The Impacts of Investors Favor Audits by Same Firm that Prepares Corporation’s Taxes:
(A Case Study of Public Corporations’ in Ghana)

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Abstract
A new study indicates that despite calls for greater auditor independence, investors prefer companies to be audited by the same firm that also provides it with tax services. A study, which appears in the spring issue of the Journal of the American Taxation Association, published by the American Accounting Association, found that audits gain credibility with investors when they are performed by firms that combine them with tax services. “On average, investors perceive the benefits of auditor-provided tax services (i.e., enhanced financial-reporting quality due to knowledge spillover) to be greater than the cost (i.e., the likely threat to auditor independence associated with auditor – provided tax services),” said the study’s.

Introduction
“Everyone agrees that there are potential hazards and benefits to combining tax services with auditing; the question is, which are greater? “The principal risk is that auditors who perform tax services will get too close to the client and lose a critical measure of independence and objectivity that the public has a right to demand. Certainly we’ve seen some flagrant examples of this. But doing tax services also provides lessons about a company that we call knowledge spillover, which can enhance audit quality. What the study reveals is that investor, on the whole, consider the spillover benefits to outweigh the independence risk.”

How Might Spillover from the Tax Side to the Audit Side Work?
“Knowledge of an audit client’s aggressive tax-reporting can shed light on management’s mindset, the company’s tone at the top.” “This helps an auditor devise ways of detecting and constraining earnings manipulation. For example, substantial differences in what a company reports on public financial statements and what it reports to the IRS in its tax returns can be a red flag to the auditor, signaling fraud or overly aggressive financial reporting.”

Analysis of the Companies
This research paper analyzed thousands of Ghanaian public companies over the course of the nine-year span 2004-2012, yielding approximately 8,000 firm-years’ worth of data. In about two-thirds of the cases, a single accounting company provided both audit and tax services.

For each of the 8,000 firm-years, the research analyzed how the interaction between two key variables affected company stock price--1) the ratio of tax fees to total fees paid to the auditor, and 2) earnings per share. In general, the higher the ratio of tax fees to total fees, the more pronounced the effect of earnings on stock price.

It is found that earnings results had more credibility when auditors provided both tax and auditing service than when they did not. Indeed, the effect of earnings on stock price was about 16 percent greater, all else being equal, with the valuation increasing in the amount of tax services rendered.

“In addition, the joint provision of audit and tax services helps detect potential financial-reporting problems on a timely basis. ‘As part of the reviews of quarterly financial statements, auditors will have access to quarterly tax reviews, and this will likely uncover controversial issues more quickly than when the auditor has to rely on information provided at year’s end. Timely detection is important because the auditor can take steps immediately to constrain future attempts at earning management.’ ” At what point did joint services gain favor on Wall Street? While the study doesn’t seek to answer that, it is observed that previous studies have found the two in combination to be associated with less earnings manipulation, fewer financial restatements, more going-concern opinions, and more ample tax reserves. “While is started out with no idea what investors sentiments would be, it turns out not be too far from what scholars have been finding.”

Conclusions
In conclusions’, the research see three principal implications from the study: “First, for firms currently using their auditor for tax services, the findings indicate that investors are supportive of their decision… Second, for firms that have hired a non-auditor for their tax services, the findings suggest that the decision to decouple audit and tax service providers could be a costly choice…Third, to PCAOB and other regulators, the result suggest
that further restriction or outright banning of auditor-provided tax services might have an unintended consequence on the value-relevance of earnings.”

References

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