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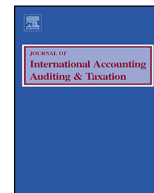

Taxing audit markets and reputation: An examination of the U.S. tax shelter controversy

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ABSTRACT

From 2002 to 2007, the nation's largest CPA firms faced allegations of illegal activity related to the sale of tax shelters: EY, KPMG and PwC paid fines; KPMG was investigated by a federal grand jury; and EY faced a criminal inquiry. These shelter events occurred shortly after the 2002 collapse of Arthur Andersen, when policy makers were concerned about audit market concentration. This is the first paper to provide a chronological summary of how the tax shelter controversy started and ended. We investigate the stock market reaction to tax shelter news developments between 2003 and 2005 to make inferences about the market's view of audit competition and CPA firm reputation. Our results are consistent with market concern over large audit firm concentration, evidenced by large negative returns for clients of all audit providers upon the KPMG grand jury investigation announcement. We also find that tax shelter activities impact both the reputation of the accounting profession and the individual CPA firms marketing tax shelter products.

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1. Introduction

In November 2003, Congress held hearings on allegedly abusive and/or illegal tax shelters sold by Ernst & Young, LLP (EY), KPMG, LLP (KPMG) and PricewaterhouseCoopers, LLP (PwC). The accounting profession, as well as these named firms, faced a loss of reputation from information disclosed at these hearings.[1] KPMG and EY also faced possible criminal indictments or convictions resulting from Department of Treasury and Justice Department (DOJ) investigations, which ultimately could have led to the demise of these firms.

We examine market concerns about the concentration of audit providers. Companies with global operations require an international audit firm for auditor efficiency, reputation, and industry expertise, limiting their choice of auditor. If the reputation of one of the large international audit firms is tarnished such that the firm is either unable to or precluded from

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[1] We investigate publicly available information, including Congressional hearing documents and reports in the financial press. There could have been investigations of other CPA firms which were not made public. The hearing included shelters sold by groups other than CPAs. Our discussion is limited to CPA firms.

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providing audit services, publicly listed global firms on both U.S. and foreign stock markets could be significantly impacted. Therefore, our research should be of interest to academics and practitioners in international jurisdictions.

We use event study methodology to examine whether the market reacted negatively to news large auditors faced criminal investigations during the public announcement of key tax shelter events from 2003 to 2005. Because these investigations could have led to the demise of another large CPA firm, we use market reactions to specific tax shelter public investigation announcements and related public disclosures to make inferences about the potential impact of concentration in the audit market. We find evidence suggesting the market was concerned with large audit firm market concentration from 2003 to 2005.

We also examine whether sale of tax shelters had a reputational spillover effect, both to the involved audit firms and to the profession as a whole. We address this question by examining cumulative abnormal returns (CARs) of audit clients when information was revealed during and following congressional hearings. For audit firms marketing these tax shelters, two competing hypotheses could explain negative abnormal returns. First, the reputation of the audit firm may be impaired, reducing perceived quality of the audit (DeAngelo, 1981). Second, to the extent firm survival was threatened, the stock market may discount client stock prices because of concerns the CPA firm will no longer be available as a form of insurance (Menon & Williams, 1994). To our knowledge, this is the first study to examine a profession-wide spillover effect when members of the audit profession have been accused of wrongdoing.

To draw conclusions about audit competition, we measure CARs surrounding February 20, 2004, the KPMG Federal Grand Jury investigation announcement date, and May 25, 2004, the date EY announced it was the subject of a criminal inquiry. We examine six groups of audit clients: audit clients of each Big 4 firm, Midsize firms, and Small firms. Audit clients of all groups have significant negative CARs on the KPMG announcement date. We conclude that the market was concerned with potential diminishing competition among large audit providers. On the EY announcement date, CARs are significantly negative for clients of Midsize and Small firms. Audit clients of both KPMG and EY have significantly negative CARs on their respective investigation announcement dates; these negative returns may also be attributed to reputation loss and audit quality concerns.

To address reputational spillover, we examine CARs surrounding November 18, 2003, the first day of Congressional hearings. Testimony on this date includes information about tax shelters sold by EY, KPMG, and PwC. Returns for all client groups are negative and significant. Our interpretation, in part, is that there is reputation damage to the profession as a whole because the negative market reactions are not limited to the clients of tax shelter providers singled out in the testimony. For audit clients of firms testifying at the hearings, there are other potential interpretations of the negative returns. The hearings allege compromised independence as a result of these tax shelters being sold to audit clients. To the extent the hearings were a precursor to criminal investigations, the market may have anticipated the future demise of one or more of these CPA firms.

We evaluate two other important dates, January 12, 2004 and August 29, 2005, for the market reaction of KPMG audit clients. On January 12, 2004, the KPMG announcement of tax practice personnel changes, we observe positive CARs. This reaction is consistent with a reputation explanation, as the firm appeared to be taking steps to address problems identified in the hearings. On August 29, 2005, when KPMG admitted to criminal wrongdoing and announced a deferred settlement agreement with the DOJ, we observe negative CARs. These results are consistent with KPMG's reputation being damaged by entering into such an agreement.

The remainder of this paper is structured as follows. Section 2 provides background information on the hearings and the history of tax shelters and tax shelter abuses. Section 3 reviews the literature and develops research questions and methodology. Section 4 describes the sample, descriptive statistics, and CAR estimation method. Section 5 summarizes results, Section 6 provides additional analyses, and Section 7 presents our conclusions.

2. Background

2.1. The Congressional hearings

Table 1 describes the event dates in the tax shelter timeline. On October 2, 2002, the U.S. Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs began an investigation into development, marketing, and implementation of tax shelters by accountants, lawyers, financial advisors, and bankers.[2] On November 18 and 20, 2003, the Subcommittee held hearings[3] in which three of the Big 4 firms testified.[4] The hearings underscored the extent of accounting

[2] United States Senate, 2003, p. 1.

[3] The hearings were held on November 18 and 20, 2003, with CPA firms testifying on the first day. The November 18 testimony can be viewed at: http://www.hsgac.senate.gov/subcommittees/investigations/hearings/u-s-tax-shelter-industry-the-role-of-accountants-lawyers-and-financial-professionals-day-1. The transcript can be found at (Item 4 on that page): http://www.hsgac.senate.gov/search/?q=abusive%20tax%20shelters&start=15&as_sitesearch=&page=2.

[4] Also testifying at the Congressional hearings are various financial institutions, lawyers, investment advisors, and charitable organizations.

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