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The Effect of Tax Aggressiveness and Corporate Governance on Audit Fees

Evidences from Brazil

Antonio Lopo Martinez

Fucape Business School, Vitoria, Brazil

E-mail: lopo@fucape.br

Rubem Cardoso Lessa

Faculdade Pitágoras, Vitoria, Brazil

E-mail: rubem.lessa@gmail.com

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Abstract

The study investigates the relationship between tax avoidance practices and audit fees. The literature has reported various factors that determine the amount of audit fees, among them the possible risks faced by the audit firm. This article focuses on the effect of tax avoidance by Brazilian companies on the fees charged by auditors. Based on audit fee data for the period from 2009 to 2011 and book-tax differences as an empirical proxy for tax avoidance, we find that tax avoidance practices are positively related to audit fees, i.e., companies that are more aggressive in their tax planning tend to be penalized by having to pay higher fees to their auditors. However, in the contextualized analysis, the results indicate that good corporate governance practices tend to minimize this relationship, attenuating the incremental effects on the remuneration of audit firms. This study also evidences the risk perception of independent auditors and identifies interactions of tax planning, independent auditing and corporate governance not usually perceived by the market.

Keywords: Audit fees, Tax avoidance, Audit risk, Corporate governance

1. Introduction

This article investigates the relationship between the level of tax avoidance of companies and the amount charged by audit firms. The concept adopted for tax avoidance is the simplified concept developed by Hanlon and Heitzman (2010), the reduction of explicit taxation, which leads to a broad vision of tax planning. The definition includes various tax planning strategies independent of the aggressiveness, so the definition covers both illegal tax evasion and legal tax avoidance (Hanlon & Heitzman, 2010).

External auditors play a key role in the representation of financial information, acting as intermediaries between the financial statements and their users (Hanlon, Krishnan & Mills, 2012). Krishnan and Visvanathan (2008) argued that the risk of corporate governance failure is highly relevant to auditors, because it increases the risk of reformulations, and consequently of auditing in general (Krishnan & Visvanathan, 2008). Therefore, audit fees can be expected to be higher to compensate the greater efforts and greater chance of losses due to the risk of litigation and/or harm to reputation (Hanlon et al., 2012).

The literature has reported evidence that highly elaborate structures to lower taxes can lead the market to believe that not only are the tax rules being circumvented, the financial statements are also being manipulated (Hanlon & Slemrod, 2009). There is also evidence that more complex tax avoidance structures permit companies to manage earnings (Desai & Dharmapala, 2006). Hence, an increase in audit fees would be expected as tax avoidance becomes more aggressive. Based on the foregoing, we examine the following research question: Is there a relationship between the level of tax avoidance and the audit fees paid by listing Brazilian companies?

For this purpose, we investigate if there is a relationship between the variation of external auditors' fees and the variation in levels of tax avoidance of Brazilian firms listed on the BM&FBovespa. We also verify if there is any relationship between audit fees and the level of corporate governance, represented by listing on one of the special trading segments of that exchange reserved for companies with enhanced governance structures. We do not attempt to judge the legality of tax avoidance, only its influence on the fees charged by independent auditors, since they are sensitive to situations that can pose risks to their reputation.

The results confirm the theoretical expectation, in harmony with the findings of other studies, indicating that auditors consider tax avoidance as a parameter to measure the audit risks. Another relevant finding is the inverse relationship between the interaction of being audited by one of the Big 4 and enhanced corporate governance and audit fees, according to which the largest audit firms interpret good corporate governance as a reducer of risks, leading to lower audit fees paid by firms listed for trading in one of the enhanced corporate governance segments.

The paper is organized into five sections including this introduction. Section 2 contains a brief review of the literature and states the research question. Sections 3, 4 and 5 cover the methodology, analysis of the results and conclusion, respectively.

2. Theoretical Framework

Since the aim of this study is to verify if audit firms charge higher fees, *ceteris paribus*, to companies with higher levels of tax avoidance, it is first necessary to define what is meant by tax avoidance.

2.1 Tax Avoidance

According to Hanlon and Heitzman (2010), a main challenge to research on this theme is the lack of universally accepted definitions or constructs for tax avoidance. Here we follow their broad definition, namely the reduction of explicit taxation. This definition reflects all the transactions that have any effect on the company's tax obligation, without distinguishing between real activities that receive favorable tax treatment and activities specifically undertaken to reduce taxes.

McGuire, Omer and Wang (2012) point out the lack of evidence of a relationship between tax expertise of the auditor and the level of tax avoidance, although there are studies relating the industry-specific expertise of the auditor and the quality of the financial statements. They address this issue by analyzing if audit firms specialized in taxation tend to raise the level of tax avoidance of their clients. Their results indicate that clients that acquire tax planning services from external auditors that are specialized in taxation tend to have more aggressive tax avoidance. They then expand the study to auditors that, besides being tax specialists, are industry specialists. The results of this inclusion indicate that clients that engage auditors with tax and industry expertise have higher levels of tax avoidance than those that hire auditors that only have special expertise in taxation.

The literature confirms that audit firms try to specialize to be able to charge higher fees (Dunn & Maydew, 2004) and suggests that audit firms can influence the tax avoidance level of their clients, since the search to reduce tax expenses is directly linked to the application of accounting rules and tax laws (Maydew & Shackelford, 2007).

Furthermore, Hanlon and Slemrod (2009) suggest that very complex tax arrangements can cause the market to fear the company is not only dodging tax legislation, but also is stretching the rules on preparing the financial statements.

2.2 Audit Fees

The first mathematical model developed to measure the variables that influence audit fees was that of Simunic (1980). It considers various aspects, such as the size, complexity of activities and financial situation of the audited company. It was developed to try to find empirical evidence with respect to the virtual monopoly held at the time by the eight largest audit firms (Simunic, 1980).

More recent studies have focused on the existence of a relationship between audit fees and earnings management or quality of earnings, such as the article by Bedard and Johnstone (2004), according to which auditors must reformulate their approach for companies that manage earnings, causing an increase in the fees charged. Krishnan and Visvanathan (2008) also argue that the risk of earnings management is relevant to auditors, because it increases

the risk of having to carry out reformulations, and thus raises the overall risk of auditing.

Finally, according to Hanlon et al. (2012), large differences between book income and taxable income (book-tax differences, or BTD), a proxy for tax avoidance, represent a greater risk of earnings management, making the audit firms work harder and thus charge more.

2.3. Corporate Governance

Cassell, Giroux, Myers and Omer (2012) list two reasons why auditors are interested in their clients' corporate governance. First, governance characteristics are associated with relevant audit findings, such as commission of fraud, and second, the added effort required to audit companies with inadequate governance makes auditing more expensive.

The results found by Bedard and Johnstone (2004) indicate that auditors work harder and charge commensurately higher fees to clients perceived as having higher risk of managing earnings, and that the positive relation between risk of earnings manipulation and higher audit fees is less pronounced when companies have better corporate governance.

Consistent with previous findings, the results reported by Cassell et al. (2012) suggest that Big 4 auditors consider the client's governance mechanisms in making decisions on which clients to work for and how much to charge them. In particular, the termination of contracts is more likely for clients with lower scores on the corporate governance index. Based on the above discussion, we test the following null hypothesis and the corresponding alternative hypothesis:

H1: Companies with more aggressive tax planning pay higher audit fees than those that are less tax aggressive.

3. Methodology

This study is descriptive, in view of the proposed objectives. We also used bibliographic and experimental research, while the approach to the question is quantitative. The model developed by Hanlon et al. (2012), employed as a reference, was modified according to the data availability and the specific aspects of the Brazilian setting.

We analyzed the influence of tax avoidance on audit fees by regression models that consider as explanatory variables, besides the level of tax avoidance itself, accounting data such as current assets and liabilities, along with other aspects like engagement of a Big 4 auditor and level of corporate governance.

3.1 Sample and Database

The sample consists of 300 companies listed on the BM&FBovespa in the period from 2009 to 2011. The reasons for the limitation to this time frame are the fact that data on audit fees are only available starting in 2009 (because of the obligation of listed companies to disclose this information according to CVM Instruction 480/2009) and the latest financial data on companies at the time of this study was for 2011. We did not include financial institutions in the sample because they have different accounting and tax rules than companies in other sectors.

The financial data were obtained from the Standardized Financial Statements available at the BM&FBovespa website as well as figures in the Economática® database. The data on audit fees were also extracted from the BM&FBovespa database. The final sample is composed of 300 companies, and after making the exclusions for incomplete data, 770 company/year observations.

3.2 Empirical Data

3.2.1 Audit Fees – Dependent Variable

The dependent variable is the logarithm of the audit fees, since the aim of this study is to investigate if there is a relationship between the level of tax avoidance and the fees charged by auditors. The reason for calculating the logarithms was to make the results uniform.

Other studies have found that auditors respond to low quality of profits reported and earnings management risk by charging higher fees, to compensate the greater efforts and higher risk of litigation and loss of reputation (Hanlon et al., 2012).

3.2.2 Tax Aggressiveness – Variable of Interest

The variable of interest, tax aggressiveness or tax avoidance propensity, is estimated here by the book-tax difference (BTD), the difference between the accounting income and taxable income. Since the latter figure is not publicly available, it was estimated from the amount of income tax reported divided by 34%, which is the normal corporate income tax rate in Brazil[1].

According to Hanlon and Slemrod (2009), overly complex tax arrangements can cause the market to suspect that not only are the tax rules being gamed, the financial statements are also being manipulated. This influences the external auditor, given the indications of earnings management with the consequent need for greater efforts. By this reasoning, higher levels of tax avoidance should be related to higher audit fees.

We used the absolute value of BTD, given that our aim is to investigate the effect of variations in the amplitude of tax avoidance, not the effect of whether this is positive (higher accounting income) or negative (higher taxable income).

3.2.3 Control Variables

To control for variations in audit fees due to the size of the client company, we added the logarithm of total assets, and to control for audit firm size we included the variable BIG 4, a dummy indicating if the auditor in each company/year observation was one of the largest four (PricewaterhouseCoopers, Deloitte Touche Tohmatsu, KPMG and Ernst & Young).

To consider the effects of the financial situation in each company/year observation, we included the variables Indebtedness (DEBT), calculated as the ratio of long-term liabilities to total assets, and Return on Assets (ROA), the ratio of net income to total assets.

[1] Actually this is the combined rate of the Corporate Income Tax (IRPJ) and Social Contribution on Net Profit (CSLL). The difference between taxes and contributions is that the revenue from the former goes into the general fund while the revenues from the latter are reserved for specific uses.

3.2.4 Proxy for Corporate Governance

We also included a dummy variable to indicate whether in the company/year observation the audited company was listed in one of the trading segments of the BM&FBovespa reserved for firms with enhanced corporate governance (Level I, Level II and Novo Mercado, each with specific rules, focused on the overall goal of reducing information asymmetry). The reasoning behind this inclusion is that better governance, meaning greater transparency and less opportunity for managers to put their own short-term interests above the long-term interests of shareholders and other stakeholders, has an inverse relationship with tax avoidance and consequently with audit fees.

3.3 Regression Model

Our regression model used to test the hypotheses is an adaptation of those of Larcker & Richardson (2004) and Hanlon *et al.* (2012):

$$\text{Log}(AUD\ FEES) = \alpha + \beta_1 \log(\text{ABS BTD})_t + \beta_2\ \log(\text{ATIVO})_t + \beta_3\ BIG4_t + \beta_4\ PNC_t + \beta_5\ ROA_t + \beta_6\ CORPGOV_t + \beta_7 \log(ABS\ BTD)_t * CORPGOV_t + \beta_8\ BIG4_t * CORPGOV_t + \beta_9\ \log(ABS\ BTD)_t * BIG4_t * CORPGOV_t + \varepsilon$$

Where:

Log (AUD FEES): Natural logarithm of the fees charged by the independent auditor for audit services;

Log(ABS-BTD)_t: Natural logarithm of the absolute value of the book-tax difference (difference between accounting income and taxable income);

Log(ASSETS)_t: Natural logarithm of total assets;

BIG4_t : Dummy variable, with value 1 if the auditor is one of the Big 4 and 0 otherwise;

DEBT_t: Long-term liabilities divided by total assets;

ROA_t: Return on total assets;

CORPGOV_t: Dummy variable, with value 1 for companies listed in one of the special governance segments of the BMF&Bovespa and 0 otherwise;

Log(ABS-BTD)_t*CORPGOV_t : Interaction of BTD and special segment listing;

BIG4_t*CORPGOV_t : Interaction of Big4 and special segment listing;

Log(ABS-BTD)_t*BIG4_t*CORPGOV_t : Interaction of BTD, Big4 and special segment listing.

As can be seen, we added three variables to measure the interaction of the other independent variables, seeking to capture the effects of situations in which the variation of audit fees is related to the joint presence of the situations measured by the other variables. These measure the interactions of tax avoidance and corporate governance, Big 4 auditor and corporate

governance and all three of these aspects.

4. Analysis of the Results

In this section we discuss the results obtained by the empirical tests as well as the descriptive statistics of the present study.

4.1 Descriptive Statistics and Correlation Analysis

In this topic we present the descriptive statistics and analysis according to the Spearman correlation coefficients.

Table 1. Descriptive Statistics of the Data

DESCRIPTIVE STATISTICS

	Log(AUD FEES)	***Log(ABS-BTD)***	***Log(ASSETS)***	***BIG4***	***DEBT***	***ROA***	***CORPGOV***
Mean	*5.623662706*	*4.597322818*	*6.33135877*	*0.794805*	*0.301665*	*-0.58407*	*0.5415584*
Median	5.596046659	4.667928382	6.3416409	1	0.279749	0.036637	1
Std. Dev.	0.617270077	0.934788525	0.791814818	0.404106	0.359108	17.29577	0.4985938
25%	5.267757032	4.108734391	5.854809136	1	0.11861	0.009064	0
75%	5.957962242	5.208005888	6.817427805	1	0.395631	0.07235	1

From analysis of Table 1, some details of the sample that are relevant for correct interpretation of the results stand out. First, in the large majority of company/year observations the companies were audited by one of the Big 4 audit firms, as can be noted from the mean of this dummy variable (79.4805%). Second, in 54.15584% of the observations, the audited company was listed in one of the special corporate governance trading segments.

Table 2. Spearman Correlation Matrix

CORRELATION MATRIX

	Log(AUD FEES)	*Log(ABS-BTD)*	*Log(ASSETS)*	*BIG4*	*DEBT*	*ROA*	*CORPGOV*
Log(*AUD FEES*)	1						
Log(ABS-*BTD*)	0,268834067	1					
Log(ASSETS)	0,269662384	0,686672971	1				
BIG4	0,48083339	0,099939791	0,14563982	1			
DEBT	0,576177345	0,124534021	0,101842537	0,217644003	1		
ROA	-0,040888042	0,005642091	0,207910536	-0,01748597	-0,00994612	1	
CORPGOV	0,121247804	0,278934209	0,345059295	0,145643187	0,031297123	-0,03241098	1

Table 2 presents the Spearman correlations, for the purpose of identifying the possible effects of multicollinearity of the model's variables. It can be seen that the variables BIG 4 and DEBT are moderately correlated with the variable Log(AUD FEES) and the same applies to Log (ASSETS) and Log(ABS-BTD).

4.2 Regression and Analysis

In this topic we present and analyze the results obtained from the regressions, calculated by linear regression with pooled data. Therefore, the equation was tested to assess the influence of tax avoidance on audit fees, controlling for client company size (Log(ASSETS)), audit firm size (BIG 4), indebtedness (DEBT), performance (ROA), corporate governance and the joint effects of tax avoidance and corporate governance (Log(ABS-BTD)*CORPGOV), audit firm size and corporate governance (BIG4*CORPGOV), and finally of tax avoidance, audit firm size and corporate governance (Log(ABS-BTD)*BIG4*CORPGOV), as indicated in Table 3.

Table 3. Regression Results

	Coefficients	*T-statistic*	*P-value*	*Standard Error*
Intersection	3.784836464	24.99953846	0.000	0.151396254
Log(ABS-BTD)	**0.116253374**	**4.242504461**	**0.000**	**0.027402063**
Log(ASSETS)	0.099743581	3.403088554	0.001	0.029309723
BIG4	0.570173155	10.67449017	0.000	0.053414556
DEBT	0.820210802	18.26237574	0.000	0.044912601
ROA	-0.002040731	-2.162453813	0.031	0.000943711
CORPGOV	**1.599278102**	**4.148898722**	**0.000**	**0.385470509**
Log(ABS-BTD)* CORPGOV	**-0.322561747**	**-4.085840651**	**0.000**	**0.078946238**
BIG4*GOVCOR	-1.155850976	-2.88974444	0.004	0.399983805
Log (ABS-BTD)*BIG4*CORPGOV	0.216675936	2.68676523	0.007	0.080645653

Table 4. Regression Statistics

REGRESSION STATISTICS	
R-Squared	0.516747802
Adjusted R-Squared	0.511025079
Standard Error	0.431636853
Observations	770

The results in Table 4 indicate that the model has predictive power of approximately 51% considering the adjusted R^2 of 0.511025079, or 52% considering the R^2 of 0.516747802.

With respect to the results in Table 3, it should first be noted that all the variables have high t-statistics, meaning that all have a significant relation with audit fees at the 5% level. The analysis of the coefficients confirms the theoretical prediction of a positive relationship between tax avoidance and audit fees, as well as between audit fees on the one hand and company size, audit firm size, indebtedness, corporate governance and the interaction of tax avoidance, audit firm size and corporate governance. In contrast, the performance variable (ROA) and the interactions of tax avoidance x corporate governance and audit firm size x corporate governance have negative coefficients, indicating an inverse relationship with audit fees.

The Big 4 variable was added to capture the expectation that larger audit firms tend to charge higher fees than do smaller auditors. According to the theory, this results from a two-way process by which larger audit firms enjoy a better reputation, so they can charge higher fees, while they face higher potential losses from erosion of their reputation so they need to charge more.

We added a variable to evidence the possible effect of the client company's debt level (DEBT) on audit fees because other authors (Simunic, 1980; Ashbaugh, 2003; Hanlon *et al*., 2012) have reported that this variable influences audit fees. In our results, the debt variable had the second highest positive coefficient, indicating that the financial condition of the audited company is very relevant to the auditor, perhaps because highly leveraged companies tend to be less transparent, increasing the auditor's risk and effort and thus the price charged.

The result for the ROA variable also indicates that the client company's financial situation affects the audit fees charged. In this case, the negative coefficient shows that the better the financial performance, the lower the audit fees tend to be. However, from the absolute value, this effect is much weaker than that of indebtedness, indicating that auditors pay more attention to high leverage on the negative side than to good performance on the positive side in setting their fees.

The corporate governance variable presented the highest coefficient, indicating that the adoption of better governance practices is generally associated with higher audit fees. However, it is clear that corporate governance is also seen by auditors as a factor that reduces dubious practices in preparing the financial statements, which runs counter to the positive result of the interaction of tax avoidance, audit firm size and corporate governance, indicating that larger audit firms are more sensitive to corporate governance, increasing their fees.

This result for the corporate governance was certainly unexpected. The greater transparency and social commitment that come with better governance should act as signals to the auditor of more reliable financial numbers and less audit risk, thus reducing the fees charged in relation to similar companies without enhanced governance. However, according to the results, this was the strongest audit risk factor among those in the mathematical model.

This result caused a certain expectation that other factors were being captured by the corporate governance variable, so that what was indicated by the coefficient was the effect of more than one factor. Therefore, to filter this result, we added interaction variables, the first

being a variable to capture the joint effect of tax avoidance and corporate governance. This presented a negative coefficient, indicating that the tax avoidance by companies with higher governance levels is more often than not interpreted by the auditor as legal tax planning rather than illegal evasion, thus reducing the audit risk and fees.

We also added a second interaction variable to capture the combined effect of good corporate governance and Big 4 auditor. The result was interesting, producing the second-highest coefficient in absolute value of the influence on audit fees. The conclusion that can be drawn is that Big 4 auditors, because they have more experience (including at the international level), understand that companies with standout corporate governance are less risky, because of their better social responsibility, transparency and concern for all stakeholders. Finally, we tested the joint effect of the variables for Big 4 auditor, tax avoidance and corporate governance.

Although not shown, to assure the robustness of the statistics we carried out additional tests, namely: (i) the Jarque-Bera (JB) test of normality, which indicated that the residuals are normally distributed; (ii) the factor inflation variance (FIV) test, which presented high values, but below the limits that would characterize a serious problem of multicollinearity; and (iii) the Breusch-Godfrey (BG) test, which indicated no autocorrelation of the residuals.

5. Conclusion

The aim of this study was to investigate the existence of a relationship between audit fees and aggressiveness of tax avoidance. This was achieved by applying a regression model adapted from those of Larcker and Richardson (2004) and Hanlon et al. (2012). We applied the model to a sample of 300 Brazilian companies listed on the BM&FBovespa in the period from 2009 to 2011. We analyzed the descriptive statistics to confirm or refute the hypothesis posed. The results show that independent auditor consider the level of tax avoidance in pricing their service, indicating acceptance of H1.

The chart below summarizes the findings.

Chart 1. Main Findings

MAIN FINDINGS
Confirmation of the expected positive relation between the size of the audited company and the audit fees (larger companies pay more for audit services);
Confirmation of the expected positive relation between the size of the audit firm and the audit fees (Big 4 auditors charge more than smaller auditors);
Confirmation of the expected positive relation between the indebtedness of the audited company and the audit fees (more leveraged companies pay more for audit services);
Confirmation of the expected negative relation between financial performance and audit fees (companies with better ROE pay lower audit fees;
Conclusion that audited companies that have high tax aggressiveness along with better corporate governance are viewed by the auditor as more likely to be practicing legal tax planning than comparable companies without special governance;
Conclusion that Big 4 auditors view enhanced corporate governance as evidence of greater transparency, thus reducing audit fees;
Conclusion that Big 4 auditors, when faced with highly tax-aggressive clients that also have high corporate governance, respond by increasing their fees.

Besides the question of tax avoidance, other results should be highlighted. The main one is the positive sign of the coefficient of the total assets metric, meaning there is a positive relationship between the client company's size and the fees charged. This agrees with both the theoretical expectation and the current findings of the literature. However, this coefficient was the smallest of those with positive values, indicating that company size is the least important factor of those studied here considered by auditors in setting their fees.

The principal contribution of this article is that tax avoidance practices are positively related to audit fees in Brazil. In other words, companies that are more aggressive in their tax planning tend to be penalized with larger audit fees. However, analysis of this aspect in context shows that the adoption of good corporate governance practices minimizes this relationship, attenuating the incremental effects on audit fees. This reveals the risk perception of independent auditors and how this is reflected in the fees they charge.

The main limitation is the short period analyzed, although all the variables presented good statistical significance. Another limitation is the shortage of financial data in the Economática

database, causing a substantial reduction in the amount of data for analysis.

There are many avenues for future research. We particularly propose investigation of the effect of other proxies of tax avoidance, aiming to separate legal tax avoidance from illegal tax evasion, possibly through measurement of temporary and permanent accruals. We also suggest separately examining the effect of the three different levels of better corporate governance on audit risk and hence fees, or the effect on audit fees of measures of the quality of earnings or other factors linked to the quality of the financial statements.

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