sophisticated users of financial statements. Bank loan officers deal with all types of corporations, public and nonpublic, as well as have similar backgrounds and financial knowledge. However, to obtain a fair homogeneous group of loan officers, a commercial prepared list was purchased from a commercially prepared mailing list. To obtain information about the prior experience of the bank loan officers, the questionnaire included a demographic section. The researcher performed a random selection of 1,500 bank loan officers then mailed a questionnaire to each of them. To evaluate the two research questions, we look at what the regulators say is a problem with auditors providing their tax services to their non-public audit clients. The main problems of the regulators, state that the auditing firm: (1) should not audit its own work; (2) should not function as part of client management or as a client employee; and (3) should not act as an advocate for the audit client (U.S. Senate, 2002). Each question was designed to solicit the Bank Loan Officer’s opinion about Independence, Objectivity, or Reliability. Some of the questions were directly related to the requirements of regulators for auditor independence. For example, the first question asked the Bank Loan Officer to agree or disagree with the statement that CPA firms are acting in an advocacy role for the audited entity when they also do tax compliance work for the audited entity. The second question asked if auditors provide tax compliance work for the audited entity, will auditor independence be impaired. For example, KPMG provided loaned staff to audit clients for certain tax services, to which the SEC stated that these services were management functions and impaired auditor independence. Furthermore, the SEC further stated that Management functions included acting, temporarily or permanently, as a director, officer or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client. (SEC, 2014). “The independence of CPAs is the hallmark of the profession. As such, accountants put forth significant focus and effort to comply with the independence requirements related to everything from investments to business and employment relationships to services delivered to clients.” (Beckett, 2013). On the other hand, a study conducted by Krishnan, Visvanathan and Yu states that investors feel that the benefits of auditor-provided tax services outweigh the risks that the audit will not be performed independently enough. (Krishnan, Visvanathan, Yu, 2013).

There are ten independence questions, two objective questions, five reliability questions and three questions dealing with auditors performing tax services for executives of the audit client. Respondents were instructed to circle their level of agreement on a 5-point Likert scale. The scale ranged from -2 to +2 with -2 indicating “strong disagreement” and +2 indicating “strong agreement”. The research used a mean response score to analyze each of the questions. Various statistical methods were used to analyze the information received from the questionnaire.

The participants of the study are very sophisticated and knowledgeable. A large majority of the respondents were CEO/President of their organizations (68%). Over 95% of respondents were somewhat or very knowledgeable of the auditing process. In addition, over 90% of the respondents have 10 or more years of experience in medium size lending institutions (less than $1 Billion). Most of the respondents were male, over the age of forty, and held at least a bachelor’s degree.

Table 1. Demographics of Respondents of the Questionnaire

	Count	*Percent*
Group Size	200	100.0%
Title of Current Positions		
CEO/President	134	68.0%
Vice President	35	17.8%
Loan Officer	11	5.6%
Credit Analyst	2	1.0%
Other	15	7.6%
	197	100.0%
Knowledge of Auditing		
Not Knowledgeable	10	5.1%
Somewhat Knowledgeable	109	55.6%
Knowledgeable	63	32.1%
Very Knowledgeable	14	7.2%
	196	100.0%
Lending Experience		
Less than 1 year	2	1.0%
1-5 years	5	2.5%
Over 5 years but less than 10 years	12	6.1%
10 years or more	178	90.4%
	197	100.0%
Company Size		
Less than $1 Billion	167	85.2%
$1 Billion but less than $50 Billion	16	8.2%
$50 Billion but less than $100 Billion	4	2.0%
Over $100 Billion	9	4.6%

	196	100.0%
Gender		
Male	169	84.5%
Female	31	15.5%
	200	100.0%
Age		
Less than 25	0	0.0%
25-40	14	7.1%
41-55	92	46.7%
Over 55	91	46.2%
	197	100.0%
Highest Education Attained		
High School Diploma	10	5.1%
Associate's Degree	14	7.1%
Bachelor's Degree	120	60.9%
Master's Degree	33	16.8%
Doctorate's Degree	3	1.5%
Other	17	8.6%
	197	100.0%

*For various reasons some respondents did not complete some of the demographic questions, causing the results to be different.

V. Questionnaire Findings

Table 2 shows the responses to the 20 items in the questionnaire. Responses 1 and 2 were collectively referred to as "disagree" and "neutral" respectively while 3 was collectively referred to as "agree." The analysis of the results uses the percentage of participants who disagree (1) and those who agree (3) with the statement to explain the responses. Certain statements in the questionnaire addressed each of the situations outlined by the SEC.

The results of the questions in Table 2 can be summarized by four categories. The four categories are Independence, Objectivity, Reliability and General. Participants responded to several questions directly related to auditor independence (1, 2, 3, 5, 7, 8 and 12). To evaluate these four categories, we use the four determining factors that regulators states constitute a violation of one or all of the categories.

Independence

A 39% of the participants agreed that permitting the auditor to perform tax compliance work for an audited entity impairs auditor independence (2). When asked if doing compliance work for the entity that they audit would constitute acting in the role of management, only 25% agreed (3). When asked if auditors were acting in an advocacy role when they do tax compliance work for audited clients, 54% agreed (1). The response was 50% agreement with the question that CPA firms are auditing their own work when they also do tax compliance work for the audited entity (7). With respect to the standard of conflict of interest, only 29% of the participants thought there was a conflict of interest when the auditor provided tax advice to the entities that they audited (13). The last independence question asks if auditor independence was impaired by representing an attest client in an open court proceeding. 53% of the participants agreed with the auditor representing an attest clients in an open court proceeding (12). In sum, the participants were very much concerned that auditor independence could be impaired if the attest auditor performed the additional services.

Objectivity

Objectivity deals with biases and independence in appearance. There were two questions which asked specific Objective questions. Frist, the statement was made that permitting the auditor to perform tax compliance work for an audited entity impairs auditor objectivity. A significant number, 38%, of the participants agreed with this statement (9). Second, the statement was made that permitting attest auditors to provide tax advice to entities that they audit impairs auditor objectivity. This time a slightly lower percentage, 36%, of the participants agreed with the statement (4). Although most of the participants do not think that the auditor's objectivity is impaired when they perform tax compliance work for the client, there is still a significant number of participants who feel that it does impair auditor independence.

Reliability

It is a consensus that if independence is impaired, reliability of the auditor's report will be questioned. Since this is a very important issue, five questions addressed the issue of Reliability. First, the question was asked if reliability on the auditor's opinion was enhanced when the auditor only provides the audit and the client provides the tax service with internal staff. 45% of the participants agreed with this statement while only 27% disagreed with the statement (16). When asked if reliability on the auditor's opinion was enhanced when the auditor provides the audit and tax services for the client, only 30% of the participant agreed with the statement (17). However, when the participants were asked if providing the audit and tax services for executives of the client enhanced the reliability of the auditor's report, 50% of the participants disagreed (18). When the question was asked about the auditor providing the audit, tax services for the client and tax services for the executives of the client enhancing the reliability of the auditor's report, 55% of the participants disagreed (19). Finally, 34% of the participants agreed that reliability on auditor's opinion on the financial statements was impaired when the attest auditor provides tax compliance and audit services to the same client (20). In summary. the consensus of the participants indicates that reliability is affected when the attest auditor provides various tax services to the client and the participants are even more positive that reliability is not enhanced when attest auditors provide these attest services as some have suggested.

General

Five General statements were made concerns auditors providing tax service to attest clients. First, the statement was made that CPA firms should be allowed to perform tax compliance work for entities that they audit (6). 57% of the participant agreed with this statement. The second statement said that attest auditors should be allowed to represent an audit client in an administrative proceeding before a taxing authority. Again, 66% of the participants agreed with the statement (10). The participants also had a similar response to attest auditors representing clients in tax court (11). Over 61% of the participants thought that attest auditors should be allowed to represent an audit client in tax court. When tax services for executives of the clients was added to the audit and/or tax services to the client, over 40% of the participants disagreed with this combination (14, 15). Finally, 53% of the participants disagreed with the statement that CPA firms create a conflict of interest when they provide tax advice to entities that they audit (13). Overall, a majority of the participants indicated that attest auditors should not provide these tax services to their clients.

Table 2. Bank Loan Officers' Opinions of Certain Issues Concerning Auditor Independence, Objectivity, and Reliability

Item No.		*Mean Score*	*Std. Dev.*	*D (%)* (1)	*N* (2)	*A (%)* (3)	*Total*
1.	CPA firms are acting in an advocacy role for the audited entity when they also do tax compliance work for the audited entity.	.50	1.12	19.9	26.5	53.6	100
2.	Permitting the auditor to perform tax compliance work for an audited entity impairs auditor independence.	-.13	1.07	43.5	17.1	39.4	100
3.	When CPA firms do tax compliance work for the entities they audit, they are acting in the role of management for the entities.	-.53	1.19	56.6	18.7	24.7	100
4.	Permitting the auditor to perform tax compliance work for an audited entity impairs auditor objectivity.	-.16	1.27	45.2	19.3	35.5	100
5.	Permitting attest auditors to provide tax advice to entities that they audit impairs auditor independence.	.00	1.26	39.5	17.4	43.1	100
6.	CPA firms should be allowed to perform tax compliance work for entities that they audit.	.42	1.22	26.0	16.8	57.2	100
7.	CPA firms are auditing their own work when they also do	.30	1.19	27.4	22.9	49.7	100

	tax compliance work for the audited entity.						
8.	Permitting the auditor to perform tax compliance work for an entity and also perform tax compliance work for executives of that entity impairs auditor independence.	.32	1.28	32.0	18.3	49.7	100
9.	Permitting attest auditors to provide tax advice to entities that they audit impairs auditor objectivity.	-.04	1.14	37.1	25.3	37.6	100
10.	The attest auditor should be allowed to represent an audit client in an administrative proceeding before a taxing authority.	.58	1.17	15.2	18.8	66.0	100
11.	The attest auditor should be allowed to represent an audit client in tax court.	.47	1.09	21.9	16.4	61.7	100
12.	Auditor independence is impaired by representing an attest client in an open court proceeding.	-.28	1.14	45.9	29.1	25.0	100
13.	CPA firms create a conflict of interest when they provide tax advice to entities that they audit.	-.36	1.24	52.8	17.8	29.4	100
14.	CPA firms should be allowed to perform tax compliance work for executives of entities that they audit.	-.07	1.24	39.6	23.3	37.1	100
15.	CPA firms should be allowed to perform tax compliance work for entities that they audit and also perform tax compliance work for executives of the entities that they audit.	-.16	1.23	44.4	19.9	35.7	100
16.	Reliability on the auditor's opinion is enhanced when the auditor only provides the audit and the client provides the tax service with internal	.24	1.10	27.2	28.2	44.6	100

	staff.						
17.	Reliability on the auditor's opinion is enhanced when the auditor provides the audit and tax services for the client.	-.11	1.01	36.2	34.2	29.6	100
18.	When the auditor provides the audit and tax services for the executives of the client, reliability on the auditor's opinion on the financial statements is enhanced.	-.48	.98	49.7	33.9	16.4	100
19.	When the auditor provides the audit, tax services for the client, and tax services for the executives of the client, reliability on the auditor's opinion on the financial statements is enhanced.	-.63	.98	55.4	33.3	11.3	100
20.	When the attest auditor provides tax compliance and audit services to the same client, reliability on the auditor's opinion on the financial statements is impaired.	-.02	1.10	35.2	31.1	33.7	100

*The measurement is a five-point scale ranging from –2 (SD) to 2 (SA). SD = Strongly Disagree; D = Disagree; N = Neither Agree or Disagree; A = Agree; SA = Strongly Agree.

VI. Summary of Questionnaire Results

Results of the questionnaire indicated that the bank loan officers thought that the attest auditor should be allowed to provide tax compliances services to the client even though they maybe auditing their own work. These participants indicated that providing tax compliance services to attest clients does not amount to acting in the role of management for the entities. Additionally, the participants also indicated that independence and objectivity would be impaired and reliability would not be enhanced when the attest auditor provides tax compliance services to the client, and tax compliance services to the executives of the client and the audit. However, most of the participants indicated that the attest auditor should be allowed to provide tax compliance services to the attest clients.

Although some conclusions suggest by the results of the questionnaire, that there is still a significant difference of opinion amount between the participants, a one-way ANOVA and the Kruskal-Wallis test were conducted for each group of participants and the results, Table 3, indicate a significant difference between the groups. For

Independence, the results for all questions, except the results of the ANOVA test for question 12, indicate a significant difference between the groups. The results for Objectivity showed a significant difference between the groups for both questions. These results were repeated for Reliability except for questions 17 and 18. However, the final General category shows a significant difference between the groups with the lone exception of the ANOVA results for question 11.

Table 3. ANOVA and KRUSKAL-WALLIS
Test Results for Auditor Independence, Objectivity, and Reliability and General

	Knowledge	
	ANOVA	KRUSKAL-WALLIS
Independence		
Questions #	.Sig	Asymp. Sig.
1.	.144	.079
2.	.115	.119
3.	.074	.068
5	.003	.003
7.	.056	.035
8.	.097	.069
12.	.454	.564
Objectivity		
4.	.041	.045
9.	.053	.052
Reliability		
16.	.442	.434
17.	.566	.556
18.	.633	.501
19.	.247	.277
20	.132	.124
General		
6.	.153	.208
10.	.382	.468
11.	.411	.518
13.	.234	.298
14.	.413	.410
15	.083	.072

VII. Recommendations

First, more research is needed on this subject in a nonpublic environment with future results examining other stakeholders besides bankers, such as government regulators and private regulators and practitioners. Secondly, just as the PCAOB and SEC are planning to review their current regulation, the AICPA and GAO need to also revisit their current regulations. It is suggested by this study and other similar studies that current regulations are not achieving the goals that they are designed to achieve. More empirical studies like this one are needed to help these regulators to determine the relationship, if any, of auditors providing tax services to their audit clients and independence. Studies involving all the stakeholders; investors, regulators and lenders should be done to help clear up the confusion involving this important issue of auditor independence.

VIII. Conclusions

Bankers are uncertain about the implications of the provision of tax services to audit clients have on independence, objectivity and reliability. However, bankers feel that auditors should be able to provide tax services to clients that they also provide the audit. Bankers do not think that auditors should provide tax services to executives of clients to whom audit services are also provided. Additionally, bankers perceive that reliability is not affected by the provision of tax services to audit clients. Moreover, regulators are undecided regarding the affects of tax service to audit clients and executives of audit clients on independence, objectivity and reliability. Based on the uncertainty of the bankers in this study and the decision of the public company regulators, the regulators of non-public companies may want to reconsider the issue.

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