**Auditors Who Also Prepare Clients' Taxes Use Less Aggressive Tax Positions, Study Finds (February 2, 2016)**

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# Today's News

### Governance News

**Auditors Who Also Prepare Clients' Taxes Use Less Aggressive Tax Positions, Study Finds**

**Topic(s): Ethics, GAAP, FASB, External Auditing, Financial Reporting, Tax, Internal Revenue Service, Disclosure, Risk, Financial Management**

***Summary:*** *An academic study found that auditors who prepare taxes for their financial audit clients are less likely to use questionable tax claims, a study found. The authors believe that the harm to their reputation that comes from the Internal Revenue Service overturning the tax claims may not be worth the risk of taking aggressive tax treatments.*

Auditors who also prepare taxes for their corporate clients are less likely to use questionable tax claims than companies that use one outside auditor to examine their financial reports and a second to help with taxes, a study found.

Companies whose taxes were prepared by their financial statement auditors claimed 34 percent less in aggressive tax benefits than those that relied on another accountant and about 28 percent less than those who prepared them internally.

"An external preparer is more sensitive to having tax positions overturned by the tax authority when that preparer jointly provides tax and audit work... due to reputation threats than when providing tax work alone," said a paper by Kenneth Klassen of the University of Waterloo, Petro Lisowsky of the University of Illinois at Urbana-Champaign, and Devan Mescall of the University of Saskatchewan. The academic research appears in the January and February 2016 issue of *The Accounting Review* published by the American Accounting Association.

"These higher enforcement-related costs will lead to more certain tax filing positions," the paper said.

The Internal Revenue Service imposes a penalty that is the greater of $1,000 or half of the income derived with respect to preparing the tax return.

"This latter explicit penalty, coupled with litigation and implicit costs, can be economically significant for large preparers," the study noted.

The paper explained that there are at least two types of risk that are absent in other preparer types. One is financial reporting restatement risk as a result of an audit failure related to the tax accounts. The other is reputation risk: an auditor-preparer's work is more visible and sensitive to the company's leadership.

"For example, if the firm employs its auditor for tax services, then its audit committee has explicitly sanctioned this relationship under the requirements of the **Sarbanes-Oxley Act of 2002** [so that] the board of directors, as well as managers, may bear additional costs if negative tax outcomes result from joint provisioning relative to the case if the tax work was conducted separately from the audit," the paper said.

The study comes amid a debate about the services auditors should be allowed to provide to audit clients.

"Ever since the turn-of-the-century accounting scandals involving Enron, WorldCom, and others, regulators have consistently expressed concern over companies' purchasing both audit and tax services from the same accounting firm," Lisowsky noted. "Given regulators' perennial distrust of auditors' providing tax services to their clients, our study will probably come as a surprise, since it finds that company taxes prepared by the external auditor tend to shun questionable tax breaks considerably more than those prepared by another accountant or by a firm's tax department."

The researchers looked at 804 U.S. public companies in 2008 and 729 U.S. companies in 2009. They checked the identities by looking at the "paid preparer" signature of the tax return. If the identity is missing, the researchers assigned it as being internally prepared.

The study found that 45 percent of the tax returns were externally prepared, and 55 percent prepared internally. About 20 percent were signed by the firm's external auditor, and the remaining 25 percent by another accountant.

To test whether a tax preparer is using a questionable tax position, they looked at the company's application of FASB Interpretation **(FIN) No. 48** , *Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109*, (FASB ASC 740-10), on tax reserves. The authors note that a tax reserve is a liability that reflects the dollar amount of tax benefits related to all open tax positions that may ultimately be disallowed by the tax authority.

Under **FIN No. 48** , recognition of a tax reserve requires that the tax benefit should be more likely than not sustainable in a court of law based on its technical merits, assuming the position is audited by the tax authority. If the tax benefit meets this test, then the amount of the benefit that is recognized as a reduction in current tax expense is measured as the largest value that has a cumulative probability of being realized upon settlement of 50 percent. Any remaining benefit claimed on the tax return, but not recognized on the income statement, is held in reserve as the unrecognized tax benefit. Prior research found that a FIN 48 tax reserve is a suitable summary proxy for tax aggressiveness.

In the meantime, the study found that companies that internally do their taxes tend to be large, with mean assets of $24.8 billion, compared to companies that had their taxes done by external professionals at $8.9 billion.

"The descriptive statistics suggest that our sample firms internally preparing their tax returns are very well resourced, and likely sophisticated enough to not exhibit demand for outside tax preparers," the study said.