Study Shows IRS Audits Increase Business Compliance

By Frank L. Brunetti on November 5th, 2012

Companies that are fearful of audits tend to be more compliant with federal tax law and financially responsible, a new survey reveals.

New research appearing in the American Accounting Association's journal, Accounting Review, found that a decline in the Internal Revenue Service's business auditing correlates with less federal taxes being paid to the government. In addition, corporations that run a higher risk of being audited may be more likely to report more accurate information in public financial statements, which could be a positive sign for shareholders.

"The idea that shareholders benefit from having their companies audited by the IRS may seem strange to some investors," said Jeffrey Hoopes of the University of Michigan, who co-authored both studies. "Our research, however, suggests that strict tax enforcement promotes good financial reporting and tends to check managers' proclivities to divert corporate resources for their personal use under the guise of saving taxes."

According to the research of 5,000 businesses whose previous financial and tax records were analyzed over a 17-year span, those companies' effective tax rates increased by an average of two percentage points when the likelihood of being audited doubled. In addition, companies may have put more effort into ensuring all financial paperwork, valuations and investment portfolio information were accurate prior to filing their returns.

Hoopes also noted that as the IRS continues to focus on companies and their tax reporting strategies to close the widening tax gap, companies may become more diligent about complying with tax law, and avoiding the types of practices that can trigger a costly and extensive audit. This is especially the case following the tax agency's most recent and ongoing probes into offshore tax havens and popular business tax loopholes.