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Introduction

Following the introduction of Aksjeloven § 7-6, having an auditor became voluntary for smaller listed companies with revenues below 5 million NOK, total assets below 20 million NOK and number of employees below 10. However, there are certain exceptions, such as apothecaries, attorney firms, parent companies in a group, and when the company is put under surveillance by Finanstilsynet or when auditing is mandated by tax authorities.

This law was imposed in an effort to reduce cost and complexity for smaller listed firms, in line with similar laws imposed in the European Union. Langli (2009) argues that there are fewer users of accounting data for smaller companies and thus, the cost of producing them outweigh the positives. In these smaller companies, the owners usually tend to take part in everyday business as managers, hence external reporting quality is less important than for larger companies with external shareholders. Still, for creditors, information asymmetry is an issue, making quality external reporting important. Therefore, we expect our report to be relevant to this group of stakeholders and to relevant legislation authorities.

Since the introduction of voluntary auditing, several research papers have been written, examining various effects of this new law in Norway, such as Langli, (2015) However, we find no papers written specifically about the effects on earnings management and tax aggressiveness. We hence believe that this gap in existing literature requires further research. In general, the fields of tax aggressiveness and earnings management in particular have been extensively researched and building on this literature adds robustness and reliability to our research paper.

In this preliminary thesis we are going to look closer at the existing literature on the different topics we are going to research as well as explain more thoroughly our contemplated method for how we are going to measure this.

Literature Review

In 2011, there was a law change in Norway that allowed small firms to choose not to be audited. Prior to 2011, all Norwegian firms were required to be audited. In our master thesis we seek to investigate differences in earnings management and tax aggressiveness between firms that use in-house accounting experts and out-of-house accounting experts before and after this legislation. We assume that there are two central differences between the two categories which is 1) motivation and 2) skill/quality.

Motivation impact on earnings management has been researched by Burgstahler and Dichev (1997) and management's communications are more likely to be biased when they are not verified by a third party (Schwartz and Young, 2002). Further, year-end financial audit work by external auditors appears to play a role in moderating earnings management by minimizing managers' opportunities to manage earnings in the fourth quarter (Brown and Pinello, 2007).

There have also been research focusing on the difference in objectivity between internal and external accounting experts. Internal accountants are considered to be less objective than external due to less independence to the firm, and lack of independence affects the auditor's advocacy towards financial reporting (Ahlawat and Lowe 2004). We hence believe that motivation can be a strong indicating factor to determine the difference between in-house accounting experts and out-of-house accounting experts.

Norwegian firms who chose to continue to be audited after the law change in 2011 had a higher compliance quality than firms who did not get audited (Downing and Langli 2017). However, mandatory audits do not necessarily mean high quality, since companies with demands for high-quality audit are believed to be able to find an auditor who meets these requirements even under a mandatory regime (Vanstraelen and Schelleman 2017). It is therefore important to differentiate between auditors and accountants when doing research on related topics.

Extensive research has been done comparing audited firms with non-audited firms. Firms who chose to be audited has been compared to those who chose not to, to see if non-audited firms had higher financing costs (Langli and Che 2016). Similar research has also been done to see if non-audited firms had lower revenue growth and/or weaker development in operating profit (Langli 2016). Both these articles concluded with that difference in these factors is not explained by the company's choice not to be audited. However, higher compliance quality was found in firms who chose to continue to be audited after 2011 even though they were not required to do so (Downing and Langli 2017).

We are going to compare firms with in-house accounting experts with firms with out-of-house accounting experts based on two components; earnings management and tax aggressiveness. There is already a lot of existing literature on both of these topics, especially earnings management. Earnings management is using accounting techniques to give an overly positive view of the company's position and can be measured by accounting irregularities and abnormal accruals (Badolato et al. 2014). Discretionary revenues have also been proposed as a measure of earnings management and have even been argued to be less biased than the more commonly used accrual models (Stubben 2010).

Since earnings management aims to provide financial information that gives an overly positive view of the company's financial position, it is also a good indicator for the company's accounting quality. More earnings management means that the company is trying to make its financial information look more positive than what it actually is, indicating poorer accounting quality. Whether a company chooses to be audited can have an impact on the company's accounting quality and there have been studies done that compare accounting quality with whether or not a company has been audited (Langli 2015). It is the accountants job to discover discrepancies and flaws in a company's financial information and it stands to reason that being audited would hence increase the company's accounting quality. Hence, choosing not to be audited could increase the risk for discrepancies and flaws in the company's financial information. However, it is dangerous to draw such a conclusion as there are other factors impacting the results like size of inventory, size of accounts receivables and how much debt the company holds (Langli 2015).

Moreover, there has been a proven connection between the use of big accounting firms, the “Big 6” effect, and lower abnormal accruals (Kim et al. 2003). However, even though Big 6 auditors are more effective in detecting earnings management this is only the case when the managers have incentives to prefer income increasing accruals. In fact, when both managers and auditors have incentives to prefer income decreasing accruals, Big 6 auditors have been proven less effective than non-Big 6 auditors (Kim et al. 2003). Even so, the effect of Big 4/Big 6 auditor companies is on average assumed to provide better accounting quality than non-Big 4/Big 6 auditor companies (Becker et al. 1998). Moreover, there is a lot of literature that shows that Big 4/Big 6 is an important factor in determining accrual quality (e.g. Becker et al. 1998); Reynolds and Francis 2000). This is due to the “Big” auditor companies having more resources and expertise which increases the effectivity of conducting the audit and limiting the manager’s manipulative reporting behavior (Hope et al. 2013). Hence, it is clear that the effect of using “Big” auditing companies is a factor we need to account for when measuring earnings management.

Another factor that impacts a firm's degree of earnings management that has been discussed in relevant literature is size. Size has been shown to be positively correlated with accrual quality (Hribar and Nichols 2007). Smaller firms have been excluded from previous experiments as firm size has been shown to be an important determinant of financial reporting quality (Hope et al. 2013). Even though this is an important determinant of accounting quality, in our thesis we are going to look at smaller firms that are below and right above the threshold for having the option to choose not to be audited after Norwegian law (Aksjeloven § 7-6). Since we hence are going to focus on smaller firms, focusing on bigger companies is redundantly not an option for us.

Furthermore, there have been evidence that private firms have lower financial reporting quality than public firms (Ball and Shivakumar 2005). This has been proven to be true both in the UK (Ball and Shivakumar 2005) and in the US (Hope et al. 2013). However, it has been argued that research focusing on public companies may not be generalizable to private companies as these differ from public companies in several different dimensions such as more concentrated ownership and poorer access to information (Langli and Svanström 2014). Moreover, Norwegian firms who opted-out after 2011 have been found to, on average, have lower account system quality before opting-out and that this quality declines further after the companies opted-out (Downing and Langli 2015). There has hence been some literature similar to our research question and we will take their research design and results into consideration when writing our thesis.

As for research design, the most commonly used model is the Jones model (Jones 1991). This model has however been modified to create a more accurate performance adjusted model (Kothari et al. 2005). Modifying the Jones model is a necessity to increase the relevance and accuracy of the model and to adapt it to the relevant research question. This is also what we aim to do in our thesis as well as using an adjusted Jones model (Dechow and Dichev 2002). The model specified by Kothari et al. (2005) and the modification of the model in Dechow and Dichev (2002) is two of the most popular methods used in similar literature.

Taxation is a complex, ambiguous and large area of law. Even for our study, where tax planning through tax havens are expected to be virtually non-existent due to firm size, how to book transactions in tax books are often left to individual judgement. Hence, well-meaning tax employees may arrive at different conclusions.

Tax aggressiveness and tax avoidance seems to be used interchangeably in literature, hence we adopt the following definition: Tax avoidance is defined by Guenther et al (2013) as adopting tax policies that reduce the firm's income tax payments, while tax aggressiveness is the extent to which a firm takes a tax position that is unlikely to survive a challenge by tax authorities.

A study by Blaylock et al. (2015) examines the relationship between book/tax conformity and earnings management, discovering that higher levels of earnings management lead to greater differences in book/tax numbers. Further, conforming would likely lead to less earnings management, but would also leave managers with less discretion, potentially harming the reflection of underlying economic reality. Hence, we can expect the relationship between earnings management and unrecognized tax benefits to be positive in that greater upwards earnings management leads to greater unrecognized tax benefits.

Taxation policy and compliance is an ever-growing field of research. According to Klassen et al. (2015), failing to comply to tax laws are one of the most likely reasons to get a hearing in the boardroom. Hence, the importance of tax specialists is increasing - be it internal experts or external audit. Drawing on the research we conduct on earnings management, we similarly investigate whether there are differences between external and internal tax employees in tax aggressiveness. The findings from Klassen et al. (2015) are that 1) internal tax departments are more tax aggressive than auditors and 2) external non-auditor prepared tax books are more aggressive than when it is prepared by external auditors. Further, they find no significant difference between internal and external non-audit tax aggressiveness, indicating that auditors command a unique position. Hence, we do not feel the need to distinguish between external and internal tax preparers when conducting our study on tax aggressiveness.

A Finnish study done by Ojala et al. (2015) also have several similarities to us. They examine the direct and indirect effect of having a voluntary audit on tax aggressiveness. Following the definition of tax aggressiveness above, the independent variable is the likelihood of tax authorities adjusting the reported income statement, where more frequent adjusting is a signal of earnings management. Further, the study captures several parameters as ingredients to the likelihood of drawing negative attention from tax authorities. While this is a direct and sound proxy, we are uncertain whether we would be able to collect the necessary data for this and would need to further consult our supervisor.

On tax aggressiveness in general, several articles have been written on different determining factors. Chen et al. (2010) looks at ownership and how it relates to tax aggressiveness, discovering that family firms are less tax aggressive than private firms. Dyreng et al. (2010) examines the role of the CEO in tax aggressiveness, while Armstrong et al. (2012) examines the role of tax directors. Tax aggressiveness is also affected by the motivation and skill of the auditor, according to Balakrishnan et al. (2012). Kanagaretnam et al. (2016) further investigates the impact from auditor quality on tax aggressiveness. These findings are likely to be transferable to our study, assuming that auditors are of higher quality than internal tax experts.

Dhaliwal et al (2013) examines how tax planning and compliance is related to tax fees for firms that use their auditor for tax preparation. However, this study does not examine the difference in internal tax preparer and external audit, as both our study and Klassen et al. (2015) do.

Langli and Saudagaran (2004) investigate taxable income differences between foreign and domestically controlled corporations in Norway. However, as mentioned, our study is focused on smaller, unlisted companies. Moreover, Langli (2015) investigate whether opt out firms experience an increase in *tax avoidance*, with the expected relationship being that without an auditor to control, there will be an increase.

Due to the similarities in research design and hypotheses, we expect to use the same pooled Tobit regression as Klassen et al. (2015), using the logarithm of current-year unrecognized tax benefit (UTB) as our dependent variable, following Lisowsky et al. (2013) claims that it is a reliable proxy for tax aggressiveness.

However, there are some differences between our studies, other than specific firm size thresholds and geographic representation. First, while Klassen et al. (2015) examines the dual role of audit and tax preparer, we only look at internal tax preparer versus external audit. Second, ours is a difference-in-difference research post - and pre-2011 research across the two tax preparer groups. Third, in order to adjust for a possible endogeneity, we add robustness to our test by comparing our sample group to neighboring companies just above the set thresholds.

A proxy of tax avoidance is the effective tax rate (ETR) and cash effective tax rate (CETR) used in Chen et al. (2010), Dyreng et al. (2008) and Chyz et al. (2013). However, as these use foreign tax rates in relation to regional tax rates, they are far more relevant to the large, international corporations and are thus rendered irrelevant to our study.

Our Contribution

By carefully reviewing existing literature on earnings management, tax aggressiveness and the difference between in-house and out-of-house accounting experts, it is clear that there has already been committed a lot of research on these topics. However, we found no evidence that a study comparing companies using in-house accounting experts to companies using out-of-house accounting experts with regards to earnings management and tax aggressiveness has been done in Norway.

Previous literature has compared companies that choose to be audited to those who choose not to, with regards to tax aggressiveness. Nevertheless, we found no such study done in Norway. Langli (2016) compared Norwegian companies that opted out after the 2011 legislation with those who chose the continuances of auditing even though they did not have to. However, this article did not specifically compare tax aggressiveness and earnings management of said companies. To the best of our knowledge, no studies have been done on tax aggressiveness related to tax preparer in Norway and no study have been conducted comparing the difference in tax aggressiveness before and after the voluntary audit legislation of 2011 came in to effect.

Research Question and Hypotheses

Research Question:

Are firms with in-house accounting experts more involved with earnings management and more tax aggressive than firms with out-of-house accounting experts?

Higher (lower) degree of earnings management and tax aggressiveness is a reflection of lower (higher) earnings quality, hence it is a measure of how well financial reporting reflect underlying economic reality. Thus, figuring out if there is a shift in these two parameters for the opt-out firms compared to the audited firms, shows the tendency to misrepresent the underlying economic reality of a firm. If such evidence is found, it can be of relevance to creditors (and less relevant; external owners) with a stake or potential stake in unaudited companies. Further, it provides relevant insight for accounting authorities as feedback to their newly implemented legislation.

As auditors are expected to uncover and prevent accounting errors, the absence of an auditor is expected to lead to an increase in accounting error. Hence, we expect accounting quality to be lower for opt-out firms and formulate the first hypothesis.

Hypothesis 1:

Firms with in-house accounting experts are on average more involved with earnings management than firms that use out-of-house accounting experts.

Following this argument, we expect it to also hold for tax aggressiveness, as shown in Klassen (2015) and form the hypothesis below. Where audit and tax preparer are the same, they are more sensitive to having tax positions overturned by authorities due to reputation being an important factor.

Hypothesis 2:

Firms with in-house accounting experts are on average more tax aggressive than firms that use out-of-house accounting experts.

Data Collection

Methodology:

Our research design will be a difference-in-difference design. We will examine the difference in our two parameters before and after the company elected or did not elect to use of an external accounting expert.

Cross-sectional analysis is the most relevant analysis form as there will be individual differences as to when companies were formed (and liquidated) and when they (if they did at all) choose to outsource accounting, rendering time-series analysis difficult at best. Difference-in-difference and multiple regressions are not ground-breaking techniques by any means, it is tried and tested, which ads solidity to our paper.

We expect to use a performance-adjusted Jones Model, similar to Kothari et. al. (2005) and an adjusted model of Dechow and Dichev (2002), both similar to Hope (2013), as these are the most popular models for evaluating accrual quality in modern literature.

Several models for tax aggressiveness focus on tax planning through the use of tax havens. We expect this to be less relevant for small, Norwegian companies and are more interested in book/tax difference that arise due to earnings management. For tax aggressiveness, we expect to use the model used in papers such as Lisowsky et al (2013) and Klassen (2015). Klassen (2015) investigate numbers put forward by internal accountants in relation to accounting numbers put forward by external audits and test for difference in tax aggressiveness, making it a very comparable study to ours.

We expect to use data from 2006 to 2015. This period is chosen as 2006 is the first year SKD have available data regarding internal/external accountants, while our supervisor, Langli, have some data available only throughout 2015.

In addition to the threshold values mentioned in the introduction, we have chosen to go slightly beyond them for two reasons 1) The thresholds are increasing. In 2017, the threshold for revenue is 6 million instead of 5 million and we need to figure out how to treat this. 2) we might want to look at neighboring companies to test for endogeneity, similar to Langli (2015).

Hence, we have chosen the following thresholds:

- 100 000 - 7 500 000 revenue
- 100 000 - 25 000 000 total assets
- Excluding parent companies in a group
- Excluding those with mandatory auditing imposed by Finanstilsynet
- Excluding companies that have put forward accounting numbers for less than two years

Centre for Corporate Governance Research (CCGR)

We expect to find most of the data we need, particularly for earnings management, from CCGR.

Skattedirektoratet (SKD)

Our supervisor, already possess the indicator variables needed for our research and we have, together with him, applied for variables regarding:

- Which tasks have been performed by external/internal accountants
- Whether auditing is voluntary or not

Brønnøysundsregisteret (BBGR)

If the answer on our application to SKD is negative, we will need to apply to BBGR. To be prepared for a worst-case scenario, we have already enquired about price to BBGR in order to be best prepared.

Thesis progression plan

We expect to be done with collecting and reading up on existing literature by the end of February. As you can see by our bibliography, we have a lot of existing relevant literature and expect to find more. We have read a few of them from start to finish, but will need to do a lot more research in order to become experts. In this time, we will write down findings, dependent variables, independent variables, control variables etc. from existing literature in an Excel-sheet, so that it will be easy to use for our thesis. We need this information to write abstract, introduction, literature review and start with methodology/hypothesis and data.

When we can start to analyze the data is naturally contingent on when we receive them. Langli has expressed some urgency to Skattedirektoratet in our application, in an effort to shorten this time. Since we have plans to read up on theory throughout February, we will not start analysis before march anyways. Should the numbers arrive later, we will spend even more time preparing for them.

If the numbers do arrive in March, we expect that this month will be used for data analysis in Stata, creating a do-file with a number of different robustness test after the initial testing of our two hypotheses.

If all goes as we hope, and we get the numbers by March, we hope to continue writing the report by moving on to results, robustness-tests and further analysis in April.

May will then be the time to write conclusion and apply the finishing touch to our thesis. We hope to be done some time in June, but if the data arrives later than we hope, we expect that we will have to push completion date to sometime in July/August, though that is certainly sub-optimal.

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