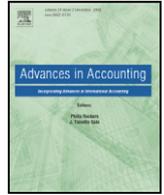




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## Audit committee financial expertise, corporate governance, and the voluntary switch from auditor-provided to non-auditor-provided tax services<sup>☆</sup>

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### ABSTRACT

A prime objective of the SOX is to safeguard auditor independence. We investigate the relation between audit committee quality, corporate governance, and audit committees' decision to switch from permissible auditor-provided tax services. We find that firms with more independent boards, audit committees with greater accounting financial expertise, higher stock ownership by directors and institutions, that separate the CEO and Chairman of the board positions, and with higher tax to audit fee ratios are more likely to switch to a non-auditor provider. Further, we document that firms are more likely to switch prior to issuing equity. We find no evidence that broad financial expertise on audit committees is related to the switch decision, suggesting that the SEC's initial narrow definition of expertise is more consistent with the objective of the SOX. Overall, our results suggest that accounting financial expertise and strong corporate governance contribute to enhanced audit committee monitoring of auditor independence.

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### 1. Introduction

Regulators have long been concerned that auditor-provided non-audit services (NAS) could impair auditor independence. Following the much-publicized failure of Enron, and the involvement of Enron's auditor, Arthur Andersen, investors' concerns about auditor independence motivated several provisions of the Sarbanes–Oxley Act (U.S. Congress 2002) (SOX). The Securities and Exchange Commission (SEC) subsequently adopted rules aimed at strengthening auditor independence, which prohibited auditors from providing a variety of NAS to their audit clients (SEC, 2002). One noticeable exception to the list of proscribed NAS is tax service, which remains permissible under the SOX. However, the SOX requires that firms obtain specific approval from audit committees before retaining the auditor to perform tax services, essentially delegating oversight responsibilities regarding auditor independence to audit committees.<sup>3</sup>

While auditor-provided tax services remain permissible under the SOX, Maydew and Shackelford (2006) and Omer, Bedard, and Falsetta (2006) have documented a significant decline in these services since 2002.<sup>4</sup> Maydew and Shackelford (2006) further observe that the trend reflects a shift away from auditor providers to non-auditor providers, and not a general decline in tax services. The switch to a non-auditor provider for tax services presents a unique setting to examine audit committee monitoring post-SOX. In contrast to other settings where audit committee monitoring is measured indirectly (for example, through the quality of firms' accruals), the switch is a direct and observable action from audit committee deliberations. Further, the switch is ostensibly motivated by the need to preserve auditor independence. Thus, while prior studies have concentrated on audit committees' monitoring of financial reporting, this setting allows a focus on audit committees' role in safeguarding auditor independence.

Investors' concerns with respect to auditor independence and auditor-provided tax services were also heightened by two other regulatory initiatives. In 2006, the SEC approved the Public Company Accounting Oversight Board (PCAOB) rules on auditor independence, limiting the types of tax services that independent auditors may provide

<sup>☆</sup> Data Availability: Data are available from sources identified in the text.<sup>\*</sup> Corresponding author. Tel.: +1 813 974 6888; fax: +1 813 974 6528.E-mail addresses: [smalbrin@syr.edu](mailto:smalbrin@syr.edu) (S. Albring), [dmlrobinson@usf.edu](mailto:dmlrobinson@usf.edu) (D. Robinson), [mnrobinson@ut.edu](mailto:mnrobinson@ut.edu) (M. Robinson).<sup>1</sup> Tel.: +1 315 443 3452; fax: +1 315 443 9517.<sup>2</sup> Tel.: +1 813 528 7247; fax: +1 813 258 7408.<sup>3</sup> Sections 201 and 202 of the SOX provide that audit committees must pre-approve allowable NAS to be performed by the auditor, provided that in doing so, the audit committee establish policies and procedures for pre-approval that are "designed to safeguard the continued independence of the auditor."<sup>4</sup> For example, Maydew and Shackelford (2006) estimate that from 2001 to 2004 a typical company went from paying its auditor equal amounts for audit and tax services to paying the auditor only a quarter as much for tax services as for audit service.

to their SEC audit clients (SEC, 2006).<sup>5</sup> Also in 2006, the Financial Accounting Standards Board (FASB) promulgated FIN 48, which would now require the disclosure of tax reserves in a company's financial statements. Because FIN 48 requires more judgment in assessing tax reserves (Seigel & Associates LLC, 2008), it may worsen the perception that auditor independence is compromised by auditor-provided tax service. Thus, the renewed regulatory focus specific to the tax function, suggests a need for timely academic research documenting the factors likely to influence the switch to a non-auditor provider for tax services. Accordingly, we investigate whether the decision to switch from the auditor to a non-auditor provider for tax service is related to audit committee quality and corporate governance factors.

Our focus on corporate governance generally, and audit committees in particular, is motivated by the fact that corporate boards and audit committees have become more sensitized to their increased responsibilities after the financial scandals of the early 2000s. Given the elevated governmental oversight, highlighted by the passage of the SOX and the establishment of the PCAOB, audit committees are particularly concerned about their increased exposure to liability.<sup>6</sup> The potential liability stems from the fact that the SEC ultimately left it to audit committees to ensure that the auditor's independence is not compromised, potentially resulting in a failed audit. The risk facing audit committee members is further heightened by an increasing public awareness of corporate governance issues in general, and auditor independence issues in particular (McTague, 2002).<sup>7</sup> Consistent with these concerns, the *Association of Audit Committee Members, Inc. (2008)* advise its members that, "although tax planning services do not impair the independence of auditors, audit committees should consider whether using the auditor for tax planning services is in the best interest of the company."

Firms' disclosures in proxy statements filed with the SEC provide corroborating evidence that audit committees' decisions to switch to a non-auditor provider for tax service are motivated by concerns about auditor independence. For example: Surmodics Inc's proxy statement for fiscal year-end 9/30/2005 stated:

*In addition, the Audit Committee considered whether provision of the above non-audit services was compatible with maintaining Deloitte & Touche LLP's independence and determined that such services did not adversely affect Deloitte & Touche LLP's independence. However, the Audit Committee approved the appointment of PricewaterhouseCoopers LLC to provide tax-related services in fiscal 2005 to avoid any questions of independence in the future.*

Our primary measure of audit committee quality is accounting financial expertise, because the perceived lack of accounting and financial expertise by boards and audit committees garnered widespread media and regulatory attention (Hilzenrath, 2002). Initially, the SOX defined financial experts as individuals with education and experience in accounting and auditing, but the SEC, largely in response to concerns from the corporate community, subsequently adopted a broader

<sup>5</sup> The rules identify circumstances in which the provision of tax services impairs an auditor's independence, including services related to marketing, planning, or opining in favor of the tax treatment of, among other things, transactions that are based on aggressive interpretations of applicable tax laws and regulations. The rules also treat registered public accounting firms as not independent of their audit clients if they enter into contingent fee arrangements with those clients or if the firms provide tax services to certain members of management who serve in financial reporting oversight roles at an audit client or to immediate family members of such persons.

<sup>6</sup> In a survey of 1200 audit committee members in seventeen countries, *KPMG Audit Committee Institute (2006)* report that the audit committee members felt that they are exposed to a higher level of litigation risk than other board members.

<sup>7</sup> In an article in the *BNA Daily Tax Report* following the passage of the SOX, reporter Rachel McTague quoted Herbert Milstein, a well-known plaintiff's attorney, as saying, "[Now] I've got a way of naming the audit committee [in a complaint] ... I don't know who in his right mind's going to go on an audit committee."

definition of financial expertise.<sup>8</sup> However, recent empirical research on audit committee quality provides evidence that the stricter definition of expertise is more consistently related to proxies for audit committee effectiveness (for e.g., Carcello, Hollingsworth, Klein, & Neal, 2009; Dhaliwal, Naiker, & Navissi, 2010; Krishnan & Visvanathan, 2008; Zhang, Zhou, & Zhou, 2007). Further, given the intense criticism of the auditing profession embodied in the SOX (DeFond & Francis, 2005), as well as the negative publicity faced by the accounting and auditing professions after the demise of Andersen, audit committee members with accounting and/or auditing qualifications are more likely to be sensitized to issues related to auditor independence.<sup>9</sup>

Our sample consists of 406 firms: 203 firms that voluntarily switched from auditor-provided to non-auditor-provided tax service and 203 control firms matched on industry and size that continue using their auditor for tax work between the years 2003 and 2006. Results from our logit analysis suggest that the likelihood of switching to a non-auditor provider for tax services is greater when audit committees have higher accounting financial expertise, but is unrelated to the SEC's broader definition of financial expertise. Further, we find that the switch decision is more likely with stronger internal corporate governance. In particular, we find that firms with more independent boards, firms that separate the CEO and Chairman of the board positions, and firms with higher director stock ownership are more likely to switch to a non-auditor provider.

We also find that the switch decision is influenced by external forces that affect governance, such as institutional ownership, legislation (SOX), and market discipline proxied by equity market activity. Firms with higher institutional ownership and firms that issue equity are more likely to switch to a non-auditor provider for tax service.<sup>10</sup> The switch decision appears to be partially driven by the effect of SOX legislation since the decision is more likely in the two years after the passage of the SOX.

Consistent with concerns about investors' perceptions that auditor-provided tax services could impair auditor independence and the resultant audit opinion, we find that firms with unqualified audit opinions, firms with tarnished images resulting from a prior restatement or irregularity, and firms with higher tax to audit fee ratios are also more likely to switch from the use of the auditor for tax work. Because of the increased attention by regulators and the financial press on the issue of audit quality and the auditor's provision of non-audit services, we also expect that firms with higher political costs are more likely to switch. We find that the likelihood of switching is positively associated with firm size and stock performance. Finally, we document that the likelihood of switching is significantly lower for firms with foreign operations and for firms engaging in mergers and/or acquisitions. These firms are more likely to need the assistance of tax professionals for more complex tax advice related to preparing tax returns in multiple jurisdictions and with changing firm structure, and may obtain that advice more efficiently from the auditor (Omer et al., 2006).

Our study makes several contributions to the literature. First, we contribute to the research investigating the role of the SOX legislation on firm decisions (Maydew & Shackelford, 2006; Omer et al., 2006). While these studies document the shift away from auditor-provided to non-auditor provided tax services, we provide an important link to these studies—empirical evidence documenting the factors influencing the observed trend. We show that audit committee and board characteristics, firm complexity, concerns about audit quality, as well as capital market activity influence the decision to switch from using the auditor for tax service.

<sup>8</sup> While the SOX stopped short of mandating the presence of a financial expert on the audit committee, it required the disclosure of whether the audit committee includes a financial expert and, if the committee does not have such an expert, why it does not (SEC 2003).

<sup>9</sup> Lindberg and Beck (2004) find that post-Enron accounting professionals had a more negative perception of the effect of non-audit service on auditor independence.

<sup>10</sup> The positive correlation on the stock issuance variable is consistent with firms attempting to reduce their exposure to litigation, since Johnson, Nelson, and Shackell (2001) find that the likelihood of litigation is higher when a firm issues new securities.

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