THE EFFECTS OF TAX AGGRESSIVENESS AND COMPLEXITY ON INVESTORS' PREFERENCES FOR JOINT PROVISION OF TAX AND AUDIT SERVICES

BY

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DISSERTATION

Submitted in partial fulfillment of the requirements
for the degree of Doctor of Philosophy in Accountancy
in the Graduate College of the
University of Illinois at Urbana-Champaign, 2012

Urbana, Illinois

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The Effects of Tax Aggressiveness and Complexity on Investors' Preferences for Joint Provision of Tax and Audit Services

ABSTRACT

Joint provision of tax and audit services has been under regulatory scrutiny for over a decade. I use a source credibility framework to map the costs and benefits of joint provision to the components of source credibility, competence and trustworthiness, to explain the effect of aggressiveness and complexity on investors' preferences and subsequent investment decisions. Experimental results indicate that investors prefer tax preparation to be provided by an accounting firm not engaged as the auditor rather than by an accounting firm jointly providing tax and audit services. Results also indicate that although aggressiveness does not affect this preference, complexity increases investors' preference for non-joint provision. Additional results indicate that the auditor tax preparer is perceived to be less competent and less trustworthy than the non-auditor tax preparer. This study contributes to the accounting literature on joint provision, with implications for both tax providers and managers.

Keywords: Tax aggressiveness, source credibility, joint provision, independence

To my loving husband, Phil

And in loving memory of my father and hero,

Bradley John Dawson

The two most amazing men God has brought into my life

ACKNOWLEDGMENTS

This project would not have been possible without the support of many people. I offer many thanks to my adviser, Steve Smith, who patiently guided and encouraged me through the dissertation process. I am thankful God brought our paths together. Your guidance and friendship has been a blessing to me. I also thank my committee members, Kevin Jackson, Petro Lisowsky, and Tiffany Barnett White for their direction, advice and valuable insights. I also thank Jay Rich, Debbie Seifert and participants at the 2011 Behavioral Tax Symposium at George Mason University for their comments and suggestions. Thanks are also extended to Jacqueline Haas who contributed her time and effort to this project. Thanks to the instructors who provided access to their classes, and the participants who generously donated their time and effort.

Thank you to my husband and family, who encouraged, supported and loved me through this long process. You prayed for me, listened to my worries, challenged me to move forward, believed in my potential, and never let me quit.

Finally, thanks most of all to God, for without His provision, none of this would be possible.

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CHAPTER 1

INTRODUCTION

During the last decade, regulators have scrutinized the role of the tax preparer. Discussions prior to the Sarbanes Oxley Act (SOX) suggested a ban on auditor-provided tax services (Lassila et al. 2010). Although SOX did not ban such services, the Public Company Accounting Oversight Board (PCAOB) examined the effect of the joint provision of tax and audit services on auditor independence and adopted rules addressing this issue in 2005 (PCAOB 2004). The Securities & Exchange Commission (SEC) requires the disclosure of tax fees paid to firms that provide tax services to audit clients. In 2011, the IRS adopted regulation requiring registration, testing and continuing education requirements for tax preparers not subject to oversight, including competency tests for all paid tax return preparers except attorneys, certified public accountants (CPAs) and enrolled agents who are active and in good standing with their respective licensing agencies (Internal Revenue Service 2011). The purpose of these regulations is to provide better protection and service for taxpayers and to increase confidence in the tax system.

The regulations proposed by the PCAOB, SEC and IRS address concerns about the competence of tax preparers, and also about their independence, especially in situations where the tax provider is also the firm's external auditor. While prior research indicates that joint provision of tax and audit services does not impair independence in fact (Kinney et al. 2004; Gleason and Mills 2011; Paterson and Valencia 2011), less is known about the effect of joint provision on investors' perceptions of independence (i.e., independence in appearance). In this study I examine whether investors share regulators' concerns about joint provision, and whether their preferences are moderated by the aggressiveness and complexity of a firm's tax strategy.

I examine investors' preferences for joint provision using a source credibility framework (Mercer 2005; Hovland et al. 1953). I map the costs and benefits of joint provision to the components of source credibility, competence and trustworthiness. An important potential benefit of joint provision is knowledge spillover [1] (i.e., synergistic gains in the provider's understanding of the client) (Lassila et al. 2010). I argue that knowledge spillover improves the preparer's competence. However, a potential cost of joint provision is a loss of independence (Lassila et al. 2010, Gaynor et al. 2006). I argue that a loss of independence reduces the preparer's trustworthiness.

Based on prior research (e.g., Gaynor et al. 2006), my first prediction is that investors will generally favor non-joint provision, due to concerns about independence. Then, using the source credibility framework, I predict that investors' preferences for joint provision will vary depending on the aggressiveness and complexity of the firm's tax strategy. Specifically, I predict that an increase in the aggressiveness of a firm's tax position is likely to increase the value of independence because of two elements of additional risk posed by the more aggressive position. First, an increase in tax aggressiveness leads to an increased risk of disallowance and subsequent cost to shareholders. Second, an increase in tax aggressiveness offers greater opportunity for

[1] Knowledge spillover refers to the fact that an external auditor obtains knowledge while providing a non-audit service that the auditor may not have otherwise gained. This additional information can lead to improved audits. Therefore, knowledge spillover is expected to improve audit quality (see, e.g. Simunic, 1984; Kinney et al 2004; Schneider et al 2006). Knowledge spillovers also can be expected to occur from the auditor to the tax preparer, and thus, would be expected to improve the quality of the tax information and preparation process, as well.

managerial diversion of resources from shareholders (Desai and Dharmapala 2006). A preparer who also provides audit services is more likely to suffer a loss of independence in appearance than a preparer providing only tax services, because the firm jointly providing audit and tax services essentially audits its own work, while no such conflict of interest exists for the non-auditor tax preparer. Because a more aggressive tax position entails greater risk, investors' need for confidence in the trustworthiness of the preparer is elevated. Thus investors are likely to attach greater importance to the trustworthiness component of preparer credibility as aggressiveness increases. Given the expected negative association between joint provision and perceptions of trustworthiness, I predict that investors are less (more) likely to favor joint provision when the firm's tax strategy is more (less) aggressive.

In contrast, an increase in the complexity of a firm's tax position is likely to increase investors' concerns about the competence of the preparer. More competent preparers are more likely to have the requisite knowledge and experience to execute complex tax strategies correctly. Thus investors are likely to attach greater importance to the competence component of preparer credibility, relative to the trustworthiness component, as complexity increases. In other words, complexity increases the potential benefits of knowledge spillover (Lassila et al. 2010). Given the expected positive association between joint provision and perceptions of competence, I predict that investors are more (less) likely to favor joint provision when the firm's tax strategy is more (less) complex.

In my experiment, MBA students participate as potential investors, analyzing information about two hypothetical firms in order to make an investment decision. I provide participants with summarized financial statements and information about a particular tax position each company has taken. The experiment employs a 2 x 2 x 2 mixed design, manipulating joint provision within subjects and tax aggressiveness and complexity between subjects. Specifically, one company has engaged the same firm to jointly provide tax and audit services, while the other company has engaged one firm to serve as the external auditor and a second firm to provide tax services. The aggressiveness and complexity of the tax position are each manipulated at two levels (high or low) through textual descriptions. Based on the information provided, participants allocate a $10,000 investment between the two companies. Participants also provide justification for their choices and evaluations of the credibility of the different preparer types.

I find that, on average, investors are less likely to invest in a firm that receives tax and audit services from the same provider than in a firm that engages separate firms to provide tax and audit services. I also find that the level of tax aggressiveness does not affect the investment decision. Non-auditor tax preparers are perceived to be more independent, less biased, more truthful, and more credible; yet as aggressiveness increases, investors are not more likely to invest in a company that has engaged the non-auditor tax preparer. Moreover, I find that tax complexity does affect investors' preferences. As complexity increases, investors are more likely to invest in the company that has engaged the tax preparer they perceive to be more competent, although the firm perceived to be more competent is not the firm I predict to be perceived as such.

This study contributes to the audit and tax literatures by providing evidence that joint provision influences investors' perceptions of tax preparer competence and independence, with subsequent effects on their investment decisions. This paper also informs the literature regarding the relative importance of audit versus tax quality by providing evidence that in a situation that potentially increases tax quality while threatening audit quality via impaired independence in appearance, investors weigh the threat to perceived audit quality more heavily than the potential benefits to tax quality. When choosing between a company that has engaged an auditor tax preparer and a company that has engaged a non-auditor tax preparer, participants indicate that the potential benefit of knowledge spillover that occurs when tax and audit services are jointly provided is less than the cost of impaired independence. The importance of independence and audit quality overwhelms the benefit that joint provision can bring to tax quality.

This paper contributes to the joint provision literature by taking a broad perspective regarding tax services; rather than focusing on tax services as an auditor-provided NAS only, the paper expands the focus by including tax services by non-auditor tax preparers. This shift in focus allows for an examination of investors' reactions to joint provision of tax and audit services compared to a "control" condition that occurs when the tax service is provided externally by a non-auditor (Kinney et al. 2004).[2] Previous literature provides evidence that increasing joint provision leads to lower quality earnings (Krishnan et al. 2005, Frances and Ke 2006), but the literature has not isolated the level of services jointly provided to compare to the same service and same level of service provided by a non-auditor because the non-jointly provided services do not

[2] The joint provision literature has not examined the comparison of a service provided as an NAS vs. as a non-NAS (a service by a non-auditor provider). The lack of research is not an omission by choice. This information is not publicly available; therefore, archival methods cannot capture this comparison.

require disclosure and are therefore unobservable. In other words, whether it is the level of the service provided or the joint provision (of the NAS and audit service) that affects earnings quality is unknown. This paper addresses the possibility that a high level of tax services provided by a non-auditor preparer may be less preferable than a high level of NAS by comparing investor perceptions across external preparers, thereby making a horizontal comparison across the provider of the service while holding the level of the service constant rather than making a vertical comparison across levels of the service provided, as has been done in the joint provision literature. This paper also provides insight into the factors affecting investor preferences for joint provision by mapping preferences to a source credibility framework.

In addition, this paper extends the source credibility literature by examining the effect of risk on the influence of source credibility, by studying tax aggressiveness and complexity as moderating variables. Risk factors related to the tax position, i.e., aggressiveness and complexity, affect the relative importance of the credibility components, trustworthiness and competence. This extends the source credibility literature by providing evidence that risk moderates the effect of source credibility on judgment, in this case, the effect that source credibility has on an investment decision.

This study contributes to the regulatory discussion regarding the costs and benefits of the joint provision of tax and audit services. Specifically, I address whether the concerns expressed by regulators relating to tax preparer independence are shared by investors, and I provide evidence that joint provision does affect independence in appearance. In general, investors perceive the threat to independence to be too great a cost when choosing between an auditor tax preparer and a non-auditor tax preparer. This result provides evidence in support of the concerns that regulators expressed prior to the passing of SOX related to the decision to allow joint provision of tax and audit services.

Chapter 2 provides a theoretical background. Chapter 3 develops the hypotheses. Chapter 4 presents the experiment. Chapter 5 discusses the results. Chapter 6 concludes the paper.

CHAPTER 2

THEORETICAL BACKGROUND

Joint Provision of Tax and Audit Services

The provision of non-audit services by auditors has been under regulatory scrutiny for more than 10 years. In the 1990's, fees from NAS increased at a greater rate than audit fees, and by 2000, NAS fees were twice as high as audit fees in a sample of over 2,500 public companies (Kinney et al. 2004; Markelevich et al. 2005). The rapid growth of NAS fees as well as increases in restatements and other accounting irregularities led the SEC to require disclosure of audit fees and other components in 2000 (SEC 2000). Accounting scandals such as Enron and WorldCom led to the enactment of SOX in 2002, which prohibited the joint provision of audit services and certain NAS. In 2003, the SEC again revised disclosure rules to require separate statements of audit fees, audit-related fees, tax fees, and other NAS fees (SEC 2003).

Discussions prior to and following SOX debated whether tax services should be allowed as an NAS. In 2004, the PCAOB held roundtable discussions regarding whether joint provision of tax and audit services impairs auditor independence. Opponents of joint provision argued that tax NAS can lead to lower audit quality via impaired independence because the revenues and high margins from tax services might affect auditors' judgments (Kinney et al. 2004; Lassila et al. 2010; Omer et al. 2006). They also argued that auditors cannot objectively assess the reasonableness of tax strategies sold to audit clients by their own firm (Rankin 2004). In addition to concerns regarding impaired independence in fact, concerns exist that joint provision of tax and audit services might impair independence in appearance, leading to perceptions of lower financial reporting quality (Kinney et al. 2004). Proponents of joint provision argued that audit quality and the firm's tax position can be improved through the knowledge spillovers that occur between the audit and tax teams of a firm jointly providing both services (Lassila et al. 2010, Omer et al. 2006). Gleason and Mills (2011) find that firms purchasing auditor provided tax services have more adequate and accurate tax reserves than firms that do not purchase auditor provided tax services, providing evidence of the benefit of knowledge spillover for the tax preparer, in addition to the benefits provided to the auditor.

Auditors must maintain independence in fact and in appearance in their relationships with audit clients as a requirement of the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct and a rule of the SEC (e.g. SEC 2000). Kinney et al. (2004) provide evidence that joint provision of tax and audit services does not impair independence in fact, as firms that pay more for tax NAS had fewer financial reporting restatements than those who paid smaller amounts or nothing for tax NAS. Whether joint provision impairs auditor independence in appearance is an important and unanswered question. Lassila et al. (2010) examine factors affecting independence in appearance via companies' perceptions of the trade-off between knowledge spillovers and perceived impaired independence. They find evidence that increased complexity, stronger corporate governance, and more auditor independence lead to the retention of the auditor as tax service provider. These results suggest that factors that increase the value of knowledge spillovers, such as complex transactions or positions, or factors that decrease concerns about auditor independence, such as stronger controls, lower nontax NAS fees, and shorter auditor tenure, lead to a greater likelihood of retaining the auditor as tax provider.

The audit literature suggests that firms providing both NAS and audit services benefit from having further insight into the client's business and transactions, leading to greater audit effectiveness (e.g., Simunic 1984; Whisenant et al. 2003; Kinney et al. 2004). In particular, Kinney et al. (2004) find that joint provision of tax and audit services is associated with higher quality financial reporting. [3]

Source Credibility

Source credibility is the extent to which a communicator is perceived to be trustworthy and competent (Hovland et al. 1953; Giffin 1967; Mercer 2005). Source credibility has been examined in various literatures; for example, in examining juror's perceptions of eyewitness accounts and expert testimonies (for a review, see Spellman and Tenney 2010) and readers' comprehension of text (e.g., Sparks and Rapp 2011). Prior research in accounting has shown that source credibility affects users' reactions to financial statement information and their investment decisions. Hirst et al. (2007) find that the source credibility of management is enhanced when earnings forecasts are disaggregated rather than aggregated. Clor-Proell (2009) finds that the extent to which reported financial statement information matches financial statement users' expectations affects users' credibility judgments of management, and those credibility judgments mediate the users' investment decisions. Williams (1996) finds that analysts' perceptions

[3] Alternatively, knowledge spillover may present an opportunity for management malfeasance. Cook et al. (2008) provide evidence of increased earnings management associated with joint provision of tax and audit services. For firms that would miss consensus earnings forecasts without effective tax rate (ETR) changes, higher tax fees paid to auditors are associated with greater reductions in third-to-fourth quarter ETRs. These third-to-fourth quarter ETR reductions are potential signals of earnings management because tax expense is one of the last accounts closed in determining reported earnings.

of management credibility are affected by previous earnings forecasts. Research in auditing has examined whether and how auditors incorporate the perceived competence and integrity of management into the evaluation of audit evidence (Rebele et al. 1988, Hirst 1994, Peecher 1996, Beaulieu 2001, Kizirian et al. 2005).

Trustworthiness is the degree of confidence the recipient of a message has in the communicator's intent to communicate the assertions he considers most valid (Hovland et al. 1953). Components of trustworthiness include reliability, honesty, goodwill and intentions. Competence is the extent to which a communicator is perceived to be a source of valid assertions (Hovland et al. 1953). Competence may be evidenced by the quantity of pertinent information, degree of ability or skill, or validity of judgment that the communicator possesses (Giffin 1967).

Joint Provision and Source Credibility

Joint provision of tax and audit services offers potential costs and benefits that can be modeled within the source credibility framework (see Figure 1). Joint provision poses a potential threat to independence in fact for two reasons. First, although the tax and audit work is performed by two separate teams, those teams are part of the same firm, and the firm is effectively auditing its own work. Second, the high margins and revenues produced by providing tax services might affect auditors' judgments regarding financial reporting (Omer et al. 2006). Although joint provision of tax and audit services is permitted under SOX, tax services are similar to the NAS banned by SOX in that the providing firm profits by selling services in addition to the audit. If the client and auditor disagree about a financial reporting decision, the auditor must weigh the cost of losing the tax fee in addition to the audit fee. If providing the tax service is highly profitable, the auditor has greater incentive to concede to the client so as to not lose the additional revenue.

Independence and trustworthiness are inherently related. A trustworthy communicator is honest and reliable and communicates information with positive goodwill and intentions. Honesty and reliability tie closely to the definition of auditor independence provided by the AICPA: an attitude of mind "that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism" (AICPA). A communicator who is perceived to be honest and reliable also should be perceived to have integrity and objectivity. Goodwill and intentions relate to the communication process and define the perception that the communicator will actually relay accurate and relevant information. Independence in appearance and goodwill and intentions appear to be closely aligned. When independence is questioned, there is a perception of a lack of trustworthiness. The auditor may either be acting without integrity or may be communicating information in a biased manner.

Joint provision of tax and audit services provides a potential benefit through increased competence because, although the tax and audit work is performed by two separate teams, those teams are part of the same firm, which potentially facilitates knowledge spillover between the tax and audit teams. Knowledge spillover refers to the fact that an external auditor obtains knowledge while providing a non-audit service that the auditor may not have otherwise gained. The non-auditor tax preparer does not have access to the additional information that is obtained by the auditor preparer via the joint provision knowledge spillover.

Tax services are not included in the list of non-audit services prohibited by SOX, in part because of the presumed benefits that joint provision may provide, such as lower cost of capital and increased after-tax earnings (Omer et al. 2006). When choosing a tax preparer, companies must decide whether the benefit of joint provision, an increase in competence primarily arising from knowledge spillover, outweighs the cost of joint provision, a threat to trustworthiness via the perception of impaired auditor independence, which may affect perceptions of audit quality. [4]

[4] An additional potential benefit companies may consider in choosing whether to engage the external auditor as the tax preparer is a fee discount that may be available from bundled services.

CHAPTER 3

HYPOTHESES

Although joint provision of tax and audit services can increase audit quality through potential knowledge spillover, it can also lead to perceived threats to auditor independence. When evaluating the costs and benefits of joint provision, investors may be influenced by the ease of recalling recent high-profile audit failures, such as Enron, WorldCom, and Waste Management. Tversky and Kahneman (1974) explain that the ease with which instances or occurrences can be brought to mind affects individuals' assessment of the probability of an event. More salient occurrences are perceived to occur more frequently than less salient occurrences. This heuristic is referred to as availability. The availability heuristic is problematic when the ease of retrieving examples is influenced by factors unrelated to the actual frequency of occurrence. One such factor is media coverage of events. For example, the media is more likely to cover violent, dramatic events leading to death, such as tornadoes and homicides, than less sensational (but more frequent) causes of death, such as disease (Kunda 1999).

Similarly, the media is more likely to focus on high-profile instances of audit failure than on the many successful audits conducted each year. In addition, media coverage of audit failure tends to focus disproportionately on auditor independence (Taylor et al. 2003). With regards to the failure of Enron, concern about auditor independence was pervasive in the media coverage, while other important factors related to auditor integrity (paper shredding) and auditor expertise (the complexity of Enron's audit) were overlooked. Therefore, when investors recall instances of audit failure, concerns regarding auditor independence are likely to be highly available.

Gaynor et al. (2006) provide evidence that when the joint provision of audit services and NAS that improve audit quality is disclosed to investors, audit committee members do not choose joint provision, citing concerns about independence. Even when the NAS will improve audit quality, independence concerns override the potential benefits. Gaynor et al. (2006) find that investors prefer joint provision when they are provided detailed information regarding the boost in audit quality, but when only provided with a basic disclosure regarding joint provision, investors' concerns about joint provision align more closely with audit committee members' concerns. Based on this research, I predict that investors' concerns regarding auditor independence will outweigh any potential benefit arising from knowledge spillover and that these concerns will be manifest in their investment decisions.

> **H1:** *Ceteris paribus*, investors are likely to invest more in a company engaging a non-auditor tax preparer than a company engaging an auditor tax preparer.

The Effects of Tax Risk Factors

Aggressiveness

Tax avoidance is defined as the reduction of explicit taxes, and such tax avoidance activities lie along a continuum of aggressiveness (Hanlon and Heitzman 2010). Evasion, which is illegal tax avoidance or extremely high aggressiveness, lies on one end of the continuum, while tax strategies such as investing in tax-preferred municipal bonds lie near the opposite end.

Because risk-neutral investors desire profit maximization, they prefer management to pursue tax minimizing strategies for which the expected benefits exceed the potential costs (Hanlon and Heitzman 2010). As a tax strategy moves further along the tax aggressiveness continuum toward tax evasion, the risk associated with that strategy increases. A more aggressive strategy offers greater tax savings but also brings a higher risk of being disallowed upon IRS audit, with a subsequently higher cost resulting from fines and penalties.

I propose that because of the higher risk and potential cost involved, high levels of tax aggressiveness increase investors' sensitivity to the credibility of the preparer. Friedman and Friedman (1979) find that participants prefer expert endorsers for products high in financial risk, as compared to celebrity or typical-consumer endorsers. Harmon and Coney (1982) find that when participants' initial attitudes toward an action are unfavorable (favorable), the use of a highly (moderately) credible source is more effective than the use of a moderately (highly) credible source. In other words, demand for source credibility increases as risk increases.

I hypothesize that the increased risk associated with a higher level of tax aggressiveness will lead investors to prefer firms with more independent tax preparation. Agency problems that exist in corporations resulting from the separation of ownership and control can lead to corporate tax decisions that benefit management at the expense of investors. Hanlon and Slemrod (2009) find evidence that a company's stock price declines when there is news about its involvement in a tax shelter. One potential explanation for this finding is that shareholders are concerned that management's willingness to cheat the IRS is a signal of its willingness to also cheat them. They find that tax shelter firms with strong corporate governance have a smaller stock price decline than other tax shelter firms. Wilson (2009) also finds evidence that strong corporate governance mediates the effect of aggressiveness on stockholder value. Wilson finds that firms actively engaged in tax shelters with strong corporate governance exhibited positive abnormal returns, whereas firms with poor corporate governance had no abnormal returns when compared to the control sample of firms not engaged in tax shelters.

In addition to corporate governance, tax authorities have been studied as a control mechanism for potential agency problems (Jensen and Meckling 1976; Desai et al. 2007). Desai et al. (2007) argue that a strong tax authority provides monitoring and has aligned incentives with shareholders to reduce diversion of resources by management. They find that as tax enforcement increases, diversion of resources decreases, and stock prices increase.

I argue that a non-auditor tax preparer can serve as a monitor in a manner similar to a tax authority. A company that engages a non-auditor tax preparer rather than an auditor preparer is providing additional monitoring of the tax position taken. Instead of one firm being responsible for tax planning and compliance as well as auditing the tax position taken, two firms are involved: one responsible for tax planning and compliance, the other providing assurance that the transaction is reported according to generally accepted accounting principles. As the tax position becomes more aggressive and the risk associated with potential diversion of resources by management increases, the importance of the monitoring increases.

Aggressiveness increases risk of disallowance, leading to potentially higher cost for the shareholder via subsequent fines and penalties. The increased potential cost leads shareholders to prefer more assurance via stronger monitoring of the decisions being made by management. A more credible and trustworthy monitor is preferred. Threats to independence in appearance related to joint provision of audit and tax services negatively affect the perceived trustworthiness of auditor preparers relative to non-auditor preparers. Therefore, aggressiveness magnifies the importance of independence, triggering greater concern regarding auditor tax preparers. Subsequently, investors' preferences for a firm with a non-auditor tax preparer will be greater when aggressiveness is higher rather than lower, relative to a firm with an auditor tax preparer.

> **H2:** Investors' relative preference for a firm engaging a non-auditor tax preparer is greater when tax aggressiveness is high than when it is low.

Complexity

Another factor that is likely to affect investors' relative preferences for tax preparation is the complexity of the firm's tax strategies or position. Tax complexity can result from firm characteristics (i.e., firm size), operating decisions (e.g., foreign involvement), or tax transactions structured in a complex manner (Lassila et al. 2010). Research indicates that tax or operational complexity is positively associated with tax compliance and planning costs (Omer et al. 2006; Mills et al. 1998). Based on these findings, Lassila et al. (2010) assume that high compliance and planning costs resulting from tax complexity create a greater potential for value from exploiting knowledge spillover opportunities. Lassila et al. (2010) find that a company with greater tax complexity is more likely to retain its auditor as the tax preparer than a company with less tax complexity, in order to take advantage of knowledge spillover opportunities. Lassila et al. (2010) also find that companies with high complexity appear to expect the benefits of the potential knowledge spillover opportunities to exceed the costs of impaired independence. Complexity enhances the benefit of potential knowledge spillover, as the additional knowledge that flows from audit to tax teams regarding the company or transaction is increasingly valuable as the knowledge needed to handle the complex situation increases. In other words, as complexity is added to a tax position, the benefits of knowledge spillover are more fully realized, leading to an increase in investors' perceptions of the competence of the auditor tax preparer. Although Lassila et al. (2010) provide evidence regarding management's perception of the trade-off between independence and knowledge spillover, investors' perceptions of that tradeoff remain an empirical question. Thus I test the following hypothesis:

> **H3:** Investors' relative preferences for a firm engaging a non-auditor tax preparer are greater when tax complexity is low than when it is high.

Joint Effects of Aggressiveness and Complexity

As previously hypothesized, aggressiveness increases investors' concerns about independence; *ceteris paribus,* high aggressiveness increases investors' relative preference for non-auditor tax preparers. Moreover, complexity increases the value of potential knowledge spillovers; *ceteris paribus,* high complexity decreases investors' relative preference for non-auditor tax preparers. Therefore, in a situation of high complexity and low aggressiveness, the auditor tax preparer is perceived as more competent than the non-auditor tax preparer with little threat to independence. In a situation of low complexity and high aggressiveness, the auditor tax preparer is perceived as being relatively less trustworthy than the non-auditor tax preparer due to threats to independence in appearance, and the benefits from knowledge spillovers are low.

Tension lies in the high complexity and high aggressiveness condition, in which both components of source credibility are affected simultaneously in opposite directions (see Table 1 for a synopsis of these effects). For the auditor tax preparer, high complexity enhances the relative benefit of the opportunity for knowledge spillover, but high aggressiveness signals the need for greater independence, which non-auditor tax preparers can provide more easily relative to auditor tax preparers. In other words, auditor tax preparers' increased competence via knowledge spillover is more valuable as complexity increases but the auditor tax preparer is perceived as relatively less trustworthy as aggressiveness increases. If the combination of high aggressiveness and high complexity simply poses a trade-off of increased competence and decreased trustworthiness, making a prediction regarding the relative preference for an auditor tax preparer difficult.

As previously discussed, as aggressiveness increases, the risk associated with potential diversion of resources by management increases. Adding complexity to high aggressiveness could signal an attempt by management to hide self-serving behavior via transactions that are difficult for investors to understand. If the increased complexity in the presence of high aggressiveness signals a need for additional monitoring, then the benefit of knowledge spillover could be over-shadowed by the threat to independence (Desai et al. 2007). Therefore, the more independent monitor, the non-auditor preparer, would be preferred in a high aggressiveness, high complexity condition.

I therefore pose the following research question.

RQ1: What is the combined effect of high aggressiveness and high complexity on investors' relative preference for a firm engaging an auditor versus non-auditor tax preparer?

CHAPTER 4

METHODOLOGY

Participants

Participants were recruited from MBA courses at a large state university. 22.4% of participants reported more than 5 years experience in their current position. 21.1% reported 3 years to less than 5 years. 28.9% reported 1 year to less than 3 years. 27.6% reported less than 1 year. [5] 29.4% of the participants had experience buying or selling an individual company's stock, and 75.3% plan to invest in a company's stock in the next five years. For every ten participants, one participant was selected to receive $100 in a random drawing.

Experimental Design and Task

The hypotheses are tested in an experiment using a 2 x 2 x 2 design that manipulates tax aggressiveness and tax complexity between subjects at two levels each. Joint provision is a within-subjects manipulation. Participants are randomly assigned to one of four conditions.

Participants assume the role of investors making an investment decision, allocating $10,000 across two fictitious companies, Bradley's Books and Sight & Sound Superstore. After reading background information for each company including basic financial statements, participants are presented with additional information regarding a

[5] Of the participants reporting less than 1 year work experience, 71.4% reported "student" or "graduate assistant" as their current profession indicating a probable recent change from full-time employment to enrollment as a graduate student. Therefore, the amount of real-world work experience those participants have is unknown but is expected to be greater than 1 year, and the percentage reported to have less than 1 year of work experience in the current position is likely inflated.

particular tax position the company has taken and the public accounting firm(s) the company has engaged as tax preparer and auditor. In all conditions, Bradley's Books engages separate firms to provide tax and audit services, and Sight & Sound Superstore engages one firm for joint provision of tax and audit services. The firms are identical in all other respects (e.g., Big 4 public accounting firms). [6] The financial statement ratios and additional information for Bradley's Books and Sight & Sound Superstore are identical.[7]

Aggressiveness is communicated in the financial statements by a difference in effective tax rate (ETR).[8] Aggressiveness is also communicated explicitly in the additional information by explaining that the company engaged in an innovative tax transaction that reduced the firm's ETR from 26.8% in 2009 to 26.3% (26.7% for low aggressiveness) in 2010 and that the industry average ETR was 26.8% for 2010. For high aggressiveness, the additional information also states that the transaction's legitimacy is pending before the IRS, and it is uncertain whether the position will be sustained upon IRS audit. For low aggressiveness, the information states that it is likely that the position would be allowed upon audit, and the transaction does not increase the risk of audit. Complexity is communicated explicitly in the additional information provided by stating in the high complexity condition that some of the tax planning involves complex tax

[6] Many companies use tax service providers that are not public accounting firms (e.g., tax attorneys). In this experiment, the tax preparer is always a Big 4 public accounting firm in order to make the comparison between tax preparers as clean as possible, emphasizing only the difference in joint provision.
[7] The financial statements differ as one company's financial statement numbers are greater than the other company's by a multiplier of 1.4. I have counterbalanced the company with larger numbers so that 50% of participants see financial statements in which Bradley's Books has higher revenues, assets, etc. and 50% see statements in which Sight & Sound Superstore has higher numbers.
[8] ETR is calculated as Income Tax Expense / Earnings Before Income Tax. In the low aggressiveness conditions, the ETR decreases from 26.8% in 2009 to 26.7% in 2010. In the high aggressiveness conditions, the ETR decreases from 26.8% in 2009 to 26.3% in 2010. In all conditions, participants might perceive an element of aggressiveness, as the 2010 ETR is lower than the industry average ETR (26.8%).

positions and strategies. In the low complexity condition, participants are told that tax planning is relatively straightforward, involving uncomplicated tax positions and strategies.

Participants provide their judgments of the level of aggressiveness and complexity of each firm's tax position. Participants then make an investment decision, allocating a $10,000 investment between the two companies. Participants are asked to explain the factors that influenced their decision. Participants complete the instrument by answering questions indicating perceptions of source credibility of the tax preparer, providing judgments of the riskiness of the tax position, answering manipulation checks, and providing demographic information. A detailed description of the manipulated and measured variables follows below.

Independent Variables

The experiment manipulates whether the tax preparer is also the firm's auditor, as well as both the aggressiveness and complexity of the firm's tax position. Participants are presented with two companies, one which has engaged its Big 4 auditor to provide tax services, the other which has engaged separate Big 4 firms to provide auditing and tax services. Aggressiveness is manipulated between subjects at two levels. In the high (low) aggressiveness condition, participants are told that each company has engaged in an innovative tax transaction that decreased the firm's effective tax rate, and it is uncertain if (highly likely that) the position will be upheld upon IRS audit. Complexity is also manipulated between subjects at two levels. In the high (low) complexity condition, participants are explicitly told that both companies have engaged in tax planning that involves complex (straightforward) tax strategies.

Dependent Variable

Participants' investment decisions are captured by asking them to allocate $10,000 of potential investment between Bradley's Books and Sight & Sound Superstore. The dependent variable is the amount participants invested in the company that engaged a non-auditor tax preparer (Bradley's Books).

Mediating Variable

The mediating variable is the participant's perception of the tax preparers' credibility. Source credibility is defined as the extent to which a communicator is perceived to be competent and the degree of confidence in the communicator's intent to communicate the assertions he considers most valid (Giffin 1967). Thus, I measure investors' perceptions of credibility, as well as the underlying constructs of competence and trustworthiness.

Mercer (2005) is perhaps the most widely cited accounting paper to measure source credibility. Mercer (2005) measured investors' perceptions of management's reporting credibility by using six questions adapted from Leathers (1992) and McCroskey (1966). Mercer (2005) conducted a reliability analysis on participants' responses to the six questions, which yielded a Cronbach's alpha of .78, suggesting that the scale is reliably capturing one underlying construct. I adapt the questions used by Mercer (2005) for the context of this study. I also include a straightforward question regarding perceptions of source credibility: "Which of the two tax preparers is more credible?" See

Appendix A for the source credibility questions. All source credibility questions are answered using a 7-point Likert-type scale with the non-auditor tax preparer at "1" and the auditor tax preparer at "7."

CHAPTER 5

RESULTS

Manipulation Checks

Responses to the manipulation check questions indicate that the manipulations were successful. Participants indicated that the tax position was less aggressive when in the low aggressiveness condition (4.03 and 4.05 out of 7.0 for Bradley's Books and Sight & Sound Superstore, respectively) than in the high aggressiveness condition (4.67 and 4.98 out of 7.0; $p = 0.02$ and $p < .001$, respectively). Participants also evaluated the firms' tax positions as less complex when in the low complexity condition (3.78 and 3.53 out of 7.0) than in the high complexity condition (4.95 and 5.02 out of 7.0; $p < .001$).

Hypothesis Testing

Table 2 reports the descriptive data used to test the hypotheses and research question. Panel A presents the mean investment in Bradley's Books, the company not engaging the auditor tax preparer for all conditions. Panel B shows the ANOVA table for the effects of aggressiveness and complexity on participants' investment allocations. Panel C reports the results of the t-tests for H1 through H3. Panel D presents the results for the research question.

H1 predicts that investors are likely to invest more in a company that engages a non-auditor tax preparer than in a company that hires an auditor tax preparer. To test this hypothesis, I conduct a t-test to determine whether the percentage invested in a company with a non-auditor tax preparer is significantly greater than 50% of the total investment. Consistent with H1, participants invested more of the $10,000 investment in the company engaging a non-auditor tax preparer ($5,990) than in a company engaging an auditor tax preparer ($4,010) and more than would be expected by chance ($5,000) (see Table 2, Panel C: t = 3.632, p = < .001). This result provides evidence that investors prefer non-joint provision of tax and audit services, consistent with regulators' concerns. In further support of H1, 33.3% of participants specifically indicated concern about joint provision when asked for the single most important factor considered in support of the investment decision.[9]

H2 predicts that investors are relatively more likely to invest in a company that engages a non-auditor preparer when tax aggressiveness is high than when tax aggressiveness is low. To test this hypothesis, I use a one-sided t-test to determine whether the amount invested in the company engaging a non-auditor tax preparer is higher in the high aggressiveness condition than in the low aggressiveness condition. Contrary to H2, investors are not more likely to invest in a company engaging a non-auditor preparer when tax aggressiveness is high ($6,043) than when tax aggressiveness is low ($5,927) at a significant level (Table 2, Panel C: t = .211, p = .417).

Figure 1 presents a model mapping perceptions of independence through the credibility component of trustworthiness. The model outlines H2 as follows: the non-auditor tax preparer will be perceived as more independent, and therefore more

[9] Of those participants who provided an answer to the question, 37.8% indicated concern regarding joint provision. Two other participants provided the vague response "tax preparer" without a direct tie to joint provision concerns (2.7%). The remaining participants provided a factor related to the financial statements, i.e., revenues, shareholders' equity, etc. The financial statements differed between Bradley's Books and Sight & Sound Superstore only by a multiplier of 1.4, and the difference was counterbalanced.

trustworthy. The value of being more trustworthy will be greater as aggressiveness increases; therefore the preference for the non-auditor tax preparer will increase as aggressiveness increases. Participants indicate that the non-auditor tax preparer is both more trustworthy (Table 3: $t = 10.788, 5.958$; $p = <.001, <.001$)[10] and more independent ($t = 10.929$, $p = <.001$). Although the non-auditor tax preparer is perceived to be more trustworthy and more independent, aggressiveness does not affect the value of being more trustworthy and independent; the investment in the non-auditor tax preparer does not increase significantly as aggressiveness increases.

H3 predicts that investors are relatively more likely to invest in a company that engages a non-auditor preparer when tax complexity is low than when it is high. To test this hypothesis, I use a one-sided t-test to determine whether the percentage invested in a company engaging a non-auditor tax preparer is higher in the low complexity condition than in the high complexity condition. H3 is not supported, as the mean investment in a company engaging a non-auditor preparer when tax complexity is low ($5,549) is *lower* than when complexity is high ($6,402).

H3 predicts that the mean investment in the company engaging a non-auditor preparer will be lower when tax complexity is high than when complexity is low. In other words, the value of non-auditor preparation decreases as complexity increases. This argument is based on the assumption that auditor preparers benefit more than non-auditor preparers as complexity increases due to knowledge spillover that can occur between audit and tax teams during joint provision. The results of the experiment are

[10] Two values are provided for the t-statistic and p-value because two questions are asked to derive participants' perceptions of trustworthiness: which preparer is less biased and which preparer is less truthful.

opposite to what was predicted. The mean investment in the company engaging a non-auditor preparer *increased* with greater complexity.

The model presented in Figure 1 shows links between tax complexity, the importance of preparer competence, the value of knowledge spillover, and preferences for joint provision. Further analysis of the data indicates that the link between competence and knowledge spillover does not hold. Table 3 presents the results of post-experimental questions in which participants indicated that they perceived the *non-auditor* tax preparer as more competent than the auditor tax preparer ($t = 3.905$, $p = <.001$). When asked about the components of competence, participants indicate that the auditor tax preparer has more client-specific knowledge ($t = 3.360$, $p = .001$) and client-specific resources than the non-auditor tax preparer ($t = 5.162$, $p = <.001$). These client-specific assets relate to potential for knowledge spillover. Therefore, participants indicate that knowledge spillover is possible, but they appear to dissociate knowledge spillover with overall competence. When asked about knowledge of factors involved in *general* tax preparation, participants indicate no significant difference between the two preparer types ($t = 1.546$, $p = .126$).

This result suggests that while investors do not appear to associate joint provision and the potential for knowledge spillover with greater preparer competence, the prediction that the value of competence increases with complexity, and that this will be reflected in investors' decisions, may still be supported. After removing the knowledge spillover link, an alternative form of H3 could be stated as follows: as complexity increases, the value of preparer competence increases, leading to a stronger preference for the preparer that is perceived to be more competent. To test this alternatively stated hypothesis, I use a t-test to determine whether a difference exists in perceived competence for auditor vs. non-auditor preparers. On average, the non-auditor preparer is perceived as more competent than the auditor preparer (t = 3.905; p = <.001). I then use a one-sided t-test to determine whether investment is greater in the firm engaging the more competent preparer when complexity is high vs. low. The result of this test supports the "alternative" H3. Investment in the preparer that is perceived to be more competent (the non-auditor) is significantly greater when complexity is high than when complexity is low (t = 1.577, p = .059).

RQ1 explores investors' preferences when both tax aggressiveness and complexity are high compared to the other three conditions. To examine this question, I conduct t-tests to determine whether the amount invested in a company engaging a non-auditor tax preparer is significantly different in the high aggressiveness, high complexity condition than in each of the other three conditions. Table 2, Panel D presents the results of the t-tests, and Figure 2 presents the means of the four conditions. Results indicate that investment is significantly higher in the high aggressiveness, high complexity condition ($6,717) than in the high aggressiveness, low complexity condition ($5,370) (t = 1.737, p = .089); but no significant difference exists between investments in the high aggressiveness, high complexity condition and either the low aggressiveness, high complexity ($6,056) (t = .907, p = .370) or low aggressiveness, low complexity condition ($5,778) (t = 1.151, p = .257). Although the results do not indicate a significant difference between the high aggressiveness, high complexity condition and each of the other three conditions, the means are consistent with the explanation that the cost of impaired independence in appearance overrides the benefit of potential knowledge spillovers, as the mean investment in the non-auditor tax preparer is greater in the high aggressiveness, high complexity condition than in each of the other three conditions.

In addition to the t-tests between conditions, I also use contrast coding to compare the four conditions. The expectation is that participants will prefer the non-auditor tax preparer the most in the high aggressiveness, high complexity condition and will prefer the non-auditor tax preparer the least in the low aggressiveness, high complexity condition. Therefore, I test the following planned contrast: $\mu_2 > \mu_1 = \mu_4 > \mu_3$, wherein condition 1 is high aggressiveness, low complexity; condition 2 is high aggressiveness, high complexity; condition 3 is low aggressiveness, high complexity; and condition 4 is low aggressiveness, low complexity. Untabulated results indicate that the mean investment in the high aggressiveness, high complexity condition ($6,717) is significantly greater than the mean investment in the low complexity conditions ($5,549) ($t = 1.747$, $p = .042$). The mean investment in the low complexity conditions ($5,549) is not significantly greater than the mean investment in the low aggressiveness, high complexity condition ($6,056). Again, the means are consistent with the explanation that the cost of impaired independence in appearance overrides the benefit of potential knowledge spillovers, as the mean investment in the non-auditor tax preparer is greater in the high aggressiveness, high complexity condition than in the conditions of low complexity. The mean investment in the conditions of low complexity is not greater than the mean investment in the low aggressiveness, high complexity condition. This result corresponds to the findings of H3; that is, high complexity leads participants to prefer the non-auditor tax preparer more than low complexity

Supplemental Analysis

Participants were asked two questions about the relative importance of the tax preparer's independence and competence. First, participants were asked about their relative concern about independence and competence in general. Then, participants were asked about their relative concern about the tax preparer's independence and competence under joint provision. Participants responded on a Likert-type scale with "independence" at "1" and competence at "7" and a midpoint of "equally concerned regarding both." Table 4, Panel A presents the mean response for these two questions and the difference between the two responses across the aggressiveness conditions. Table 4, Panel B presents the mean response for these two questions and the difference between the two responses across the complexity conditions. I use a t-test to determine whether the difference between the two responses was significant, indicating that aggressiveness and complexity led to a differential shift in participants' relative concern about independence and competence. Table 4, Panel C presents the results of the t-tests.

H2 proposes that participants' preferences for joint provision decrease as aggressiveness increases, due to independence concerns. Therefore, support for H2 would follow from participants indicating greater relative concern about independence under joint provision than non-joint provision. On average, participants in the aggressive conditions exhibit a greater shift in concern from competence to independence (1.42) than participants in the non-aggressive conditions (.85) ($t = 1.514$, $p = .067$). In other words, as aggressiveness increases, participants shift the focus from competence concerns to independence concerns.

H3 proposes that participants' preferences for joint provision increase as complexity increases, due to benefits from knowledge spillover. Therefore, support for H3 would be evidenced by participants indicating greater relative concern about competence under joint provision than non-joint provision. On average, participants do not exhibit a significant shift in concern from independence to competence across the complexity conditions ($t = .271$, $p = .394$).

CHAPTER 6

CONCLUSION

Joint provision of audit and tax services has been a subject of regulatory scrutiny and academic research for many years. One problem cited in regulatory debates concerning the restriction of joint provision of audit and non-audit services is the lack of empirical evidence that joint provision leads to impaired auditor independence in fact or appearance (e.g., POB 2000; Turner 2001). This study partly addresses this issue by providing evidence that joint provision leads to impaired independence in appearance; investors perceive joint provision to impair independence and prefer non-joint provision of audit and tax services.

This study also contributes to the audit and tax literatures regarding the costs and benefits of joint provision by examining the effect of tax aggressiveness and complexity on investors' preferences for joint provision. Using a source credibility framework, I map the benefits and costs of joint provision to the components of source credibility, competence and trustworthiness, to explain the hypothesized effects of aggressiveness and complexity on investors' preferences and subsequent investment decisions.

Results of the study indicate that a tax preparer firm that is not engaged to serve as the auditor is perceived to be more competent and more trustworthy than a firm jointly providing audit and tax services. Although the non-auditor tax preparer is perceived to be more trustworthy and more independent, the value of the increased trustworthiness and independence does not increase as tax aggressiveness increases. Investors consistently prefer the non-auditor tax preparer across levels of tax aggressiveness. In other words, the non-auditor tax preparer is preferred regardless of the aggressiveness of the tax position; but an increasingly aggressive position does not increase the value of the non-auditor tax preparer's independence.

The non-auditor tax preparer is perceived to be more competent than the auditor tax preparer; and as tax complexity increases, investor preference for the non-auditor tax preparer increases. In other words, the non-auditor tax preparer is preferred to the auditor tax preparer regardless of the complexity of the tax position. As the tax position's complexity increases, the value of the non-auditor tax preparer's competence increases.

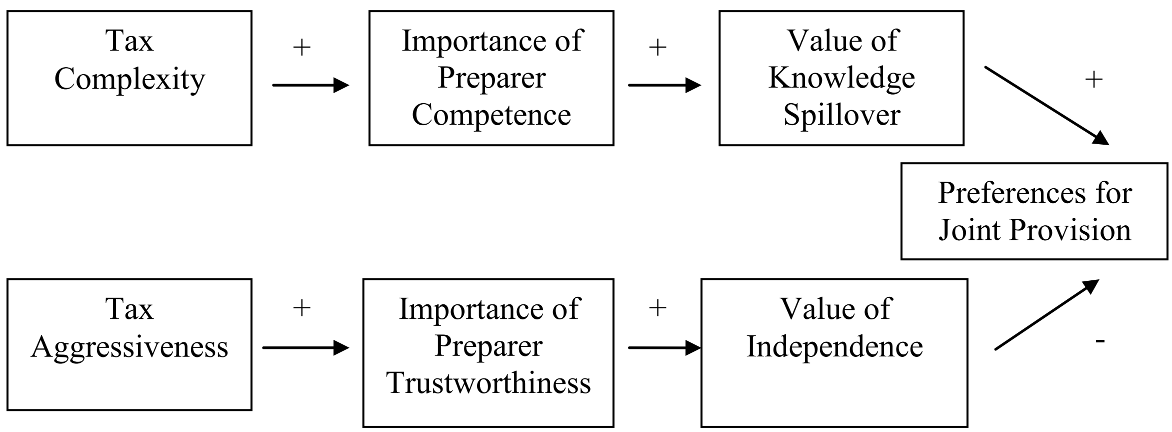
One limitation of this study is the participants' perception of "low" aggressiveness and complexity. Although the aggressiveness manipulation is supported, low aggressiveness is actually perceived to be neutral. Participants are asked to indicate how aggressive they perceive the tax position to be. Although participants indicate that the tax position in the high aggressiveness condition is more aggressive than in the low aggressiveness condition at a statistically significant level, participants do *not* indicate that the low aggressiveness condition is different than neutral at a statistically significant level ($t = .119, .255$; $p = .906, .800$ for Bradley's Books and Sight & Sound Superstore, respectively). This limitation could partly explain the lack of results for H2, as the two levels of aggressiveness are different from one another but represent high versus neutral aggressiveness rather than high versus low aggressiveness. This limitation could preclude observation of the full effect of aggressiveness on investors' preferences. Future research could create a low aggressiveness condition in order to further address how aggressiveness affects investors' preferences for joint provision. The tax aggressiveness literature has posited the question of whether a company can be too conservative in its tax planning strategies (Hanlon and Heitzman 2010). A study with a condition of truly low aggressiveness can address whether a situation exists in which investors perceive a tax position as *too* conservative, and if so, how the overly conservative tax position affects perceptions of source credibility and the preference for joint provision. Perceptions of low complexity were significantly less than neutral for Sight & Sound Superstore (t = 2.165, p = .036) but not for Bradley's Books (t = .922, p = .362). Therefore, a similar opportunity for future research examining the effect of an even less complex tax strategy exists. A tax strategy that is overly simplistic may call to question the competence of the preparer.

Future research could also further examine the apparent disconnect between competence and knowledge spillover and between competence and the specific components of competence. Results of this study indicate that the non-auditor tax preparer is perceived to be more competent than the auditor tax preparer, regardless of the benefits that the auditor tax preparer receives via potential knowledge spillover. Participants are asked which preparer is more competent and also asked three questions related to components of competence, adapted from two widely accepted credibility scales (McCroskey 1966; Leathers 1992; Mercer 2005). Participants indicate that the auditor tax preparer is perceived to have additional knowledge of client-specific factors involved in tax preparation, to have additional client-specific resources available for tax preparation, and to be more qualified to serve as the tax preparer; yet when participants are asked directly which preparer is more competent, they indicate that the non-auditor tax preparer is more competent. Therefore, in the scenario presented, responses to the more detailed competence questions are inconsistent with responses to the straightforward question of which preparer is more competent. One potential explanation for this disconnect is that participants perceive that the non-auditor tax preparer must be more competent in order to earn the tax business from the client without a prior relationship, such as the auditor tax preparer would have. This explanation allows for a separation of competence and knowledge spillover that would explain the results found in the study. Future research could examine this potential explanation as well as other factors that could contribute to the apparent disconnect to determine whether joint provision, in particular, presents a unique situation in which competence is composed of factors that differ from those outlined in prior studies.

An additional limitation is that participants are not asked what specific services the tax preparer has provided in the case. Participants may have varying opinions of what the tax preparer's responsibility and participation has been in the tax planning and preparation process. Some participants may perceive the tax preparer to be an entity that simply completes the tax return forms by entering numbers supplied by the client. Other participants may perceive the tax preparer to be an entity that is involved in planning and implementing tax strategies. Because participants are randomly assigned to conditions, it is unlikely that differences in expectation regarding the tax preparer's services are the determining factor for the results of the experiment.

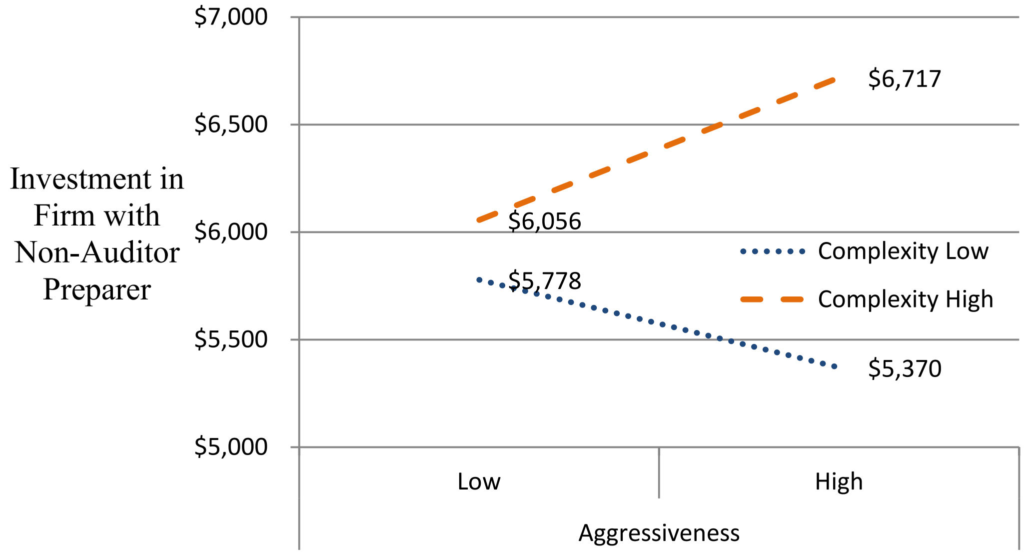
FIGURES AND TABLES

Figure 1: A Model of Tax Risk Factors and Investors' Joint Provision Preferences



This figure presents the model specifying the predicted effects of two tax risk factors, complexity and aggressiveness, on investors' preferences for joint provision. Using a source credibility framework, I predict that tax complexity increases the importance of tax preparer competence, increasing the value of knowledge spillover and subsequently increasing investors' preferences for joint provision of tax and audit services. I also predict that tax aggressiveness increases the importance of tax preparer trustworthiness, increasing the value of independence and subsequently decreasing investors' preferences for joint provision of tax and audit services.

Figure 2: Graphed Results



This figure represents the observed effects of aggressiveness and complexity on investors' preferences for joint provision. In the experiment, participants allocate a hypothetical $10,000 investment between a firm engaging its auditor as the tax preparer and a firm engaging a non-auditor preparer as the tax preparer. The dollar amount invested in the firm engaging a non-auditor preparer represents investors' preference for joint provision of tax and audit services. Aggressiveness and complexity are manipulated between-subjects in the experiment at two levels: low and high.

Table 1: Hypothesized Effects of Aggressiveness and Complexity on Independence and Knowledge Spillover

		Complexity	
		Low	**High**
Aggressiveness	**Low**	Independence: No effect Knowledge spillover: No effect	Independence: No effect Knowledge spillover: Increase
	High	Independence: Decrease Knowledge spillover: No effect	Independence: Decrease Knowledge spillover: Increase

This figure represents the predicted effects of the tax risk factors aggressiveness and complexity on independence and knowledge spillover. In the high aggressiveness, high complexity cell, aggressiveness and complexity present opposing effects on the value of the auditor tax preparer. The auditor tax preparer is at a disadvantage compared to the non-auditor tax preparer due to concerns regarding independence and has an advantage compared to the non-auditor tax preparer due to benefits arising from knowledge spillover. These competing effects lead to RQ1.

Table 2. The Effect of Aggressiveness and Complexity on Investors' Preference for Joint Provision of Tax and Audit Services [a]

Panel A: Amount invested in company engaging the non-auditor tax preparer (mean [standard deviation]):

Condition	Low Complexity	High Complexity	Total
Low Aggressiveness	5,777.78 [2,550.79] n = 18	6,055.52 [2,163.66] n = 21	5,927.33 [2,322.59] n = 39
High Aggressiveness	5,369.57 [2,633.77] n = 23	6,717.39 [2,627.76] n = 23	6,043.48 [2,689.13] n = 46
Total	5,548.78 [2,576.43] n = 41	6,401.50 [2,412.91] n = 44	5,990.19 [2,513.50] n = 85

Panel B: ANOVA Results: Amount invested in company engaging the non-auditor tax preparer:

	df	MSE	F-statistic	p-value
Aggressiveness	1	284,710.84	.045	.832
Complexity	1	15,616,461.82	2.486	.119
Aggressiveness x Complexity	1	6,022,534.84	.959	.330
Error	81	6,281,008.22		

Table 2 (cont.)

Panel C: *t*-tests with amount invested in company engaging the non-auditor tax preparer as the independent variable:

	t-statistic	p-value
H1: Investors are more likely to invest in a company engaging a non-auditor tax preparer than a company engaging an auditor tax preparer.	**3.632**	**< .001**
H2: Investors' relative preferences for a firm engaging a non-auditor tax preparer is greater when tax aggressiveness is high than when it is low.	.211	.417
H3: Investors' relative preferences for a firm engaging a non-auditor tax preparer are greater when tax complexity is low than when it is high.	1.577	.059

Panel D: *t*-tests for RQ comparing high aggressive/high complexity condition to other three conditions:

RQ1: What is the combined effect of high aggressiveness and high complexity on investors' relative preference for a firm engaging an auditor versus non-auditor tax preparer?

High Aggressiveness/High Complexity compared to:	*t*-statistic	p-value
High Aggressiveness/Low Complexity	**1.737**	**.089**
Low Aggressiveness/High Complexity	.907	.370
Low Aggressiveness/Low Complexity	1.151	.257

[a] Participants allocated a $10,000 investment between Bradley's Books and Sight & Sound Superstore. The investment decision dependent measure is the amount of $10,000 invested in Bradley's Books. Bradley's Books engaged a non-auditor tax preparer. Sight & Sound Superstore engaged its auditor as the tax preparer. The amount invested in Sight & Sound Suuperstore is $10,000 less the amount invested in Bradley's Books.

Table 3: Descriptive Statistics and Results for Tests Regarding Source Credibility Questions

Panel A: Response to Likert-type questions with non-auditor tax preparer at "1" and auditor tax preparer at "7":

	Mean	N	Std. Deviation
More competent	3.46	85	1.278
More likely to have additional knowledge of general tax preparation [a]	4.24	85	1.403
More likely to have additional client-specific knowledge [a]	4.68	85	1.872
More likely to have additional client-specific resources [a]	5.00	85	1.786
More qualified to serve as the tax preparer [a]	3.65	84	1.410
More independent	2.21	84	1.498
Less biased [b]	2.21	85	1.528
Less truthful [b]	5.20	85	1.857
More credible	2.79	85	1.390

[a] These questions relate to specific aspects of competence.

[b] These questions relate to specific aspects of trustworthiness.

Panel B: *t*-tests for determining whether the mean response is significantly different than "neutral":

	t-statistic	p-value [a]
Q1: Which of the two tax preparers is more competent in your judgment?	**-3.905**	**< .001**
Q2: Which of the two preparers is more likely to have additional knowledge of the factors involved in general tax preparation? [b]	1.546	.126
Q3: Which of the two preparers is more likely to have additional knowledge of client-specific factors involved in tax preparation? [b]	**3.360**	**.001**
Q4: Which of the two preparers is more likely to have additional client-specific resources available for tax preparation? [b]	**5.162**	**< .001**
Q9: Which firm is more qualified to serve as the tax preparer for its respective client? [b]	**-2.244**	**.027**
Q5: Which of the two preparers is more independent?	**-10.929**	**< .001**
Q6: Which of the two preparers is less biased in tax preparation and reporting? [c]	**-10.788**	**< .001**
Q7: Which of the two tax preparers is less likely to be truthful in their tax planning, preparation, and reporting? [c]	**5.958**	**< .001**
Q8: Which of the two preparers is more credible? [c]	**-8.040**	**< .001**

[a] p-values are two-tailed.

[b] These questions relate to specific aspects of competence.

[c] These questions relate to specific aspects of trustworthiness.

Table 4: Mean response for relative concern about independence and competence of tax preparer

Panel A: Results for comparing across high and low aggressiveness conditions:

	General concern	Concern under joint provision	Difference
Low Aggressiveness	4.33 n = 39 [1.628]	3.49 n = 39 [2.037]	.85 n = 39 [1.531]
High Aggressiveness	4.56 n = 45 [1.589]	3.13 n = 45 [1.804]	1.42 n = 45 [1.901]

Panel B: Results for comparing across complex and not aggressive conditions:

	General concern	Concern under joint provision	Difference
Low Complexity	4.50 n = 40 [1.881]	3.40 n = 40 [1.985]	1.10 n = 40 [1.582]
High Complexity	4.41 n = 44 [1.317]	3.20 n = 44 [1.862]	1.20 n = 44 [1.912]

Panel C: t-tests to determine whether participants show a significant shift in focus between independence and competence

	t-statistic	p-value [a]
Aggressiveness	**1.514**	**.067**
Complexity	.271	.394

[a] One-tailed p-values are reported as a directional prediction is made regarding the shift in focus between independence and competence.

These tables represent mean responses to the following questions: "In general, are you relatively more concerned about the independence of the tax preparer or the competence of the tax preparer?" and "When the same accounting firm is providing both audit and tax services, are you more concerned about the independence of the tax preparer or the competence of the tax preparer?" Participants responded to the question on a scale from "1 – Independence" to "7 – Competence" with a midpoint of "4 – Equally concerned regarding both."

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APPENDIX A: SOURCE CREDIBILITY QUESTIONS

Q1: Which of the two tax preparers is more competent in your judgment?

Q2: Which of the two tax preparers is more likely to have additional knowledge of the factors involved in general tax preparation?

Q3: Which of the two tax preparers is more likely to have additional knowledge of client-specific factors involved in tax preparation?

Q4: Which of the two tax preparers is more likely to have additional client-specific resources available for tax preparation?

Q5: Which of the two tax preparers is more independent?

Q6: Which of the two tax preparers is less biased in tax preparation and reporting?

Q7: Which of the two tax preparers is less likely to be truthful in their tax planning, preparation, and reporting?

Q8: Which of the two tax preparers is more credible?

Q9: Which firm is more qualified to serve as the tax preparer for its respective client?

APPENDIX B: EXPERIMENTAL INSTRUMENT

HIGH AGGRESSIVENESS, HIGH COMPLEXITY CONDITION

BACKGROUND INFORMATION

As a potential investor, you have obtained the following background information from the 2010 annual reports of *Bradley's Books* and *Sight and Sound Superstore*. Additional information has been provided for your consideration as well. Please review both sets of information before answering the case questions.

Bradley's Books

Business and Products

Bradley's Books, a publicly traded, Fortune 500 company (BDB), operates book and music superstores. At December 31, 2010, Bradley's Books operated 350 superstores in the United States. In addition, Bradley's Books operates a proprietary e-commerce Web site, www.BradleysBooks.com, which was launched in 2007.

Bradley's Books' business strategy is designed to address the most significant opportunities and challenges facing the Company. In particular, challenges include commoditization in primary product categories, an extremely competitive marketplace (including both store-based and online competitors), the seasonal nature of sales as a retailer, and product formats that are evolving from physical to digital formats.

Significant Accounting Policies

In accordance with U.S. Generally Accepted Accounting Principles (GAAP), revenue is recognized when earned. In preparing financial statements in conformity with GAAP, the Company is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

Income Statement (all figures in millions)

Fiscal Year ending December 31

	AUDITED 2009	AUDITED 2010
Revenue	$51.00	$61.00
Cost of Sales	25.40	30.50
Gross Profit	25.60	30.50
Lease Expense	4.90	5.80
Selling, General & Administrative Expense	12.50	14.80
Earnings Before Income Taxes	8.20	9.90
Income Tax Expense	2.20	2.60
Net Income	$6.00	$7.30

Balance Sheet (all figures in millions)

Fiscal Year ending December 31

	AUDITED 2009	AUDITED 2010
Assets		
Current Assets	$17.2	$19.6
Property, Plant, and Equipment	8.2	8.1
Intangible Assets	2.4	2.4
Other Assets	2.1	2.4
Total Assets	29.9	32.5
Liabilities		
Current Liabilities	$14.8	$15.9
Long-term Liabilities	5.9	5.9
Total Liabilities	20.7	21.8
Stockholders' Equity	9.2	10.7
Total Liabilities and Stockholders' Equity	29.9	32.5

Additional information:

- Bradley's Books' effective tax rate for 2010 was 26.3%. The industry average effective tax rate was 26.8%.

- During 2010, Bradley's Books engaged in an innovative tax transaction that reduced the firm's effective tax rate from 26.8% in 2009 to 26.3% in 2010. This transaction is captured in the tax reserve liability (unrecognized tax benefit). This transaction's legitimacy is pending before the IRS, and it is uncertain whether the position will be sustained upon IRS audit.

- Some of the tax planning for Bradley's Books involved complex tax positions and strategies, which required careful structuring and an in-depth understanding of relevant, interacting factors from the financial statements and tax records.

- Bradley's Books has engaged Crandall Hedge, LLP, as the tax preparer. Crandall Hedge, LLP, will only provide tax services to Bradley's Books. Crandall Hedge, LLP, is a Big 4 public accounting firm.

- Bradley's Books has engaged Burton & Olde, LLP, also a Big 4 public accounting firm, to serve as the external auditor.

Please answer the following questions by marking the circle that corresponds to your judgment. Feel free to refer back to the case materials in order to answer the questions.

Q1: How aggressive do you believe the tax position taken by the company is?

O	O	O	O	O	O	O
1 Extremely unaggressive	2	3	4 Neutral	5	6	7 Extremely aggressive

Q2: How complex do you believe the company's tax planning is?

O	O	O	O	O	O	O
1 Not complex at all	2	3	4 Somewhat complex	5	6	7 Extremely complex

Q3: Which of the following best describes Bradley's Books?

A. Bradley's Books is a small, privately owned company, operating a handful of bookstores.

B. Bradley's Books is a large, publicly traded company, operating many bookstores.

C. The information is not provided in the case.

Q4: Which of the following is true regarding the tax preparer engaged by Bradley's Books? Remember: You **may** look back over the case materials to determine the correct answer.

A. Bradley's Books has engaged Crandall Hedge, LLP, a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

B. Bradley's Books has engaged Crandall Hedge, LLP, a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged Burton & Olde, LLP, to provide audit services.

C. Bradley's Books has engaged Crandall Hedge, LLP, which is **NOT** a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

D. Bradley's Books has engaged Crandall Hedge, LLP, which is **NOT** a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged Burton & Olde, LLP, to provide audit services.

Sight and Sound Superstore

Business and Products

Sight and Sound Superstore, a publicly traded, Fortune 500 company (SSS), operates book and music superstores. At December 31, 2010, Sight and Sound Superstore operated 350 superstores in the United States. In addition, Sight and Sound Superstore operates a proprietary e-commerce Web site, www.SandSSuperstore.com, which was launched in 2007.

Sight and Sound Superstore' business strategy is designed to address the most significant opportunities and challenges facing the Company. In particular, challenges include commoditization in primary product categories, an extremely competitive marketplace (including both store-based and online competitors), the seasonal nature of sales as a retailer, and product formats that are evolving from physical to digital formats.

Significant Accounting Policies

In accordance with U.S. Generally Accepted Accounting Principles (GAAP), revenue is recognized when earned. In preparing financial statements in conformity with GAAP, the Company is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

Income Statement (all figures in millions)

Fiscal Year ending December 31

	AUDITED	
	2009	**2010**
Revenue	$71.40	$85.40
Cost of Sales	35.56	42.70
Gross Profit	35.84	42.70
Lease Expense	6.86	8.12
Selling, General & Administrative Expense	17.50	20.72
Earnings Before Income Taxes	11.48	13.86
Income Tax Expense	3.08	3.65
Net Income	$8.40	$10.21

Balance Sheet (all figures in millions)

Fiscal Year ending December 31

	AUDITED	
	2009	**2010**
Assets		
Current Assets	$ 24.08	$27.44
Property, Plant, and Equipment	11.48	11.34
Intangible Assets	3.36	3.36
Other Assets	2.94	3.36
Total Assets	41.86	45.50
Liabilities		
Current Liabilities	$20.72	$22.26
Long-term Liabilities	8.26	8.26
Total Liabilities	28.98	30.52
Stockholders' Equity	12.88	14.98
Total Liabilities and Stockholders' Equity	41.86	45.50

Additional information:

- Sight and Sound Superstore's effective tax rate for 2010 was 26.3%. The industry average effective tax rate was 26.8%.

- During 2010, Sight and Sound Superstore engaged in an innovative tax transaction that reduced the firm's effective tax rate from 26.8% in 2009 to 26.3% in 2010. This transaction is captured in the tax reserve liability (unrecognized tax benefit). This transaction's legitimacy is pending before the IRS, and it is uncertain whether the position will be sustained upon IRS audit.

- Some of the tax planning for Sight and Sound Superstore involved complex tax positions and strategies, which required careful structuring and an in-depth understanding of relevant, interacting factors from the financial statements and tax records.

- Sight and Sound Superstore has engaged Livingston, LLP, as the tax preparer. Livingston, LLP, is a Big 4 public accounting firm. Sight and Sound Superstore has engaged Livingston, LLP, to also serve as the external auditor.

Q5: How aggressive do you believe the tax position taken by the company is?

O	O	O	O	O	O	O
1 Extremely unaggressive	2	3	4 Neutral	5	6	7 Extremely aggressive

Q6: How complex do you believe the company's tax planning is?

O	O	O	O	O	O	O
1 Not complex at all	2	3	4 Somewhat complex	5	6	7 Extremely complex

Q7: Which of the following best describes Sight and Sound Superstore?

A. Sight and Sound Superstore is a small, privately owned company, operating a handful of bookstores.

B. Sight and Sound Superstore is a large, publicly traded company, operating many bookstores.

C. The information is not provided in the case.

Q8: Which of the following is true regarding the tax preparer engaged by Sight and Sound Superstore? Remember: You **may** look back over the case materials to determine the correct answer.

A. Sight and Sound Superstore has engaged Livingston, LLP, a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

B. Sight and Sound Superstore has engaged Livingston, LLP, a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged SAIB, LLP, to provide audit services.

C. Sight and Sound Superstore has engaged Livingston, LLP, which is **NOT** a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

D. Sight and Sound Superstore has engaged Livingston, LLP, which is **NOT** a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged SAIB, LLP, to provide audit services.

INSTRUCTIONS

- After reviewing the background information provided above for Bradley's Books and Sight and Sound Superstore, please answer the following questions by providing an answer that best indicates your judgment. You <u>may</u> refer back to the case materials in answering the questions.

- After you have answered a question, please <u>do not</u> go back and change your response.

Q9: Please allocate a $10,000 investment between Bradley's Books and Sight and Sound Superstore in the space provided. <u>Please confirm that your total equals $10,000</u>.

Amount allocated to Bradley's Books: ______________________________

Amount allocated to Sight and Sound Superstore: ______________________

Q10: What is the single most important factor you considered in support of your investment allocation?

Q11: If the tax preparer had an effect on your investment decision, please rank the following factors by the importance each played in your decision for which company you prefer.

A. Client-specific competence
B. General competence
C. Independence
D. Other factors ___________________

1.

2.

3.

4.

If you would like to provide a justification for your decisions, please feel free to do so in the space provided below.

Q12: Please indicate on the scale below how attractive you believe Bradley's Books is as a potential investment.

O	O	O	O	O	O	O
1 Not at all attractive	2	3	4 Neutral	5	6	7 Very Attractive

Q13: Please indicate on the scale below how attractive you believe Sight and Sound Superstore is as a potential investment.

O	O	O	O	O	O	O
1 Not at all attractive	2	3	4 Neutral	5	6	7 Very Attractive

When done, please return the completed materials to Envelope #1, and open Envelope #2.

INSTRUCTIONS

- Please answer the following questions by circling the letter or checking the circle that corresponds to your personal judgment.
- Please answer the questions in the order presented, and please do not read ahead.
- After you have answered a question, please do not go back and change your response.

As a reminder:

- Both Bradley's Books' and Sight and Sound Superstore had an effective tax rate of 26.3% for 2010. The industry average effective tax rate was 26.8%.
- Both Bradley's Books and Sight and Sound Superstore engaged in an innovative tax transaction which reduced the firm's effective tax rates from 2009 to 2010. The transaction was captured in the tax reserve liability (unrecognized tax benefit). The transaction's legitimacy is pending before the IRS, and it is uncertain whether the position will be sustained upon IRS audit.
- Some of the tax planning for Bradley's Books and Sight and Sound Superstore involved complex tax positions and strategies, which required careful structuring and an in-depth understanding of relevant, interacting factors from the financial statements and tax records.
- Bradley's Books engaged Crandall Hedge, LLP, a Big 4 public accounting firm, to provide tax services. Bradley's Books engaged Burton & Olde, LLP, also a Big 4 public accounting firm, to serve as the external auditor.
- Sight and Sound Superstore engaged Livingston, LLP, a Big 4 public accounting firm to provide both tax and audit services.

Q1: Which of the two tax preparers is more competent in your judgment?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally competent	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q2: Which of the two preparers is more likely to have additional knowledge of the factors involved in general tax preparation?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers have equal general tax knowledge	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q3: Which of the two preparers is more likely to have additional knowledge of client-specific factors involved in tax preparation?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers have equal client-specific tax knowledge	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q4: Which of the two preparers is more likely to have additional client-specific resources available for tax preparation?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers have equal resources available	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q5: Which of the two preparers is more independent?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally independent	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q6: Which of the two preparers is less biased in tax preparation and reporting?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally biased or unbiased	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q7: Which of the two preparers is less likely to be truthful in their tax planning, preparation, and reporting?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally truthful	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q8: Which of the two preparers is more credible?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally credible	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q9: Which firm is more qualified to serve as the tax preparer for its respective client?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally qualified	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q10: The cost associated with a loss of reputation due to performing the tax planning and preparation work poorly is higher for…

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 Neither. The cost is the same for both preparers	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q11: Bradley's Books' management is credible.

O	O	O	O	O	O	O
1 Completely Disagree	2	3	4 Neutral	5	6	7 Completely Agree

Q12: Sight and Sound Superstore's management is credible.

O	O	O	O	O	O	O
1 Completely Disagree	2	3	4 Neutral	5	6	7 Completely Agree

Q13: How risky do you believe the tax position taken by Bradley's Books is?

O	O	O	O	O	O	O
1 Not risky at all	2	3	4 Neutral	5	6	7 Extremely risky

Q14: If you perceive the tax position is risky, to what factor do you attribute the risk?

Q15: How risky do you believe the tax position taken by Sight and Sound Superstore is?

O	O	O	O	O	O	O
1 Not risky at all	2	3	4 Neutral	5	6	7 Extremely risky

Q16: If you perceive the tax position is risky, to what factor do you attribute the risk?

Please answer the following questions according to your general opinion (not specifically related to the case provided).

Q17: In general, are you relatively more concerned about the independence of the tax preparer or the competence of the tax preparer?

O	O	O	O	O	O	O
1 Independence	2	3	4 Equally concerned regarding both	5	6	7 Competence

Q18: When the same accounting firm is providing both audit and tax services, are you more concerned about the independence of the tax preparer or the competence of the tax preparer?

O	O	O	O	O	O	O
1 Independence	2	3	4 Equally concerned regarding both	5	6	7 Competence

Q19: When comparing two firms, one which has engaged a single accounting firm to jointly provide both tax and audit services and one which has engaged two separate accounting firms to provide tax and audit services, does your relative concern for independence or competence change? In other words, how would you complete the following sentences:

When one firm provides both tax and audit services, I am ______________________ than when separate firms provide tax and audit services.

A. More concerned about independence
B. Less concerned about independence
C. No more or less concerned about independence

When one firm provides both tax and audit services, I am ______________________ than when separate firms provide tax and audit services.

A. More concerned about competence
B. Less concerned about competence
C. No more or less concerned about competence

Q20: In general, the cost associated with a loss of reputation due to performing the tax planning and preparation work poorly is…

O	O	O	O	O	O	O
1 Higher for the auditor tax preparer	2	3	4 The same for both entities	5	6	7 Higher for the non-auditor tax preparer

Q21: To what extent do you believe the joint provision of tax and audit services by an auditor impairs auditor independence?

O	O	O	O	O	O	O
1 Auditor independence is not impaired	2	3	4 Neutral	5	6	7 Auditor independence is severely impaired

Q22: To what extent do you believe the joint provision of tax and audit services by an auditor affects the quality of a firm's tax services?

O	O	O	O	O	O	O
1 Tax quality is much lower	2	3	4 No effect on tax quality	5	6	7 Tax quality is much higher

Q23: To what extent do you believe the joint provision of tax and audit services by an auditor affects financial reporting quality?

O	O	O	O	O	O	O
1 Financial reporting quality is much lower	2	3	4 No effect on financial reporting quality	5	6	7 Financial reporting quality is much higher

Q24: To what extent do you believe the joint provision of tax and audit services by an auditor affects audit quality?

O	O	O	O	O	O	O
1 Audit quality is much lower	2	3	4 No effect on audit quality	5	6	7 Audit quality is much higher

Q25: How important do you consider tax policy to be when evaluating a potential investment *in general*?

O	O	O	O	O	O	O
1 Not important at all	2	3	4 Neutral	5	6	7 Extremely important

Q26: Do you think your thoughts about a firm engaging one accounting firm to provide both tax and audit services would be different if you were a current shareholder rather than a potential shareholder? Please explain.

Q27: What is your current profession?

Q28: How many years' experience do you have in your current position?

A. Less than 1 year

B. 1 year to less than 3 years

C. 3 years to less than 5 years

D. More than 5 years

Q29: How much experience do you have as a tax professional (answer in years or months of tax experience)?

____

Q30: Do you have personal experience buying or selling an individual company's common stock or debt securities (not through a mutual or pension fund?)

A. Yes

B. No

Q31. Do you intend to invest in an individual company's common stock or debt securities in the next five years?

A. Yes

B. No

Q32: How familiar are you with FIN 48 and/or Unrecognized Tax Benefits?

O	O	O	O	O	O	O
1 Very unfamiliar	2	3	4 Somewhat familiar	5	6	7 Very familiar

Q33: Do you think the reserve for Unrecognized Tax Benefit is a signal of earnings management?

O	O	O	O	O	O	O
1 Absolutely not	2	3	4 Unsure	5	6	7 Absolutely

Q34: In which graduate program are you currently enrolled? ______________________

YOU ARE FINISHED.

THANK YOU FOR YOUR PARTICIPATION.

PLEASE PLACE THESE COMPLETED MATERIALS IN ENVELOPE #2, AND

RETURN ALL ENVELOPES TO THE RESEARCHER.

HIGH AGGRESSIVENESS, LOW COMPLEXITY CONDITION

BACKGROUND INFORMATION

As a potential investor, you have obtained the following background information from the 2010 annual reports of *Bradley's Books* and *Sight and Sound Superstore*. Additional information has been provided for your consideration as well. Please review both sets of information before answering the case questions.

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Fiscal Year ending December 31

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Income Tax Expense	2.20	2.60
Net Income	$6.00	$7.30

Balance Sheet (all figures in millions)

Fiscal Year ending December 31

	AUDITED	
	2009	**2010**
Assets		
Current Assets	$17.2	$19.6
Property, Plant, and Equipment	8.2	8.1
Intangible Assets	2.4	2.4
Other Assets	2.1	2.4
Total Assets	29.9	32.5
Liabilities		
Current Liabilities	$14.8	$15.9
Long-term Liabilities	5.9	5.9
Total Liabilities	20.7	21.8
Stockholders' Equity	9.2	10.7
Total Liabilities and Stockholders' Equity	29.9	32.5

Additional information:

- Bradley's Books' effective tax rate for 2010 was 26.3%. The industry average effective tax rate was 26.8%.
- During 2010, Bradley's Books engaged in an innovative tax transaction that reduced the firm's effective tax rate from 26.8% in 2009 to 26.3% in 2010. This transaction is captured in the tax reserve liability (unrecognized tax benefit). This transaction's legitimacy is pending before the IRS, and it is uncertain whether the position will be sustained upon IRS audit.
- The tax planning for Bradley's Books is relatively straightforward, involving uncomplicated tax positions and strategies.
- Bradley's Books has engaged Crandall Hedge, LLP, as the tax preparer. Crandall Hedge, LLP, will only provide tax services to Bradley's Books. Crandall Hedge, LLP, is a Big 4 public accounting firm.
- Bradley's Books has engaged Burton & Olde, LLP, also a Big 4 public accounting firm, to serve as the external auditor.

Please answer the following questions by marking the circle that corresponds to your judgment. Feel free to refer back to the case materials in order to answer the questions.

Q1: How aggressive do you believe the tax position taken by the company is?

O	O	O	O	O	O	O
1 Extremely unaggressive	2	3	4 Neutral	5	6	7 Extremely aggressive

Q2: How complex do you believe the company's tax planning is?

O	O	O	O	O	O	O
1 Not complex at all	2	3	4 Somewhat complex	5	6	7 Extremely complex

Q3: Which of the following best describes Bradley's Books?

A. Bradley's Books is a small, privately owned company, operating a handful of bookstores.

B. Bradley's Books is a large, publicly traded company, operating many bookstores.

C. The information is not provided in the case.

Q4: Which of the following is true regarding the tax preparer engaged by Bradley's Books? Remember: You **may** look back over the case materials to determine the correct answer.

A. Bradley's Books has engaged Crandall Hedge, LLP, a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

B. Bradley's Books has engaged Crandall Hedge, LLP, a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged Burton & Olde, LLP, to provide audit services.

C. Bradley's Books has engaged Crandall Hedge, LLP, which is **NOT** a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

D. Bradley's Books has engaged Crandall Hedge, LLP, which is **NOT** a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged Burton & Olde, LLP, to provide audit services.

Sight and Sound Superstore

Business and Products

Sight and Sound Superstore, a publicly traded, Fortune 500 company (SSS), operates book and music superstores. At December 31, 2010, Sight and Sound Superstore operated 350 superstores in the United States. In addition, Sight and Sound Superstore operates a proprietary e-commerce Web site, www.SandSSuperstore.com, which was launched in 2007.

Sight and Sound Superstore' business strategy is designed to address the most significant opportunities and challenges facing the Company. In particular, challenges include commoditization in primary product categories, an extremely competitive marketplace (including both store-based and online competitors), the seasonal nature of sales as a retailer, and product formats that are evolving from physical to digital formats.

Significant Accounting Policies

In accordance with U.S. Generally Accepted Accounting Principles (GAAP), revenue is recognized when earned. In preparing financial statements in conformity with GAAP, the Company is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

Income Statement (all figures in millions)

Fiscal Year ending December 31

	AUDITED	
	2009	**2010**
Revenue	$71.40	$85.40
Cost of Sales	35.56	42.70
Gross Profit	35.84	42.70
Lease Expense	6.86	8.12
Selling, General & Administrative Expense	17.50	20.72
Earnings Before Income Taxes	11.48	13.86
Income Tax Expense	3.08	3.65
Net Income	$8.40	$10.21

Balance Sheet (all figures in millions)

Fiscal Year ending December 31

	AUDITED	
	2009	**2010**
Assets		
Current Assets	$ 24.08	$27.44
Property, Plant, and Equipment	11.48	11.34
Intangible Assets	3.36	3.36
Other Assets	2.94	3.36
Total Assets	41.86	45.50
Liabilities		
Current Liabilities	$20.72	$22.26
Long-term Liabilities	8.26	8.26
Total Liabilities	28.98	30.52
Stockholders' Equity	12.88	14.98
Total Liabilities and Stockholders' Equity	41.86	45.50

Additional information:

- Sight and Sound Superstore's effective tax rate for 2010 was 26.3%. The industry average effective tax rate was 26.8%.

- During 2010, Sight and Sound Superstore engaged in an innovative tax transaction that reduced the firm's effective tax rate from 26.8% in 2009 to 26.3% in 2010. This transaction is captured in the tax reserve liability (unrecognized tax benefit). This transaction's legitimacy is pending before the IRS, and it is uncertain whether the position will be sustained upon IRS audit.

- The tax planning for Sight and Sound Superstore is relatively straightforward, involving uncomplicated tax positions and strategies.

- Sight and Sound Superstore has engaged Livingston, LLP, as the tax preparer. Livingston, LLP, is a Big 4 public accounting firm. Sight and Sound Superstore has engaged Livingston, LLP, to also serve as the external auditor.

Q5: How aggressive do you believe the tax position taken by the company is?

O	O	O	O	O	O	O
1 Extremely unaggressive	2	3	4 Neutral	5	6	7 Extremely aggressive

Q6: How complex do you believe the company's tax planning is?

O	O	O	O	O	O	O
1 Not complex at all	2	3	4 Somewhat complex	5	6	7 Extremely complex

Q7: Which of the following best describes Sight and Sound Superstore?

A. Sight and Sound Superstore is a small, privately owned company, operating a handful of bookstores.

B. Sight and Sound Superstore is a large, publicly traded company, operating many bookstores.

C. The information is not provided in the case.

Q8: Which of the following is true regarding the tax preparer engaged by Sight and Sound Superstore? Remember: You **may** look back over the case materials to determine the correct answer.

A. Sight and Sound Superstore has engaged Livingston, LLP, a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

B. Sight and Sound Superstore has engaged Livingston, LLP, a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged SAIB, LLP, to provide audit services.

C. Sight and Sound Superstore has engaged Livingston, LLP, which is **NOT** a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

D. Sight and Sound Superstore has engaged Livingston, LLP, which is **NOT** a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged SAIB, LLP, to provide audit services.

INSTRUCTIONS

- After reviewing the background information provided above for Bradley's Books and Sight and Sound Superstore, please answer the following questions by providing an answer that best indicates your judgment. You <u>may</u> refer back to the case materials in answering the questions.

- After you have answered a question, please <u>do not</u> go back and change your response.

Q9: Please allocate a $10,000 investment between Bradley's Books and Sight and Sound Superstore in the space provided. <u>Please confirm that your total equals $10,000</u>.

Amount allocated to Bradley's Books: ______________________________

Amount allocated to Sight and Sound Superstore: ______________________

Q10: What is the single most important factor you considered in support of your investment allocation?

Q11: If the tax preparer had an effect on your investment decision, please rank the following factors by the importance each played in your decision for which company you prefer.

A. Client-specific competence
B. General competence
C. Independence
D. Other factors ___________________

1.

2.

3.

4.

If you would like to provide a justification for your decisions, please feel free to do so in the space provided below.

Q12: Please indicate on the scale below how attractive you believe Bradley's Books is as a potential investment.

O	O	O	O	O	O	O
1 Not at all attractive	2	3	4 Neutral	5	6	7 Very Attractive

Q13: Please indicate on the scale below how attractive you believe Sight and Sound Superstore is as a potential investment.

O	O	O	O	O	O	O
1 Not at all attractive	2	3	4 Neutral	5	6	7 Very Attractive

When done, please return the completed materials to Envelope #1, and open Envelope #2.

INSTRUCTIONS

- Please answer the following questions by circling the letter or checking the circle that corresponds to your personal judgment.
- Please answer the questions in the order presented, and please do not read ahead.
- After you have answered a question, please do not go back and change your response.

As a reminder:

- Both Bradley's Books' and Sight and Sound Superstore had an effective tax rate of 26.3% for 2010. The industry average effective tax rate was 26.8%.
- Both Bradley's Books and Sight and Sound Superstore engaged in an innovative tax transaction which reduced the firm's effective tax rates from 2009 to 2010. The transaction was captured in the tax reserve liability (unrecognized tax benefit). The transaction's legitimacy is pending before the IRS, and it is uncertain whether the position will be sustained upon IRS audit.
- The tax planning for both Bradley's Books and Sight and Sound Superstore is relatively straightforward, involving uncomplicated tax positions and strategies.
- Bradley's Books engaged Crandall Hedge, LLP, a Big 4 public accounting firm, to provide tax services. Bradley's Books engaged Burton & Olde, LLP, also a Big 4 public accounting firm, to serve as the external auditor.
- Sight and Sound Superstore engaged Livingston, LLP, a Big 4 public accounting firm to provide both tax and audit services.

Q1: Which of the two tax preparers is more competent in your judgment?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally competent	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q2: Which of the two preparers is more likely to have additional knowledge of the factors involved in general tax preparation?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers have equal general tax knowledge	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q3: Which of the two preparers is more likely to have additional knowledge of client-specific factors involved in tax preparation?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers have equal client-specific tax knowledge	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q4: Which of the two preparers is more likely to have additional client-specific resources available for tax preparation?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers have equal resources available	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q5: Which of the two preparers is more independent?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally independent	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q6: Which of the two preparers is less biased in tax preparation and reporting?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally biased or unbiased	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q7: Which of the two preparers is less likely to be truthful in their tax planning, preparation, and reporting?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally truthful	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q8: Which of the two preparers is more credible?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally credible	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q9: Which firm is more qualified to serve as the tax preparer for its respective client?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally qualified	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q10: The cost associated with a loss of reputation due to performing the tax planning and preparation work poorly is higher for…

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 Neither. The cost is the same for both preparers	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q11: Bradley's Books' management is credible.

O	O	O	O	O	O	O
1 Completely Disagree	2	3	4 Neutral	5	6	7 Completely Agree

Q12: Sight and Sound Superstore's management is credible.

O	O	O	O	O	O	O
1 Completely Disagree	2	3	4 Neutral	5	6	7 Completely Agree

Q13: How risky do you believe the tax position taken by Bradley's Books is?

O	O	O	O	O	O	O
1 Not risky at all	2	3	4 Neutral	5	6	7 Extremely risky

Q14: If you perceive the tax position is risky, to what factor do you attribute the risk?

Q15: How risky do you believe the tax position taken by Sight and Sound Superstore is?

O	O	O	O	O	O	O
1 Not risky at all	2	3	4 Neutral	5	6	7 Extremely risky

Q16: If you perceive the tax position is risky, to what factor do you attribute the risk?

Please answer the following questions according to your general opinion (not specifically related to the case provided).

Q17: In general, are you relatively more concerned about the independence of the tax preparer or the competence of the tax preparer?

O	O	O	O	O	O	O
1 Independence	2	3	4 Equally concerned regarding both	5	6	7 Competence

Q18: When the same accounting firm is providing both audit and tax services, are you more concerned about the independence of the tax preparer or the competence of the tax preparer?

O	O	O	O	O	O	O
1 Independence	2	3	4 Equally concerned regarding both	5	6	7 Competence

Q19: When comparing two firms, one which has engaged a single accounting firm to jointly provide both tax and audit services and one which has engaged two separate accounting firms to provide tax and audit services, does your relative concern for independence or competence change? In other words, how would you complete the following sentences:

When one firm provides both tax and audit services, I am ______________________ than when separate firms provide tax and audit services.

A. More concerned about independence
B. Less concerned about independence
C. No more or less concerned about independence

When one firm provides both tax and audit services, I am ______________________ than when separate firms provide tax and audit services.

A. More concerned about competence
B. Less concerned about competence
C. No more or less concerned about competence

Q20: In general, the cost associated with a loss of reputation due to performing the tax planning and preparation work poorly is…

O	O	O	O	O	O	O
1 Higher for the auditor tax preparer	2	3	4 The same for both entities	5	6	7 Higher for the non-auditor tax preparer

Q21: To what extent do you believe the joint provision of tax and audit services by an auditor impairs auditor independence?

O	O	O	O	O	O	O
1 Auditor independence is not impaired	2	3	4 Neutral	5	6	7 Auditor independence is severely impaired

Q22: To what extent do you believe the joint provision of tax and audit services by an auditor affects the quality of a firm's tax services?

O	O	O	O	O	O	O
1 Tax quality is much lower	2	3	4 No effect on tax quality	5	6	7 Tax quality is much higher

Q23: To what extent do you believe the joint provision of tax and audit services by an auditor affects financial reporting quality?

O	O	O	O	O	O	O
1 Financial reporting quality is much lower	2	3	4 No effect on financial reporting quality	5	6	7 Financial reporting quality is much higher

Q24: To what extent do you believe the joint provision of tax and audit services by an auditor affects audit quality?

O	O	O	O	O	O	O
1 Audit quality is much lower	2	3	4 No effect on audit quality	5	6	7 Audit quality is much higher

Q25: How important do you consider tax policy to be when evaluating a potential investment *in general*?

O	O	O	O	O	O	O
1 Not important at all	2	3	4 Neutral	5	6	7 Extremely important

Q26: Do you think your thoughts about a firm engaging one accounting firm to provide both tax and audit services would be different if you were a current shareholder rather than a potential shareholder? Please explain.

Q27: What is your current profession?

Q28: How many years' experience do you have in your current position?

A. Less than 1 year

B. 1 year to less than 3 years

C. 3 years to less than 5 years

D. More than 5 years

Q29: How much experience do you have as a tax professional (answer in years or months of tax experience)?

____

Q30: Do you have personal experience buying or selling an individual company's common stock or debt securities (not through a mutual or pension fund?)

A. Yes

B. No

Q31. Do you intend to invest in an individual company's common stock or debt securities in the next five years?

A. Yes

B. No

Q32: How familiar are you with FIN 48 and/or Unrecognized Tax Benefits?

O	O	O	O	O	O	O
1 Very unfamiliar	2	3	4 Somewhat familiar	5	6	7 Very familiar

Q33: Do you think the reserve for Unrecognized Tax Benefit is a signal of earnings management?

O	O	O	O	O	O	O
1 Absolutely not	2	3	4 Unsure	5	6	7 Absolutely

Q34: In which graduate program are you currently enrolled? ______________________

YOU ARE FINISHED.

THANK YOU FOR YOUR PARTICIPATION.

PLEASE PLACE THESE COMPLETED MATERIALS IN ENVELOPE #2, AND RETURN ALL ENVELOPES TO THE RESEARCHER.

LOW AGGRESSIVENESS, HIGH COMPLEXITY CONDITION

BACKGROUND INFORMATION

As a potential investor, you have obtained the following background information from the 2010 annual reports of *Bradley's Books* and *Sight and Sound Superstore*. Additional information has been provided for your consideration as well. Please review both sets of information before answering the case questions.

Bradley's Books

Business and Products

Bradley's Books, a publicly traded, Fortune 500 company (BDB), operates book and music superstores. At December 31, 2010, Bradley's Books operated 350 superstores in the United States. In addition, Bradley's Books operates a proprietary e-commerce Web site, www.BradleysBooks.com, which was launched in 2007.

Bradley's Books' business strategy is designed to address the most significant opportunities and challenges facing the Company. In particular, challenges include commoditization in primary product categories, an extremely competitive marketplace (including both store-based and online competitors), the seasonal nature of sales as a retailer, and product formats that are evolving from physical to digital formats.

Significant Accounting Policies

In accordance with U.S. Generally Accepted Accounting Principles (GAAP), revenue is recognized when earned. In preparing financial statements in conformity with GAAP, the Company is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

Income Statement (all figures in millions)

Fiscal Year ending December 31

	AUDITED 2009	2010
Revenue	$51.00	$61.00
Cost of Sales	25.40	30.50
Gross Profit	25.60	30.50
Lease Expense	4.90	5.80
Selling, General & Administrative Expense	12.50	14.80
Earnings Before Income Taxes	8.20	9.90
Income Tax Expense	2.20	2.64
Net Income	$6.00	$7.26

Balance Sheet (all figures in millions)

Fiscal Year ending December 31

	AUDITED 2009	2010
Assets		
Current Assets	$17.2	$19.6
Property, Plant, and Equipment	8.2	8.1
Intangible Assets	2.4	2.4
Other Assets	2.1	2.4
Total Assets	29.9	32.5
Liabilities		
Current Liabilities	$14.8	$15.9
Long-term Liabilities	5.9	5.9
Total Liabilities	20.7	21.8
Stockholders' Equity	9.2	10.7
Total Liabilities and Stockholders' Equity	29.9	32.5

Additional information:

- Bradley's Books' effective tax rate for 2010 was 26.7%. The industry average effective tax rate was 26.8%.

- During 2010, Bradley's Books engaged in an innovative tax transaction that reduced the firm's effective tax rate from 26.8% in 2009 to 26.7% in 2010. This transaction is captured in the tax reserve liability (unrecognized tax benefit). It is highly likely that if Bradley's Books were to be audited by the IRS, the position would be allowed. The transaction does not increase the risk of audit.

- Some of the tax planning for Bradley's Books involved complex tax positions and strategies, which required careful structuring and an in-depth understanding of relevant, interacting factors from the financial statements and tax records.

- Bradley's Books has engaged Crandall Hedge, LLP, as the tax preparer. Crandall Hedge, LLP, will only provide tax services to Bradley's Books. Crandall Hedge, LLP, is a Big 4 public accounting firm.

- Bradley's Books has engaged Burton & Olde, LLP, also a Big 4 public accounting firm, to serve as the external auditor.

Please answer the following questions by marking the circle that corresponds to your judgment. Feel free to refer back to the case materials in order to answer the questions.

Q1: How aggressive do you believe the tax position taken by the company is?

O	O	O	O	O	O	O
1 Extremely unaggressive	2	3	4 Neutral	5	6	7 Extremely aggressive

Q2: How complex do you believe the company's tax planning is?

O	O	O	O	O	O	O
1 Not complex at all	2	3	4 Somewhat complex	5	6	7 Extremely complex

Q3: Which of the following best describes Bradley's Books?

A. Bradley's Books is a small, privately owned company, operating a handful of bookstores.

B. Bradley's Books is a large, publicly traded company, operating many bookstores.

C. The information is not provided in the case.

Q4: Which of the following is true regarding the tax preparer engaged by Bradley's Books? Remember: You **may** look back over the case materials to determine the correct answer.

A. Bradley's Books has engaged Crandall Hedge, LLP, a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

B. Bradley's Books has engaged Crandall Hedge, LLP, a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged Burton & Olde, LLP, to provide audit services.

C. Bradley's Books has engaged Crandall Hedge, LLP, which is **NOT** a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

D. Bradley's Books has engaged Crandall Hedge, LLP, which is **NOT** a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged Burton & Olde, LLP, to provide audit services.

Sight and Sound Superstore

Business and Products

Sight and Sound Superstore, a publicly traded, Fortune 500 company (SSS), operates book and music superstores. At December 31, 2010, Sight and Sound Superstore operated 350 superstores in the United States. In addition, Sight and Sound Superstore operates a proprietary e-commerce Web site, www.SandSSuperstore.com, which was launched in 2007.

Sight and Sound Superstore' business strategy is designed to address the most significant opportunities and challenges facing the Company. In particular, challenges include commoditization in primary product categories, an extremely competitive marketplace (including both store-based and online competitors), the seasonal nature of sales as a retailer, and product formats that are evolving from physical to digital formats.

Significant Accounting Policies

In accordance with U.S. Generally Accepted Accounting Principles (GAAP), revenue is recognized when earned. In preparing financial statements in conformity with GAAP, the Company is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

Income Statement (all figures in millions)

Fiscal Year ending December 31

	AUDITED	
	2009	**2010**
Revenue	$71.40	$85.40
Cost of Sales	35.56	42.70
Gross Profit	35.84	42.70
Lease Expense	6.86	8.12
Selling, General & Administrative Expense	17.50	20.72
Earnings Before Income Taxes	11.48	13.86
Income Tax Expense	3.08	3.70
Net Income	$8.40	$10.16

Balance Sheet (all figures in millions)

Fiscal Year ending December 31

	AUDITED	
	2009	**2010**
Assets		
Current Assets	$ 24.08	$27.44
Property, Plant, and Equipment	11.48	11.34
Intangible Assets	3.36	3.36
Other Assets	2.94	3.36
Total Assets	41.86	45.50
Liabilities		
Current Liabilities	$20.72	$22.26
Long-term Liabilities	8.26	8.26
Total Liabilities	28.98	30.52
Stockholders' Equity	12.88	14.98
Total Liabilities and Stockholders' Equity	41.86	45.50

Additional information:

- Sight and Sound Superstore's effective tax rate for 2010 was 26.7%. The industry average effective tax rate was 26.8%.

- During 2010, Sight and Sound Superstore engaged in an innovative tax transaction that reduced the firm's effective tax rate from 26.8% in 2009 to 26.7% in 2010. This transaction is captured in the tax reserve liability (unrecognized tax benefit). It is highly likely that if Sight and Sound Superstore were to be audited by the IRS, the position would be allowed. The transaction does not increase the risk of audit.

- Some of the tax planning for Sight and Sound Superstore involved complex tax positions and strategies, which required careful structuring and an in-depth understanding of relevant, interacting factors from the financial statements and tax records.

- Sight and Sound Superstore has engaged Livingston, LLP, as the tax preparer. Livingston, LLP, is a Big 4 public accounting firm. Sight and Sound Superstore has engaged Livingston, LLP, to also serve as the external auditor.

Q5: How aggressive do you believe the tax position taken by the company is?

O	O	O	O	O	O	O
1 Extremely unaggressive	2	3	4 Neutral	5	6	7 Extremely aggressive

Q6: How complex do you believe the company's tax planning is?

O	O	O	O	O	O	O
1 Not complex at all	2	3	4 Somewhat complex	5	6	7 Extremely complex

Q7: Which of the following best describes Sight and Sound Superstore?

A. Sight and Sound Superstore is a small, privately owned company, operating a handful of bookstores.

B. Sight and Sound Superstore is a large, publicly traded company, operating many bookstores.

C. The information is not provided in the case.

Q8: Which of the following is true regarding the tax preparer engaged by Sight and Sound Superstore? Remember: You **may** look back over the case materials to determine the correct answer.

A. Sight and Sound Superstore has engaged Livingston, LLP, a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

B. Sight and Sound Superstore has engaged Livingston, LLP, a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged SAIB, LLP, to provide audit services.

C. Sight and Sound Superstore has engaged Livingston, LLP, which is **NOT** a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

D. Sight and Sound Superstore has engaged Livingston, LLP, which is **NOT** a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged SAIB, LLP, to provide audit services.

INSTRUCTIONS

- After reviewing the background information provided above for Bradley's Books and Sight and Sound Superstore, please answer the following questions by providing an answer that best indicates your judgment. You <u>may</u> refer back to the case materials in answering the questions.

- After you have answered a question, please <u>do not</u> go back and change your response.

Q9: Please allocate a $10,000 investment between Bradley's Books and Sight and Sound Superstore in the space provided. <u>Please confirm that your total equals</u> <u>$10,000</u>.

Amount allocated to Bradley's Books: ______________________________

Amount allocated to Sight and Sound Superstore: ______________________

Q10: What is the single most important factor you considered in support of your investment allocation?

Q11: If the tax preparer had an effect on your investment decision, please rank the following factors by the importance each played in your decision for which company you prefer.

A. Client-specific competence
B. General competence
C. Independence
D. Other factors ___________________

1.

2.

3.

4.

If you would like to provide a justification for your decisions, please feel free to do so in the space provided below.

Q12: Please indicate on the scale below how attractive you believe Bradley's Books is as a potential investment.

O	O	O	O	O	O	O
1 Not at all attractive	2	3	4 Neutral	5	6	7 Very Attractive

Q13: Please indicate on the scale below how attractive you believe Sight and Sound Superstore is as a potential investment.

O	O	O	O	O	O	O
1 Not at all attractive	2	3	4 Neutral	5	6	7 Very Attractive

When done, please return the completed materials to Envelope #1, and open Envelope #2.

INSTRUCTIONS

- Please answer the following questions by <u>circling the letter or checking the circle</u> that corresponds to your personal judgment.
- Please answer the questions in the order presented, and please <u>do not</u> read ahead.
- After you have answered a question, please <u>do not</u> go back and change your response.

As a reminder:

- Both Bradley's Books' and Sight and Sound Superstore had an effective tax rate of 26.7% for 2010. The industry average effective tax rate was 26.8%.
- Both Bradley's Books and Sight and Sound Superstore engaged in an innovative tax transaction which reduced the firm's effective tax rates from 2009 to 2010. The transaction was captured in the tax reserve liability (unrecognized tax benefit). It is highly likely that if Bradley's Books or Sight and Sound Superstore were to be audited by the IRS, the position would be allowed. The transaction does not increase the risk of audit.
- Some of the tax planning for Bradley's Books and Sight and Sound Superstore involved complex tax positions and strategies, which required careful structuring and an in-depth understanding of relevant, interacting factors from the financial statements and tax records.
- Bradley's Books engaged Crandall Hedge, LLP, a Big 4 public accounting firm, to provide tax services. Bradley's Books engaged Burton & Olde, LLP, also a Big 4 public accounting firm, to serve as the external auditor.
- Sight and Sound Superstore engaged Livingston, LLP, a Big 4 public accounting firm to provide both tax and audit services.

Q1: Which of the two tax preparers is more competent in your judgment?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally competent	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q2: Which of the two preparers is more likely to have additional knowledge of the factors involved in general tax preparation?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers have equal general tax knowledge	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q3: Which of the two preparers is more likely to have additional knowledge of <u>client-specific</u> factors involved in tax preparation?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers have equal client-specific tax knowledge	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q4: Which of the two preparers is more likely to have additional client-specific resources available for tax preparation?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers have equal resources available	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q5: Which of the two preparers is more independent?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally independent	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q6: Which of the two preparers is less biased in tax preparation and reporting?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally biased or unbiased	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q7: Which of the two preparers is less likely to be truthful in their tax planning, preparation, and reporting?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally truthful	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q8: Which of the two preparers is more credible?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally credible	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q9: Which firm is more qualified to serve as the tax preparer for its respective client?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally qualified	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q10: The cost associated with a loss of reputation due to performing the tax planning and preparation work poorly is higher for…

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 Neither. The cost is the same for both preparers	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q11: Bradley's Books' management is credible.

O	O	O	O	O	O	O
1 Completely Disagree	2	3	4 Neutral	5	6	7 Completely Agree

Q12: Sight and Sound Superstore's management is credible.

O	O	O	O	O	O	O
1 Completely Disagree	2	3	4 Neutral	5	6	7 Completely Agree

Q13: How risky do you believe the tax position taken by Bradley's Books is?

O	O	O	O	O	O	O
1 Not risky at all	2	3	4 Neutral	5	6	7 Extremely risky

Q14: If you perceive the tax position is risky, to what factor do you attribute the risk?

Q15: How risky do you believe the tax position taken by Sight and Sound Superstore is?

O	O	O	O	O	O	O
1 Not risky at all	2	3	4 Neutral	5	6	7 Extremely risky

Q16: If you perceive the tax position is risky, to what factor do you attribute the risk?

Please answer the following questions according to your general opinion (not specifically related to the case provided).

Q17: In general, are you relatively more concerned about the independence of the tax preparer or the competence of the tax preparer?

O	O	O	O	O	O	O
1 Independence	2	3	4 Equally concerned regarding both	5	6	7 Competence

Q18: When the same accounting firm is providing both audit and tax services, are you more concerned about the independence of the tax preparer or the competence of the tax preparer?

O	O	O	O	O	O	O
1 Independence	2	3	4 Equally concerned regarding both	5	6	7 Competence

Q19: When comparing two firms, one which has engaged a single accounting firm to jointly provide both tax and audit services and one which has engaged two separate accounting firms to provide tax and audit services, does your relative concern for independence or competence change? In other words, how would you complete the following sentences:

When one firm provides both tax and audit services, I am _____________________ than when separate firms provide tax and audit services.

A. More concerned about independence
B. Less concerned about independence
C. No more or less concerned about independence

When one firm provides both tax and audit services, I am _____________________ than when separate firms provide tax and audit services.

A. More concerned about competence
B. Less concerned about competence
C. No more or less concerned about competence

Q20: In general, the cost associated with a loss of reputation due to performing the tax planning and preparation work poorly is…

O	O	O	O	O	O	O
1 Higher for the auditor tax preparer	2	3	4 The same for both entities	5	6	7 Higher for the non-auditor tax preparer

Q21: To what extent do you believe the joint provision of tax and audit services by an auditor impairs auditor independence?

O	O	O	O	O	O	O
1 Auditor independence is not impaired	2	3	4 Neutral	5	6	7 Auditor independence is severely impaired

Q22: To what extent do you believe the joint provision of tax and audit services by an auditor affects the quality of a firm's tax services?

O	O	O	O	O	O	O
1 Tax quality is much lower	2	3	4 No effect on tax quality	5	6	7 Tax quality is much higher

Q23: To what extent do you believe the joint provision of tax and audit services by an auditor affects financial reporting quality?

O	O	O	O	O	O	O
1 Financial reporting quality is much lower	2	3	4 No effect on financial reporting quality	5	6	7 Financial reporting quality is much higher

Q24: To what extent do you believe the joint provision of tax and audit services by an auditor affects audit quality?

O	O	O	O	O	O	O
1 Audit quality is much lower	2	3	4 No effect on audit quality	5	6	7 Audit quality is much higher

Q25: How important do you consider tax policy to be when evaluating a potential investment *in general*?

O	O	O	O	O	O	O
1 Not important at all	2	3	4 Neutral	5	6	7 Extremely important

Q26: Do you think your thoughts about a firm engaging one accounting firm to provide both tax and audit services would be different if you were a current shareholder rather than a potential shareholder? Please explain.

Q27: What is your current profession?

Q28: How many years' experience do you have in your current position?

A. Less than 1 year

B. 1 year to less than 3 years

C. 3 years to less than 5 years

D. More than 5 years

Q29: How much experience do you have as a tax professional (answer in years or months of tax experience)?

____

Q30: Do you have personal experience buying or selling an individual company's common stock or debt securities (not through a mutual or pension fund?)

A. Yes

B. No

Q31. Do you intend to invest in an individual company's common stock or debt securities in the next five years?

A. Yes

B. No

Q32: How familiar are you with FIN 48 and/or Unrecognized Tax Benefits?

O	O	O	O	O	O	O
1 Very unfamiliar	2	3	4 Somewhat familiar	5	6	7 Very familiar

Q33: Do you think the reserve for Unrecognized Tax Benefit is a signal of earnings management?

O	O	O	O	O	O	O
1 Absolutely not	2	3	4 Unsure	5	6	7 Absolutely

Q34: In which graduate program are you currently enrolled? ________________________

YOU ARE FINISHED.

THANK YOU FOR YOUR PARTICIPATION.

PLEASE PLACE THESE COMPLETED MATERIALS IN ENVELOPE #2, AND

RETURN ALL ENVELOPES TO THE RESEARCHER.

LOW AGGRESSIVENESS, LOW COMPLEXITY CONDITION

BACKGROUND INFORMATION

As a potential investor, you have obtained the following background information from the 2010 annual reports of *Bradley's Books* and *Sight and Sound Superstore*. Additional information has been provided for your consideration as well. Please review both sets of information before answering the case questions.

Bradley's Books

Business and Products

Bradley's Books, a publicly traded, Fortune 500 company (BDB), operates book and music superstores. At December 31, 2010, Bradley's Books operated 350 superstores in the United States. In addition, Bradley's Books operates a proprietary e-commerce Web site, www.BradleysBooks.com, which was launched in 2007.

Bradley's Books' business strategy is designed to address the most significant opportunities and challenges facing the Company. In particular, challenges include commoditization in primary product categories, an extremely competitive marketplace (including both store-based and online competitors), the seasonal nature of sales as a retailer, and product formats that are evolving from physical to digital formats.

Significant Accounting Policies

In accordance with U.S. Generally Accepted Accounting Principles (GAAP), revenue is recognized when earned. In preparing financial statements in conformity with GAAP, the Company is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

Income Statement (all figures in millions)

Fiscal Year ending December 31

	AUDITED	
	2009	**2010**
Revenue	$51.00	$61.00
Cost of Sales	25.40	30.50
Gross Profit	25.60	30.50
Lease Expense	4.90	5.80
Selling, General & Administrative Expense	12.50	14.80
Earnings Before Income Taxes	8.20	9.90
Income Tax Expense	2.20	2.64
Net Income	$6.00	$7.26

Balance Sheet (all figures in millions)

Fiscal Year ending December 31

	AUDITED	
	2009	**2010**
Assets		
Current Assets	$17.2	$19.6
Property, Plant, and Equipment	8.2	8.1
Intangible Assets	2.4	2.4
Other Assets	2.1	2.4
Total Assets	29.9	32.5
Liabilities		
Current Liabilities	$14.8	$15.9
Long-term Liabilities	5.9	5.9
Total Liabilities	20.7	21.8
Stockholders' Equity	9.2	10.7
Total Liabilities and Stockholders' Equity	29.9	32.5

Additional information:

- Bradley's Books' effective tax rate for 2010 was 26.7%. The industry average effective tax rate was 26.8%.

- During 2010, Bradley's Books engaged in an innovative tax transaction that reduced the firm's effective tax rate from 26.8% in 2009 to 26.7% in 2010. This transaction is captured in the tax reserve liability (unrecognized tax benefit). It is highly likely that if Bradley's Books were to be audited by the IRS, the position would be allowed. The transaction does not increase the risk of audit.

- The tax planning for Bradley's Books is relatively straightforward, involving uncomplicated tax positions and strategies.

- Bradley's Books has engaged Crandall Hedge, LLP, as the tax preparer. Crandall Hedge, LLP, will only provide tax services to Bradley's Books. Crandall Hedge, LLP, is a Big 4 public accounting firm.

- Bradley's Books has engaged Burton & Olde, LLP, also a Big 4 public accounting firm, to serve as the external auditor.

Please answer the following questions by marking the circle that corresponds to your judgment. Feel free to refer back to the case materials in order to answer the questions.

Q1: How aggressive do you believe the tax position taken by the company is?

O	O	O	O	O	O	O
1 Extremely unaggressive	2	3	4 Neutral	5	6	7 Extremely aggressive

Q2: How complex do you believe the company's tax planning is?

O	O	O	O	O	O	O
1 Not complex at all	2	3	4 Somewhat complex	5	6	7 Extremely complex

Q3: Which of the following best describes Bradley's Books?

A. Bradley's Books is a small, privately owned company, operating a handful of bookstores.

B. Bradley's Books is a large, publicly traded company, operating many bookstores.

C. The information is not provided in the case.

Q4: Which of the following is true regarding the tax preparer engaged by Bradley's Books? Remember: You **may** look back over the case materials to determine the correct answer.

A. Bradley's Books has engaged Crandall Hedge, LLP, a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

B. Bradley's Books has engaged Crandall Hedge, LLP, a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged Burton & Olde, LLP, to provide audit services.

C. Bradley's Books has engaged Crandall Hedge, LLP, which is **NOT** a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

D. Bradley's Books has engaged Crandall Hedge, LLP, which is **NOT** a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged Burton & Olde, LLP, to provide audit services.

Sight and Sound Superstore

Business and Products

Sight and Sound Superstore, a publicly traded, Fortune 500 company (SSS), operates book and music superstores. At December 31, 2010, Sight and Sound Superstore operated 350 superstores in the United States. In addition, Sight and Sound Superstore operates a proprietary e-commerce Web site, www.SandSSuperstore.com, which was launched in 2007.

Sight and Sound Superstore' business strategy is designed to address the most significant opportunities and challenges facing the Company. In particular, challenges include commoditization in primary product categories, an extremely competitive marketplace (including both store-based and online competitors), the seasonal nature of sales as a retailer, and product formats that are evolving from physical to digital formats.

Significant Accounting Policies

In accordance with U.S. Generally Accepted Accounting Principles (GAAP), revenue is recognized when earned. In preparing financial statements in conformity with GAAP, the Company is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the reporting period. Actual results could differ from those estimates.

Income Statement (all figures in millions)

Fiscal Year ending December 31

	AUDITED	
	2009	**2010**
Revenue	$71.40	$85.40
Cost of Sales	35.56	42.70
Gross Profit	35.84	42.70
Lease Expense	6.86	8.12
Selling, General & Administrative Expense	17.50	20.72
Earnings Before Income Taxes	11.48	13.86
Income Tax Expense	3.08	3.70
Net Income	$8.40	$10.16

Balance Sheet (all figures in millions)

Fiscal Year ending December 31

	AUDITED	
	2009	**2010**
Assets		
Current Assets	$ 24.08	$27.44
Property, Plant, and Equipment	11.48	11.34
Intangible Assets	3.36	3.36
Other Assets	2.94	3.36
Total Assets	41.86	45.50
Liabilities		
Current Liabilities	$20.72	$22.26
Long-term Liabilities	8.26	8.26
Total Liabilities	28.98	30.52
Stockholders' Equity	12.88	14.98
Total Liabilities and Stockholders' Equity	41.86	45.50

Additional information:

- Sight and Sound Superstore's effective tax rate for 2010 was 26.7%. The industry average effective tax rate was 26.8%.

- During 2010, Sight and Sound Superstore engaged in an innovative tax transaction that reduced the firm's effective tax rate from 26.8% in 2009 to 26.7% in 2010. This transaction is captured in the tax reserve liability (unrecognized tax benefit). It is highly likely that if Sight and Sound Superstore were to be audited by the IRS, the position would be allowed. The transaction does not increase the risk of audit.

- The tax planning for Sight and Sound Superstore is relatively straightforward, involving uncomplicated tax positions and strategies.

- Sight and Sound Superstore has engaged Livingston, LLP, as the tax preparer. Livingston, LLP, is a Big 4 public accounting firm. Sight and Sound Superstore has engaged Livingston, LLP, to also serve as the external auditor.

Q5: How aggressive do you believe the tax position taken by the company is?

O	O	O	O	O	O	O
1 Extremely unaggressive	2	3	4 Neutral	5	6	7 Extremely aggressive

Q6: How complex do you believe the company's tax planning is?

O	O	O	O	O	O	O
1 Not complex at all	2	3	4 Somewhat complex	5	6	7 Extremely complex

Q7: Which of the following best describes Sight and Sound Superstore?

A. Sight and Sound Superstore is a small, privately owned company, operating a handful of bookstores.

B. Sight and Sound Superstore is a large, publicly traded company, operating many bookstores.

C. The information is not provided in the case.

Q8: Which of the following is true regarding the tax preparer engaged by Sight and Sound Superstore? Remember: You **may** look back over the case materials to determine the correct answer.

A. Sight and Sound Superstore has engaged Livingston, LLP, a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

B. Sight and Sound Superstore has engaged Livingston, LLP, a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged SAIB, LLP, to provide audit services.

C. Sight and Sound Superstore has engaged Livingston, LLP, which is **NOT** a Big 4 public accounting firm, to provide **BOTH** tax and audit services.

D. Sight and Sound Superstore has engaged Livingston, LLP, which is **NOT** a Big 4 public accounting firm, to provide **ONLY** tax services and has engaged SAIB, LLP, to provide audit services.

INSTRUCTIONS

- After reviewing the background information provided above for Bradley's Books and Sight and Sound Superstore, please answer the following questions by providing an answer that best indicates your judgment. You <u>may</u> refer back to the case materials in answering the questions.

- After you have answered a question, please <u>do not</u> go back and change your response.

Q9: Please allocate a $10,000 investment between Bradley's Books and Sight and Sound Superstore in the space provided. <u>Please confirm that your total equals $10,000</u>.

Amount allocated to Bradley's Books: ______________________________

Amount allocated to Sight and Sound Superstore: ______________________

Q10: What is the single most important factor you considered in support of your investment allocation?

Q11: If the tax preparer had an effect on your investment decision, please rank the following factors by the importance each played in your decision for which company you prefer.

A. Client-specific competence
B. General competence
C. Independence
D. Other factors ___________________

1.

2.

3.

4.

If you would like to provide a justification for your decisions, please feel free to do so in the space provided below.

Q12: Please indicate on the scale below how attractive you believe Bradley's Books is as a potential investment.

O	O	O	O	O	O	O
1 Not at all attractive	2	3	4 Neutral	5	6	7 Very Attractive

Q13: Please indicate on the scale below how attractive you believe Sight and Sound Superstore is as a potential investment.

O	O	O	O	O	O	O
1 Not at all attractive	2	3	4 Neutral	5	6	7 Very Attractive

When done, please return the completed materials to Envelope #1, and open Envelope #2.

INSTRUCTIONS

- Please answer the following questions by circling the letter or checking the circle that corresponds to your personal judgment.
- Please answer the questions in the order presented, and please do not read ahead.
- After you have answered a question, please do not go back and change your response.

As a reminder:

- Both Bradley's Books' and Sight and Sound Superstore had an effective tax rate of 26.7% for 2010. The industry average effective tax rate was 26.8%.
- Both Bradley's Books and Sight and Sound Superstore engaged in an innovative tax transaction which reduced the firm's effective tax rates from 2009 to 2010. The transaction was captured in the tax reserve liability (unrecognized tax benefit). It is highly likely that if Bradley's Books or Sight and Sound Superstore were to be audited by the IRS, the position would be allowed. The transaction does not increase the risk of audit.
- The tax planning for both Bradley's Books and Sight and Sound Superstore is relatively straightforward, involving uncomplicated tax positions and strategies.
- Bradley's Books engaged Crandall Hedge, LLP, a Big 4 public accounting firm, to provide tax services. Bradley's Books engaged Burton & Olde, LLP, also a Big 4 public accounting firm, to serve as the external auditor.
- Sight and Sound Superstore engaged Livingston, LLP, a Big 4 public accounting firm to provide both tax and audit services.

Q1: Which of the two tax preparers is more competent in your judgment?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally competent	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q2: Which of the two preparers is more likely to have additional knowledge of the factors involved in general tax preparation?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers have equal general tax knowledge	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q3: Which of the two preparers is more likely to have additional knowledge of <u>client-specific</u> factors involved in tax preparation?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers have equal client-specific tax knowledge	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q4: Which of the two preparers is more likely to have additional client-specific resources available for tax preparation?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers have equal resources available	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q5: Which of the two preparers is more independent?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally independent	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q6: Which of the two preparers is less biased in tax preparation and reporting?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally biased or unbiased	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q7: Which of the two preparers is less likely to be truthful in their tax planning, preparation, and reporting?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally truthful	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q8: Which of the two preparers is more credible?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally credible	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q9: Which firm is more qualified to serve as the tax preparer for its respective client?

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 The two preparers are equally qualified	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q10: The cost associated with a loss of reputation due to performing the tax planning and preparation work poorly is higher for…

O	O	O	O	O	O	O
1 Crandall Hedge, LLP (Bradley's Books' preparer)	2	3	4 Neither. The cost is the same for both preparers	5	6	7 Livingston, LLP (Sight & Sound's preparer)

Q11: Bradley's Books' management is credible.

O	O	O	O	O	O	O
1 Completely Disagree	2	3	4 Neutral	5	6	7 Completely Agree

Q12: Sight and Sound Superstore's management is credible.

O	O	O	O	O	O	O
1 Completely Disagree	2	3	4 Neutral	5	6	7 Completely Agree

Q13: How risky do you believe the tax position taken by Bradley's Books is?

O	O	O	O	O	O	O
1 Not risky at all	2	3	4 Neutral	5	6	7 Extremely risky

Q14: If you perceive the tax position is risky, to what factor do you attribute the risk?

Q15: How risky do you believe the tax position taken by Sight and Sound Superstore is?

O	O	O	O	O	O	O
1 Not risky at all	2	3	4 Neutral	5	6	7 Extremely risky

Q16: If you perceive the tax position is risky, to what factor do you attribute the risk?

Please answer the following questions according to your general opinion (not specifically related to the case provided).

Q17: In general, are you relatively more concerned about the independence of the tax preparer or the competence of the tax preparer?

O	O	O	O	O	O	O
1 Independence	2	3	4 Equally concerned regarding both	5	6	7 Competence

Q18: When the same accounting firm is providing both audit and tax services, are you more concerned about the independence of the tax preparer or the competence of the tax preparer?

O	O	O	O	O	O	O
1 Independence	2	3	4 Equally concerned regarding both	5	6	7 Competence

Q19: When comparing two firms, one which has engaged a single accounting firm to jointly provide both tax and audit services and one which has engaged two separate accounting firms to provide tax and audit services, does your relative concern for independence or competence change? In other words, how would you complete the following sentences:

When one firm provides both tax and audit services, I am ______________________ than when separate firms provide tax and audit services.

A. More concerned about independence
B. Less concerned about independence
C. No more or less concerned about independence

When one firm provides both tax and audit services, I am ______________________ than when separate firms provide tax and audit services.

A. More concerned about competence
B. Less concerned about competence
C. No more or less concerned about competence

Q20: In general, the cost associated with a loss of reputation due to performing the tax planning and preparation work poorly is…

O	O	O	O	O	O	O
1 Higher for the auditor tax preparer	2	3	4 The same for both entities	5	6	7 Higher for the non-auditor tax preparer

Q21: To what extent do you believe the joint provision of tax and audit services by an auditor impairs auditor independence?

O	O	O	O	O	O	O
1 Auditor independence is not impaired	2	3	4 Neutral	5	6	7 Auditor independence is severely impaired

Q22: To what extent do you believe the joint provision of tax and audit services by an auditor affects the quality of a firm's tax services?

O	O	O	O	O	O	O
1 Tax quality is much lower	2	3	4 No effect on tax quality	5	6	7 Tax quality is much higher

Q23: To what extent do you believe the joint provision of tax and audit services by an auditor affects financial reporting quality?

O	O	O	O	O	O	O
1 Financial reporting quality is much lower	2	3	4 No effect on financial reporting quality	5	6	7 Financial reporting quality is much higher

Q24: To what extent do you believe the joint provision of tax and audit services by an auditor affects audit quality?

O	O	O	O	O	O	O
1 Audit quality is much lower	2	3	4 No effect on audit quality	5	6	7 Audit quality is much higher

Q25: How important do you consider tax policy to be when evaluating a potential investment *in general*?

O	O	O	O	O	O	O
1 Not important at all	2	3	4 Neutral	5	6	7 Extremely important

Q26: Do you think your thoughts about a firm engaging one accounting firm to provide both tax and audit services would be different if you were a current shareholder rather than a potential shareholder? Please explain.

Q27: What is your current profession?

Q28: How many years' experience do you have in your current position?

A. Less than 1 year

B. 1 year to less than 3 years

C. 3 years to less than 5 years

D. More than 5 years

Q29: How much experience do you have as a tax professional (answer in years or months of tax experience)?

____

Q30: Do you have personal experience buying or selling an individual company's common stock or debt securities (not through a mutual or pension fund?)

A. Yes

B. No

Q31. Do you intend to invest in an individual company's common stock or debt securities in the next five years?

A. Yes

B. No

Q32: How familiar are you with FIN 48 and/or Unrecognized Tax Benefits?

O	O	O	O	O	O	O
1 Very unfamiliar	2	3	4 Somewhat familiar	5	6	7 Very familiar

Q33: Do you think the reserve for Unrecognized Tax Benefit is a signal of earnings management?

O	O	O	O	O	O	O
1 Absolutely not	2	3	4 Unsure	5	6	7 Absolutely

Q34: In which graduate program are you currently enrolled? ______________________

YOU ARE FINISHED.

THANK YOU FOR YOUR PARTICIPATION.

PLEASE PLACE THESE COMPLETED MATERIALS IN ENVELOPE #2, AND RETURN ALL ENVELOPES TO THE RESEARCHER.