“Do Auditor-Provided Tax Services Impair Independence or Generate Knowledge Spillover: Evidence from Assessing Tax Accrual Quality”

--Discussant’s Comments--

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Insanity is a common side effect of tax law.
Disclaimer

“The views expressed in this discussion do not represent the official views of *Auditing: A Journal of Practice & Theory* ... and I probably won’t remember what I said next week, let alone in six months.”
Overview

- Revisiting theory: non-audit services and audit quality.
- Research design
- Some empirical issues
Improving audit quality

Uninformed Independence

Low economic value

Not feasible

Conflicted Expertise

Auditor Independence

Auditor Knowledge Base

High

Low
Independence versus Expertise

Client indifference curves

Auditor Independence

Auditor Knowledge Base
Independence versus Expertise

Independence

Auditor Independence

Low

High

Auditor Knowledge Base

Low

High

A1

A2

B1

Independence Rules

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Independence versus Expertise

So more rules are good, right?

Auditor Independence

Auditor Knowledge Base

High

Low

High

GAAS Rules

Independence Rules

A1

B1

A2

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Considering Incentives

- Audit quality = f(independence, competence)
- Auditors are not stupid but may be risk adverse. The lower the level of client-specific knowledge, the more risk adverse the auditor may be.
- If knowledge is higher (due to APTS?), the auditor may accept more extreme accruals because they have been “vetted” by his/her expertise (or is it overconfidence?).
- If knowledge is lower (due to no APTS?), then auditor may compensate by being more conservative and accepting only low levels of accruals.
- Further: What is an auditor’s incentives when they don’t provide APTS?
# Non-Audit Services and Accrual Quality

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<th>Accruals</th>
<th>Non-Audit Service Fees</th>
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## Non-Audit Services and Accrual Quality

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## Non-Audit Services and Accrual Quality

### Non-Audit Service Fees

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<tbody>
<tr>
<td>A = Knowledge Spillover</td>
<td>B = Impaired Independence</td>
<td>C = Identification</td>
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<table>
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<td>Audit fees</td>
<td>Test 1</td>
<td>Test 2</td>
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Other Important (?) Issues (1)

What Expertise?
- Industry expertise ≠ Tax expertise.
- Finding: Industry expertise does not improve tax accruals.
- Is this due to better expertise making auditor more willing to accept extreme positions by client, i.e., less risk adverse (again, a tradeoff of knowledge and independence, i.e., conservatism or overconfidence?).

APTS across time?
- Tax accrual is judged based on rolling window; APTS is determined each year.
- Consider changes in APTS over time (Paterson and Valencia CAR 2011).
Other Important (?) Issues (2)

Timing of financial reporting?

• *Firms file their tax returns subsequent to their Form 10-K, meaning managers must estimate their tax obligations in advance ...* (page 23).

• Audit report lag reflects how quickly a firm gets the audit completed → short lag implies long separation between finalizing accounting numbers and tax return.

• Evidence that short lags associated with NAS in general do not increase abnormal accruals *(Knechel and Sharma, AJPT)*

Quality of reporting systems?

• Consider subsample analysis controlling for ICW.

• Consider subsample analysis controlling for tax-related restatements.
Now for the Trivial ...

- $5,550 in APTS may be MORE significant than $1,549,000 depending on audit fee (DV is a ratio).
- P-values: be specific which tests are one-tail or two-tail.
- Two stage analysis does not seem to matter. Relegate to supplemental section or even footnote?
- Report economic significance of results.
- At 75 percentile, APTS is still only 16% of total fees. Consider quintile cutoff.