Tax Compliance and Risk Management

Perspectives from Central and Eastern Europe

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Chapter 13

Tax compliance assurance

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13 Tax compliance assurance

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13.1 Introduction

This chapter poses the question of whether the public financial or internal control audits might serve as an efficient tool for the enforcement of tax compliance. The chapter aims to provide a robust classification of auditor modifications of financial and internal control assurance and assess the undertakings' tax compliance enforcement through both channels.

For the purpose of this chapter, tax disclosure enforcement is divided into two broad categories, the first one being direct enforcement provided by the State of international tax authorities (direct channel) and enforcement resulting from the public assurance system (indirect channel). The direct channel is directly financed by the State, while the indirect channel is primarily financed from the equity holders' wealth. The primary motivation of the indirect channel to assure tax compliance lies with the financial materiality concepts, where material errors and deficiencies unadjusted in financial reporting must be reported by the gatekeeper (public auditor). As such, both the investors and the States have the expectation that the reporting entity will adequately disclose its tax position, in order to avoid potentially material deficiencies.

Prior research on the indirect channel is scarce and lacks mutual examination of both financial audit reporting and internal control reporting as two separate channels to enhance tax compliance. This chapter fills up the missing research dimension and combines an analysis of the indirect channel from both financial audit and internal control audit perspectives.

The study applies descriptive statistics to Audit Analytics data based on 369,120 financial audit opinions and internal control opinions filed with the Securities and Exchange Commission from 2000 until June 2019. In doing so, the study allows us to capture the long-term process in the most mature world economy.

The study contributes to the intersection of audit and tax compliance literature in three dimensions. Firstly, it provides evidence of the insignificance of the indirect channel in respect of tax compliance due to inefficient detection of tax disclosures. Secondly, the study suggests that documents related to the internal control channels inefficiency of the financial audit channel in the area of the identification of tax incompliance issues. Thirdly, we argue that the assurance channel is ineffective at tax compliance enforcement.

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13.1.1 Theoretical framework and prior studies

The literature on tax compliance (TC) disclosure shows different theoretical approaches. Most studies have explored TC disclosure through the perspective of managers' incentive theories, particularly agency theory[1] and signalling theory. Besides them, proprietary costs theory, litigation costs theory and legitimacy theory offer a plausible disclosure motivation. All of them deal with the issue of information asymmetry (Akerlof, 1970). Reduction of information asymmetry results in lower transaction costs and thus affects stock liquidity and reduces the cost of capital (Mio et al., 2020).

The study assumes that there is information asymmetry between tax authorities and companies. Taxpayers as gamblers are focused on reporting to tax authorities their incomes as little as possible in order to maximise the after-tax expected payoff (Allingham and Sandamo, 1972) and taxpayers assume that a tax audit, due to the limited resources, will not lead to the detection of tax incompliance which is based on a pure gambling decision (Casagrande et al., 2015). The existence of information asymmetry might have a particularly negative impact on tax enforcement and the resulting tax revenue to the State budget. This is connected with the activity of the management boards obtaining an incentive for implementing tax optimisation models and increasing compensation and bonus giving (Armstrong et al., 2015). According to our assumption, reports on the audit of financial statements might be an effective instrument that limits or eliminates information asymmetry. A similar observation applies to internal control audits. We also assume that tax disclosure enforcement resulting from the public assurance system (indirect channel), which consists of financial audit reporting and internal control reporting, might eliminate information asymmetry between tax authorities and companies.

In addition, the study is based on the assumption that reports on financial audit studies could play the role of a signal from auditors to the potential users (including tax authorities) about tax incompliance. Reports on financial audit studies also could play the role of a signal propagated by auditors to the potential users (including tax authorities) to alleviate information asymmetry. However, the effectiveness of the signals conveyed through disclosure depends on the credibility of the information (Baier et al., 2022). Thus, we focus our attention on the theories relating to information asymmetry.

Agency theory proposed by Jensen and Meckling (1976) assumes that the separation between principals (shareholders) and agents (managers) results in information asymmetry, since agents have more information than their principals. Agency theory assumes that management and ownership have different motivation, and that an agent does not always act in the best interest of the principal, in trying to maximise their own utility (Linder & Foss, 2015; Zey, 2015). Managers decrease information asymmetry and agency costs through disclosure (Fama & Jensen, 1983; Jensen & Meckling, 1976; Williamson, 1979). Such disclosure, even if dedicated to the equity owners, serves other stakeholders as well (Hill & Jones, 1992).

Signalling theory originated in labour research (Spence, 1973) subsequently applied to corporate disclosure research (Ross, 1977). According to the signalling theory, information disclosed in financial statements is a signal propagated by managers to the potential users of financial statements to alleviate information asymmetry (Mio et al., 2020). By disclosing additional information, the management earns credibility with stakeholders, which in turn allows for reducing costs, attracting capital, increasing investment, improving value, etc. (Connelly et al., 2011; Izzo & Fiori, 2016). Nevertheless, the effectiveness of the signals conveyed through disclosure depends on the credibility of the information (Baier et al., 2022). Better companies that have good news to share, would distinguish themselves from lower quality companies, while for companies that have bad news disclosure could signal their desire to improve the situation (Aghamolla & An, 2021).

Proprietary costs and litigation costs could affect corporate disclosure (Deng et al., 2021). In line with the proprietary cost theory, companies can choose to reduce the extent of disclosure, to avoid deteriorating their competitive advantage (Mittelbach-Hörmanseder et al., 2021). According to the litigation cost theory, the decision of a company regarding corporate disclosure is affected by the risk of shareholder litigation (Auerbach & Feldstein, 2002). However, additional disclosure might be the result of legal action due to inadequate or untimely information, for example enforced by the financial authorities.

Legitimacy theory (Dowling & Pfeffer, 1975) offers the explanation that there is a social contract between organisations and society; companies have to perform this contract to maintain their legitimacy. For companies, disclosure serves as a tool to maintain their legitimacy or to cure a negative situation that threatens it. If a company acts as society expects, disclosure allows for communication with interested parties (Deegan, 2002, 2019).

The above theories explain the motivation of the management to disclose information to stakeholders. However, the management is judged upon the disclosed information, so they are exposed to the temptation to present the reality in a way that is more favourable to the management than it actually is. To prevent this situation, the financial data are audited by an auditor who issues an audit report. In order to issue the audit report (opinion), the auditor applies the accounting principle of materiality.

In accounting, materiality is a fundamental reporting principle that underpins the audit process (Gray & Manson, 2005; Staszkiewicz, 2015). Materiality functions as a threshold between significant and insignificant errors or omissions, relevant to the shareholders' decision-making process. Materiality threshold is set by the management. Auditors then make independent decisions, conveyed in the audit report, about materiality in reporting on whether the financial statements offer a true and fair view (DeAngelo, 1981a). Materiality is a vague and relative concept, contingent upon the nature and context of an item (Edgley et al., 2015). Errors of more than 10% of net profit are generally considered material, with under 4%–5% considered immaterial (Gray & Manson, 2005; Staszkiewicz, 2015).

This study uses the combined perspective of agency theory and signalling theory in relation to the management and auditors, respectively, relying on the materiality threshold concepts. It conceptualises that the management reports the material tax position to limit information asymmetry while the auditors prevent incompliance by modification of their reports to signal material errors or omissions. Thus the system can convey significant and relevant information to help to enforce tax compliance. Auditor report modification can serve as a signal for tax authorities to focus the tax audit effort on pre-screened company portfolio in the resulting enforcement of tax provisions. In fact, prior research offered only scattered evidence on the above.

Balakrishnan et al. (2019) shows that aggressive tax planning requires companies to increase financial and organisational complexity resulting in less transparent disclosure. Missing disclosures combined with wrong imputation procedure lead to measurement errors (Max et al., 2021), while the tone of disclosure is subject to personal characteristics of board members (Bassyouny et al., 2020). Tax authorities suffer from resources reduction, which has an unaccounted for effect, namely loss in tax collections from tax audits of corporate tax returns exceeds the savings for enforcement budget (Nessa et al., 2020).

Armstrong et al. (2015) on the ground of agency theory, identified a correlation between tax avoidance and corporate governance in the activities of companies and incentives of the management boards of these companies. According to the classical Allingham and Sandamo (1972) model, taxpayers as gamblers are focused on reporting to tax authorities their incomes as little as possible in order to maximise the after-tax expected payoff. At the same time, they assume that a tax audit, due to the limited resources, will not lead to the detection of tax incompliance which is based on a pure gambling decision (Casagrande et al., 2015).

The management boards have an incentive for implementing tax optimisation to increase compensation and bonus giving (Armstrong et al., 2015). Similarly note Gaaya et al. (2017), who pointed out that management tends to reduce the amount of tax burden to increase profit after tax especially in the model of family ownership. Thus, the question arises whether public financial or internal control audits could serve as an efficient tool for the enforcement of tax compliance.

Agency theory implies that audit quality is important in reducing conflicts of interests between managers and external shareholders (Gaaya et al., 2017). On the one hand, publication or public presentation of financial statements, together with the auditor's opinion, to the tax authorities is the applied rule introduced in many jurisdictions. The transparency of these reports leads us to examine whether there is a relationship between the role of financial audit and the execution of tax audit. Tax audit is defined as an examination of whether a taxpayer has correctly assessed and reported their tax liability and fulfilled other obligation (OECD, 2006). The reverse relationship in the form of the impact of tax audit on financial audit, is obvious, and therefore decisions of tax authorities affect the results of companies, and the content of financial statements, which is often reflected in the internal statutory audit reports. On the other hand, a relationship has been noted between providing services by big consulting audit firms and taking advantage of solutions of the so-called tax optimisation by multinational enterprises (MNEs) (Jones et al., 2018). There is talk directly about the promotion of elaborate tax avoidance schemes by big accounting firms, which is connected with "business culture" that has become established in these firms (Sikka, 2007; Sikka & Willmott, 2013).

Last but not least, there is a relationship according to which the higher the comparability of accounting information, the lower the degree of corporate tax avoidance (Thanh Liem, 2021). Moreover, Mills and Sansing emphasise that information from financial statements might be used as part of State tax audits to select entities to be audited. They found that the tax authority is more likely to audit a transaction when it generates a positive book-tax difference (e.g. when an expenditure is deducted for tax purposes but capitalised for financial reporting purposes) than when it generates no book-tax difference (Mills & Sansing, 2000). In this regard, Blaufus, Schöndube and Wielenberg noted that granting the tax auditor access to the internal statutory audit report increases the companies' tax compliance, raises tax revenues and decreases tax audit frequency (Blaufus et al., 2020). Such information may also be a clear signal for tax auditors about the company's appetite to apply solutions that are *de facto* aggressive tax optimisation (Lisowsky et al., 2013). Kovermann and Velte (2019) show a review of the discussion on corporate governance and tax behaviour. Keeping in mind the literature review and the objective of our study, we ask the following research questions: RQ1: Does financial audit signal tax incompliance? RQ2: Does internal control audit signal tax incompliance? And finally RQ3: Does assurance enforce tax compliance? In order to answer our research questions, we hypothesised that: (H1) Financial audit prevents tax incompliance, (H2) Internal control audit prevents tax incompliance and (H3) Assurance enforces tax compliance. This study operationalises the verification of the hypotheses with the application of third party audit report content classification and frequency distinction of the auditor reports modification on the most globally developed market, mainly the US. This setup allows us to plausibly test our hypotheses and universally generalise the results on global economy.

13.2 Methodology and dataset

This study uses content analysis (Krippendorff, 2004), which is widely adopted across studies that investigate entities' disclosure. To avoid research bias, we use the external data-provider in-house developed taxonomy for financial and internal control audit reports.

13.2.1 Classification and frequencies

For classification of the tax disclosure issues, we follow the taxonomy applied by Audit Analytics (Ives Group Inc, 2019). For the audit opinion, the classification is based on the major point of going concern. We used the entire available data span period since 2000 for the audit opinion and since 2004 for internal control assurance to produce a long-term taxonomy classification structure. For H1, H2 and H3[2] we applied 10% frequency as a rule of thumb to reject the null hypothesis. If the assurance system picked up tax issues in more than 10 times over 100 engagements, we consider it to be sufficient to prevent tax incompliance either externally, internally or combined. Conversely, lower frequencies indicate an accidental function of assurance in respect of tax compliance.

13.2.1.1 Financial audit channel

The audit opinion data set covers all SEC registrants that have disclosed their auditor's report on the audit of the financial statements in electronic filings since 1 January 2000. The data has been extracted principally from the following form types: 10-K, 10KSB, 20-F, 40-F, N-CSR, S-1, SB-1 and S-11.

The "going concern" classification identifies audit opinions where the auditor has expressed substantial doubt about the issuer's ability to continue as a going concern, and the auditor has concluded that the financial statements contain appropriate/adequate disclosures in regard to the material uncertainty. The unqualified opinion will contain an Emphasis of Matter paragraph directing the reader's attention to the relevant disclosures (Ives Group Inc, 2019).

13.2.1.2 Internal control channel

The internal control data set covers all SEC registrants that have disclosed their assessments of internal controls over financial reporting in electronic filings since November 2004. The data has been extracted principally from the following form types: 10-K, 10-K/A, 20-F and 40-F. Each row represents either the data concerning the auditor's attestation report or the management's assessment of internal controls over financial reporting. With the exception of asset backed securities and registered investment companies, all SEC registrants are required to file Management's Report on Internal Control Over Financial Reporting. Note section 101(d) of the JOBS Act regarding exemptions for Emerging Growth Companies (ECGs). Accelerated filers (public float exceeds $75M) and large accelerated filers (public float exceeds $700M) are required to file both the auditor's attestation and management's report on ICFR. Historical SOX 404 Requirements were as follows: (1) US Accelerated filers were required to file both a management report and an auditor's attestation beginning with annual reports filed for year ends after 15 November 2004; (2) Foreign issuers that were large accelerated filers began to file both management reports and auditor attestations in their reporting for fiscal year ends after 15 July 2006; (3) Foreign issuers that were accelerated filers, but not large accelerated filers, had to file management reports beginning with reports filed for year ends after 15 July 2006; they were required to begin filing auditor attestations beginning with the reporting of years ending after 15 July 2007; (4) Non-accelerated filers (both foreign and domestic) were required to begin filing management reports for year ends after 15 December 2007. Section 989G of the Dodd Frank Act exempted non-accelerated filers from the auditor attestation requirement[3] (Ives Group Inc, 2019).

13.3 Results

13.3.1 Financial audit channel

Table 13.1 presents the classification and frequency of going concern audit reports according to different reasons.

Table 13.1 Relative frequency of the going concern issues phrases since 2000 until 2019

Going concern issue	*Issue frequency*	*Relative frequency (%)*
Absence of significant revenues	12,451	3.45
Accumulated/retained earnings deficit	12,721	3.45
Assets – inadequate, limited, immaterial or impaired	1,467	0.40
Bankruptcy	894	0.24
Benefit plan, pension, etc. – obligations	18	0.00
Changed industry or business	70	0.02
Compensation deferred	51	0.01
Competitor threat	83	0.02
Credit line reduced, unavailable or due	165	0.04
Credit quality deterioration	39	0.01
Debt covenants/agreements uncertain or not in compliance	1,507	0.41
Debt is substantial	331	0.09
Decline in revenue	227	0.06
Derivatives – obligations, losses	7	0.00
Development stage	12,709	3.44
Discontinued/disposal of operations	533	0.14
Exploration/pre-exploration stage	2,048	0.55
Gross margin – negative	11	0.00
Initial loss	1,455	0.39
Insufficient/limited cash, capital or liquidity concerns	12,283	3.33
Liabilities exceed assets	1,071	0.29
Limited performance/credit history	131	0.04
Liquidation of assets or divestitures	375	0.10
Litigation contingencies	366	0.10
Need for additional financing for funding obligations and/or servicing debt	3,875	1.05
Need for additional financing for growth or to meet business objectives	5,079	1.38
Need for additional financing to sustain operations	5,768	1.56
Negative cash flow from operations	12,783	3.46
Net capital deficiency	9	0.00
Net losses since inception	11,978	3.25
Net/operating loss (including recurring losses)	35,391	9.59
No dividends	49	0.01
No explanation	228	0.06
No marketable product(s)	114	0.03
Not commenced, limited or no operations	5,855	1.59
Notes payable/debt maturity; balance due, past-due, default	2,166	0.59
Pending dissolution/contract expiration or termination	40	0.01
Product demand or pricing – decline or limited	204	0.06
Profitability concerns	2,074	0.56
Prohibitive increase in operational costs	1	0.00
Recoverability of (natural) resources – uncertain	121	0.03
Refinancing contingencies	181	0.05
Regulatory capital – decline or deficiency	173	0.05
Regulatory settlements, obligations and contingencies	310	0.08
Related party/segment issues	269	0.07
Restructuring contingencies	302	0.08

(*Continued*)

Table 13.1 (Continued)

Going concern issue	*Issue frequency*	*Relative frequency (%)*
Reverse merger	2	0.00
Seeking or needs to combine with existing company	772	0.21
Significant contractual obligations and commitments pending	89	0.02
Stock/share redemption or option exercise risk(s)	31	0.01
Stockholder equity or partner capital – deficiency or decrease	7,766	2.10
Subsidiary – spin off	23	0.01
Tax liability-deferred, disputed, unfunded	2	0.00
Vendor-supplier disputes or disruptions	7	0.00
Working capital/current ratio deficit/inadequacy	18,739	5.08

Source: Own presentation based on Audit Analytics.

The tax motivation for going concern reporting is classified in one position. "Tax liability-deferred, disputed, unfunded" was identified in two cases, being less than the predefined decision threshold (10% of all the cases). Thus, the signals conveyed by the auditor in respect of tax compliance are immaterial for tax enforcement.

13.3.2 Internal control channel

Table 13.2 shows frequencies of the deficiencies reported in SOX reports, which relates to the quality of the corporate internal system of control.

The item "Acc – Tax expense/benefit/deferral/other (FAS 109) issues" consists of internal control deficiencies in approach, understanding or calculation associated with various forms of income tax obligations or benefits. These can relate to foreign tax, local taxes or tax planning issues. The accounts impacted can include expense, deferral or allowances. With the change in goodwill accounting, a number of issues have arisen regarding the failure of companies to change the level of permanent differences in their FAS 109 calculations. The item "Acc – Unspecified/unidentified/inapplicable FASB/GAAP issues" is used when the 302 or 404 disclosure lacks sufficient information to identify what accounts or areas of financial reporting are being impacted by internal control deficiencies. It may also indicate that a GAAP/FASB effect is not applicable (Ives Group Inc, 2019).

Direct references to the tax related controls inefficiency represent 3% of the population, which is below the present 10% threshold for the claim that the internal control assurance might serve as an efficient tool for tax compliance monitoring. Nevertheless, there is a grey area represented in the item "Unspecified/unidentified/inapplicable FASB/GAAP issues", which might or might not comprise the tax related issues and represents 58% of the sample under discussion. We are unable to verify the potential magnitude of the undisclosed issues, thus we treat it as an inherent limitation of this study.

Table 13.2 Frequency of the reason phrased based on the Audit Analytics database for SOX reports

Accounting rule (GAAP/FASB) application failures	*Number frequency*	
Acc – Accounts/loans receivable, investments and cash issues	2,162	10%
Acc – Acquisition, merger, disposal or reorganisation issues	226	1%
Acc – Asset Retirement Obligation issues	5	0%
Acc – Balance sheet classification of asset issues	19	0%
Acc – Capitalisation of expenditures issues	164	1%
Acc – Cash flow statement (FAS 95) classification errors	229	1%
Acc – Consolidation (Fin46r/Off BS) and foreign currency translation issues	256	1%
Acc – Debt, quasi-debt, warrants and equity (BCF) security issues	435	2%
Acc – Debt and/or equity classification issues	26	0%
Acc – Deferred, stock-based or executive comp issues	502	2%
Acc – Depreciation, depletion or amortisation issues	39	0%
Acc – Expense recording (payroll, SG&A) issues	354	2%
Acc – Fin Stmt, footnote, US GAAP conversion, segment disclosure issues	607	3%
Acc – Financial derivatives/hedging (FAS 133) accounting issues	156	1%
Acc – Foreign, related party, affiliated and/or subsidiary issues	503	2%
Acc – Gain or loss recognition issues	22	0%
Acc – Income statement classification, margin and EPS issues	34	0%
Acc – Intercompany/investment w/subsidiary/affiliate issues	233	1%
Acc – Inventory, vendor and cost of sales issues	525	2%
Acc – Lease, FAS 5, legal, contingency and commit issues	458	2%
Acc – Liabilities, payables, reserves and accrual estimate failures	318	1%
Acc – Loan covenant violations/issues	3	0%
Acc – Pension and other post-retirement benefit issues	10	0%
Acc – PPE, intangible or fixed asset (value/diminution) issues	589	3%
Acc – Revenue recognition issues	446	2%
Acc – Tax expense/benefit/deferral/other (FAS 109) issues	665	3%
Acc – Unspecified/unidentified/inapplicable FASB/GAAP issues	12,637	58%
DC – Defective – Incomplete 302 Assessment	1	0%
DC – Board, Audit Committee, Corp Governance issues	1	0%
DC – Insufficient management review, inadequate control procedures	1	0%
DC – Unreliable or deficient accounting/reporting records	1	0%
DC – Unspecified disclosure control deficiencies	1	0%
IC – Restatement or nonreliance of company filings	1	0%
Other – Registration/security (including debt) issuance issues	2	0%
Total	21,631	100%

Source: Own calculation based on the Accounting Rule (GAAP/FASB) Application Failures Definitions as per Audit Analytics.

13.3 Discussion

Our findings give the basis to address all three hypotheses and answer our research questions, namely that financial audit does not signal tax incompliance, internal control audit to a limited extent signals tax incompliance and, finally, assurance is inefficient at tax compliance enforcement from the signalling perspective. These observations allow for a critical assessment of the existing legal solutions.

The asymmetry in audit findings reporting between material errors and material internal control deficiencies is in line with the relationship reported by Balakrishnan et al. (2019) and others (Thanh Liem, 2021) between organisational complexity and less transparent disclosure. However, our findings show that less transparent disclosure does not necessarily lead to material misstatement of the financials. The results of our analysis show that signals conveyed by auditors in respect of tax compliance are immaterial for tax enforcement.

The content of the reports does not allow for obtaining appropriate information about possible tax incompliance. Auditor's report modification does not serve as a signal for tax authorities to focus the tax audit effort on pre-screened company portfolio in the resulting enforcement of tax provisions. Therefore, the reports from financial audit or internal control audit do not fulfil the basic function also in order to eliminate information asymmetry between tax authorities and companies.

Similarly, our results question the market efficiency mechanism as proposed by Staszkiewicz et al. (2021), and do not confirm the efficiency of information transmission through the capital market, as the information is not conveyed by the gatekeepers. Even if we adopted an extension of disclosure like multi-entry offered in our early study (Staszkiewicz & Werner, 2021), we would be, based on the current study results, still short of context to be disclosed. We understand those results through the audit remuneration model (Bicudo de Castro et al., 2019; DeAngelo, 1981b, 1981c; Hay et al., 2006; Larcker & Hall, 2004; Morawska & Staszkiewicz, 2016; Quick et al., 2013; Ratzinger-Sakel, 2013; Reynolds et al., 2004; Simunic, 1980; Staszkiewicz & Karkowska, 2022) as legal direct accountability of the auditors is to the shareholders (Friedman, 1970) rather than the stakeholders. This is because auditors naturally trade off, within materiality boundaries, between conveying the information potentially harmful to shareholders' value and formal tax penalties (stakeholder perspective). Whatever is the true motivation, our results confirm that the enforcement of tax provisions through the financial audit channel would not necessarily be effective for the public government. Thus, contrary to the tax office incremental effort on tax audit, Nessa et al. (2020), our finding does not support the conclusion that an increase in efficiency of tax enforcement could be realistically achieved by additional investments into financial and internal control audit.

The asymmetry of disclosure supports magnitude of the incentives for management to apply the tax-management optic as reported by Armstrong et al. (2015). This is in line with Allingham and Sandamo (1972), with taxpayers as gamblers incentives being well-executed, at least to the level of auditors planning materiality. As audit quality is important in reducing conflicts of interests between managers and external shareholders (Gaaya et al., 2017), our results show that the position of other stakeholders, in particular tax authorities, is less central than that of shareholders. We do not agree with Mills and Sansing (2000) that information from financial statements should be used as part of State tax audits to select entities to be audited because the financial audit does not convey frequent enough information on tax deficiencies. For the same reason, we do not necessarily agree with Blaufus et al. (2020) that granting the tax auditor access to the internal statutory audit report would lead to an increase in companies' tax compliance. Thus, contrary to Lisowsky et al. (2013), the signals might be too infrequent to balance the costs of monitoring.

Our study does not go without limitations. The chapter is based on empirical evidence gathered in the US economy. The extension to other economies is subject to differences in accounting and auditing standards and practical usage. The research is based on the company level analysis, thus the generalisation to the US and EU enforcement practice is subject to reconciliation of cultural values (Calu et al., 2022), for simplicity of our design we did not address this issue.

Companies that have been issued a qualified or disclaimed opinion cannot be identified using our data set. It is very rare that a company would submit a disclaimed or qualified opinion to regulators and shareholders. In such cases, the company may file NT (form 12b, Notification of late filing) enabling it to correct insufficient or inappropriate disclosures and solicit another auditor opinion. The unspecified issues container as reported in Table 13.2 represents 58% of the sample under discussion. We are unable to assess the hidden fraction of potential tax issues included in this position. Contrary to Grygiel-Tomaszewska and Turek (2021), we did not apply a formal biometrical examination of all the available disclosures literature, thus the identified gap might be already identified in some rare source which we are not aware of.

13.4 Conclusion

An assessment of whether the public assurance system (indirect channel) might serve as an efficient tool for tax compliance enforcement (direct channel) was the main aim of the chapter. We hypothesised that the indirect channel could be a useful tool for tax authorities to obtain useful information about potential solutions that could be labelled as tax incompliance.

We observe hardly any references to tax issues in going concern financial audit opinions, and infrequent instances of the internal control deficiencies reported by auditors in the tax area.

Our results show that the current financial statements and internal control audit practice have limited impact on tax enforcement. The consequence of this is that the indirect channel does not eliminate information asymmetry between tax authorities and companies. Audits provide infrequent credible signals of tax incompliance to tax authorities. Perhaps some functions are being remedied by introducing tax compliance issues as part of corporate social responsibility reports and integrated reporting, which we have isolated as a further research avenue.

Notes

1 Transaction cost economics and agency theory are generally labelled economic organisational theories (Zey, 2015).
2 Measured as a sum of the H1 and H2 frequencies.
3 The disclosure requirements regarding internal controls over financial reporting details refer to Securities and Exchange Act of 1934 §240.13a-15(f), Regulation S-K §229.308, SEC Final Rule 33-8238, 34-47986, PCAOB Auditing Standard No. 2, PCAOB Auditing Standard No. 5 (Ives Group Inc, 2019).

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