New audit rules had little effect on companies, study finds

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When new financial auditing regulations went into effect in 2019, there were concerns the rules would affect publicly traded companies and, by extension, investors. A new study finds there was an effect—but it was a small one.

At issue are the audits that publicly traded companies are required to get each year. The auditors closely examine a company's books and—if everything seems above board—sign off on a company's financial statements, stating they believe the statements are accurate within a material margin of error.

However, starting in 2019, auditors are also required to disclose any aspects of the financial statement audit that they find particularly challenging or subjective, as well as why the auditors feel those issues are worth noting. These audits are governed by the Public Company Accounting Oversight Board, which issued the regulations—called "critical audit matters" (CAMs)—that define which things in a company's financial statement merit a disclosure from auditors.

"CAMs that focus specifically on taxes are one of the areas where auditors are mostly likely to issue a disclosure," says Nathan Goldman, co-author of a paper on the work and an associate professor of accounting in North Carolina State University's Poole College of Management.

"Because these CAM regulations are so new, we wanted to see whether related tax disclosures were having an impact on how companies operate or how they report on their potential tax burden in financial statements. Ultimately, we wanted to see whether tax CAMs are changing corporate behavior in a way that could affect shareholders."

The paper, "Disclosure of Tax-Related Critical Audit Matters and Tax-Related Outcomes," is published in the journal *Contemporary Accounting Research*.

To explore this issue, Goldman and his collaborators started by looking at data from 1,298 publicly traded companies for the years 2018 (just before the CAMs took effect) and 2019 (the first year of CAM

disclosure requirements). While all of the companies received auditor disclosures due to the new CAM regulations, only 298 of the companies merited disclosures related to tax CAMs.

The researchers looked at whether there was a change between 2018 and 2019 for each company in three areas: tax-related financial reporting quality, tax avoidance and tax-related earnings management. More specifically, the researchers looked to see whether these differences were more pronounced for companies that had tax CAM disclosures, as compared to companies whose disclosures were not related to tax CAMs.

Financial reporting quality refers to how accurate the financial data in a company's financial statement was. The researchers measured financial reporting quality by looking at whether the company received a comment letter from the SEC, subsequently restated its financial statements, or had an internal control weakness—meaning the auditors had concerns over whether the company had effective controls in place to mitigate a financial accounting misstatement.

Tax avoidance refers to the extent to which a company was able to reduce its tax liability, relative to the baseline corporate tax rate. And tax-related earnings management refers to whether the actions a company took to reduce its tax liability moved the company from not meeting its earnings target to meeting its earnings target.

"We generally found very little change from year to year related to tax CAM disclosures," Goldman says. "The only three changes we found that were associated tax CAMs were: a modest increase in the reserve for uncertain tax benefits, which is called a tax accrual; a modest increase in the quality of reporting on tax accruals; and a modest reduction in the likelihood of tax-related earnings management."

The researchers then looked at data for all of the companies from 2020.

"We found that the numbers for 2020 essentially shifted back to the way things were in 2018," Goldman says. "Basically, 2019 appears to have been a slight bump in the road as everyone adjusted to the tax CAM regulations, and things returned to normal very quickly.

"This is actually a very interesting finding," Goldman says. "We used a multi-year window to monitor regulatory effects over time and found that there was an effect, but that things reverted to a norm very quickly. This is particularly valuable information for assessing potential unintended effects of the regulations."

More information: Katharine D. Drake et al, Disclosure of tax-related critical audit matters and tax-related outcomes, *Contemporary Accounting Research* (2023). DOI: 10.1111/1911-3846.12920

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