Research in Accounting Regulation 27 (2015) 14–20

Contents lists available at ScienceDirect

Research in Accounting Regulation

journal homepage: www.elsevier.com/locate/racreg

Regular Paper

Bank loan officers' perceptions concerning independence, objectivity, and reliability when external auditors also perform tax compliance activities for nonpublic clients

Dave Thompson Jr. [a,*], Quinton Booker [b]

[a] Alabama State University, P.O. Box 271, Montgomery, Alabama 36101-0271
[b] Jackson State University, JSU Campus Box 17970, Jackson State University, Jackson, MS 39217

ARTICLE INFO

Article history:
Available online 3 April 2015

Keywords:
Auditor independence
Objectivity and reliability
Tax compliance services

ABSTRACT

This study examines bank loan officers' perceptions of auditor independence, objectivity and the reliability of the report on the financial statement when the attest auditors also provide (1) tax compliance services to the nonpublic entity that they audit, and (2) tax compliance services to executives of said entities. The primary issues addressed are (1) whether performing the external audit and providing tax compliance services for the same entity affects the aforementioned perceptions, and (2) whether adding tax compliance work for the executives of the entity affects these perceptions. We used a between-subject design and bank loan officers as participants. Findings based on 181 participants indicate that bank loan officers generally perceive a significant difference in independence and objectivity when the auditor also performs tax compliance work for the audited entity. On the other hand, loan officers do not perceive a significant difference concerning the reliability of the report on the financial statements. Similar results hold when tax compliance services for entity executives are added to the services performed with the exception that perceptions regarding the reliability of the report on the financial statements are also reduced significantly. Implications and limitation of these findings are discussed.

Introduction

The American Institute of Certified Public Accountants' (AICPA) Code of Professional Conduct and the Securities and Exchange Commission (SEC) continue to allow auditor-provided tax services (ATS). Much has been written over the past decade on the pros and cons associated with ATS (e.g., Gleason & Mills, 2011; Krishnan, Visvanathan, & Yu, 2013; Roberts, 2010; Robinson, 2008; Terando & Kurtenbach, 2009). Allowing the incumbent auditor to also provide tax services is controversial since this increases the auditor's economic dependence on the client, and arguably results in auditors auditing some of their own work. This in turn may raise questions regarding auditor independence and objectivity and may decrease the extent to which third parties rely on audited financial statements. Notwithstanding, some argue that ATS provides the auditor with superior knowledge that improves the quality of audited financial statements (e.g., Gleason & Mills, 2011). The PCAOB continues to study this issue (PCAOB, 2014). Nonetheless, given these concerns associated with ATS, there is a trend toward decoupling audit and tax services at large public companies (Krishnan et al., 2013; Maydew & Shackelford, 2006).

The objective of this study is to provide empirical evidence regarding third-party users' perceptions of ATS to entities in the nonpublic sector. Our study is motivated by the lack of empirical evidence regarding third-party users' perceptions of ATS to entities in this sector. A trend toward decoupling audit and tax services has not been reported for nonpublic companies. The nonpublic sector is large and important to the U. S. economy. The vast majority of businesses in the United States are private (Anderson, 2009). Contrary

* Corresponding author. Tel.: 334-229-6809; fax: 334-229-4870.
E-mail address: dthompson@alasu.edu (D. Thompson Jr.).

http://dx.doi.org/10.1016/j.racreg.2015.03.002
1052-0457/

to what one might expect, many nonpublic entities are comparable in size to many of the large public entities. Revenues range from 3.3 to 134 billion dollars for companies on Forbes' list of 220 of America's Largest Private Companies (Murphy & DeCarlo, 2012).

We focus on nonpublic entities for additional reasons. The Sarbanes–Oxley Act (SOX) (U.S. House of Representatives, 2002) and related SEC regulations directly addressed the issue of ATS in the public environment. ATS are allowed only after approval of the audit committee regarding the potential effects of the services on the independence of the firm (PCAOB, 2006d). In the public company environment, the audit committee in effect acts as a safeguard to look out for the best interest of the users of the financial statements. There is no similar safeguard in place in the nonpublic company environment. Moreover, in the public company environment, the audit firm is not deemed independent of the client if the firm provides certain types of ATS to key personnel of the entity (PCAOB, 2006c). AICPA Ethics Rule 101, *Independence*, and related Interpretation 101-3, *Nonattest Services* (2013), are more liberal as they do not prohibit ATS to executives of the entity. ATS to entity executives may increase the auditor's economic dependence on the client and result in greater concerns regarding auditor independence. One purpose of this study is to investigate whether users of audited financial statements of nonpublic entities are sensitive to ATS. If so, SOX-type restrictions (or other safeguards) should also apply in the nonpublic company environment. The AICPA argues that SOX-type restrictions in place for public companies are not appropriate for nonpublic companies (AICPA, 2003). We believe that this is an empirical question that should be answered based in part on empirical evidence – this study provides such evidence. External parties (e.g., bankers) often rely on audited financial statements of nonpublic entities. These parties deserve the same protections as those afforded investors of public companies (Carmichael, 2004; Capital Market Institute, 2003).

This study examines bank loan officers' perceptions of ATS. We used a between-subject design experiment. Findings indicate that bank loan officers generally perceive a significant difference in auditor independence and objectivity when the incumbent auditor also performs tax compliance work for the audited entity. On the other hand, loan officers do not perceive a significant difference concerning the reliability of the report on the financial statements. Similar results hold when tax compliance services for entity executives are added to the services performed by the incumbent entity auditor with the exception that perceptions regarding the reliability of the report on the financial statements are also reduced significantly.

The remainder of this paper is organized as follows. Section two includes background information and research questions. Section three covers methods and procedures. Section four provides results. Summary, conclusions, and limitations are in section five.

Background, literature and research questions

This section provides limited background information relative to auditors providing nonaudit tax services. We provide a general overview of existing rules for public companies and for nonpublic companies. We also review prior literature relative to auditor independence for nonpublic companies and we present research questions.

Public companies rules

After the passage of SOX, the PCAOB carefully examined the potential implication of ATS for auditor independence (PCAOB, 2004, 2005). After considering several alternatives, the Board recommended and the SEC approved limited ATS. Current ATS regulations are contained in PCAOB Rules 3522, 3523, and 3524 (PCAOB, 2006a, 2006b).

PCAOB Rules 3522 and 3523 (2006a) address tax services not allowed to be performed by the entity's independent auditor during the professional engagement period to perform the audit. Rule 3522 (2006b) specifically indicates that auditors engaged in marketing, planning, or opining in favor of the tax treatment of "confidential" or "aggressive" tax position transactions are not independent. Rule 3523 (2006a) indicates that auditors providing any tax services to executives in a "financial reporting oversight role" at the audit client are not independent.

Rule 3524 specifically addresses the conditions for performing other permissible tax services. The auditor must seek pre-approval from the audit committee prior to performing tax services. Committee approval may be granted only after the auditor has (1) provided the audit committee with details (scope, fees, related compensation arrangements, referral agreements) regarding the tax services, (2) discussed with the committee the potential effects of the services on firm independence, and (3) documented the substance of said discussions. As indicated earlier, there is a trend toward decoupling audit and tax work since these rules have been put in place (Krishnan et al., 2013). Findings on whether non-audited services (NAS) in general compromise auditor independence as well as findings on whether ATS compromise independence are mixed (see Schneider, Church, & Ely, 2006 and Krishnan et al., 2013 for reviews). Nonetheless, we interpret the decoupling of the audit from tax services as a signal from audit committees that it is plausible that ATS may impair independence in fact or in theory, i.e., the risk of allowing ATS is simply not worth any potential benefits (knowledge spillover, fee savings, etc.) to be derived from allowing the auditor to provide both services.

The AICPA rules

The AICPA's general position on ATS to audited entities is significantly different from the SEC's position. Moreover, the AICPA does not specifically address the issue of ATS to certain parties associated with the audited entity. The AICPA Code of Professional Conduct addresses the auditor providing NAS in general, and it includes limited guidance on ATS in Code Subsection 101-3 – *Nonattest Services* (2013).

Members are specifically instructed to first consider independence requirements of applicable authoritative regulatory bodies (e.g., state board of accountancy, SEC, PCAOB, Department of Labor) which may be more restrictive than AICPA Code – the violation of applicable more