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# The importance of the internal information environment for tax avoidance <sup>☆</sup>, <sup>☆</sup> <sup>☆</sup>

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## ABSTRACT

We show that firms' ability to avoid taxes is affected by the quality of their internal information environment, with lower effective tax rates (ETRs) for firms that have high internal information quality. The effect of internal information quality on tax avoidance is stronger for firms in which information is likely to play a more important role. For example, firms with greater coordination needs because of a dispersed geographical presence benefit more from high internal information quality. Similarly, firms operating in a more uncertain environment benefit more from the quality of their internal information in helping them to reduce ETRs. In addition, we provide evidence that high internal information quality allows firms to achieve lower ETRs without increasing the risk of their tax strategies (as measured by ETR volatility). Overall, our study contributes to the literature on tax avoidance by providing evidence that the internal information environment of the firm is important for understanding its tax avoidance outcomes.

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## 1. Introduction

In this paper, we argue that in order to understand firms' tax avoidance outcomes it is necessary to consider the role the quality of a firm's internal information environment plays in supporting such outcomes. We define internal information quality (hereafter IIQ) in terms of the accessibility, usefulness, reliability, accuracy, quantity, and signal-to-noise ratio of the data and knowledge collected, generated, and consumed within an organization. Decision theory has established that the quality of the information on which decisions are based affects the quality of those decisions and their outcomes. Hence, the firm's ability to avoid taxes is likely to be affected by the quality of the information on which tax planning decisions are based. Without good information, tax-reducing opportunities might be overlooked, coordination of tax planning across the

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different parts of the firm might be difficult, tax risk might be high, and the firm's documentation might not be acceptable to the tax authorities. However, the internal information environment has been largely ignored in the tax avoidance literature.

Anecdotal evidence indeed suggests that internal information quality may play an important role in a firm's tax avoidance outcomes. For example, Bayer Group predicted that it would take several years to sort through the documentation problems with the IRS related to R&D tax credits dating back to 1998, because the company's accounting system could not readily provide the required information (McKinnon, 2012). Additionally, although globally coordinated transfer pricing schemes can allow multinational firms to avoid a substantial amount of taxes, a recent survey indicated that only 41 percent of multinationals prepared transfer pricing documentation concurrently on a globally coordinated basis. The other 59 percent prepared documentation either for a single country (modified to the needs of other jurisdictions as appropriate), on an as-necessary country-by-country basis with limited coordination between countries, or not at all (Ernst and Young, 2010). Decision theory and these examples suggest that firms with higher IIQ might be better able to identify and implement tax-reducing strategies. We empirically examine this hypothesis in our study.

We use four publicly available proxies of a firm's IIQ to examine the effect of IIQ on tax avoidance over the period 1994–2010: the speed with which management releases an earnings announcement after its fiscal year closing, the accuracy of management's earnings forecasts, the absence of Sarbanes-Oxley (SOX) Section 404 material weaknesses in internal controls, and the absence of restatements due to errors. With these IIQ proxies, and using the cash effective tax rate (*Cash ETR*) as the measure of tax avoidance, which we define as the reduction of explicit taxes according to Hanlon and Heitzman (2010), we find a statistically significant positive association between IIQ and tax avoidance.<sup>1</sup> Specifically, we find that a one-standard-deviation increase in the continuous IIQ proxies (earnings announcement speed and management forecast accuracy) is associated with a *Cash ETR* reduction of 1–2 percentage points, and that the absence of a restatement due to errors (Section 404 material weakness) is associated with a *Cash ETR* reduction of approximately 2 (5) percentage points. These findings are consistent with the notion that IIQ is an economically important determinant of tax avoidance.

We then investigate cross-sectional differences in the effect of IIQ on tax avoidance that help explain the mechanisms through which IIQ affects tax avoidance. First, we predict—and find—that IIQ is more important in firms with more geographically dispersed operations and hence greater coordination needs. A higher IIQ reduces information asymmetry and improves information coordination between the various business units, allowing for more effective tax planning. Second, we predict—and find—that firms operating in more uncertain environments benefit more from a higher IIQ. For these firms, IIQ can help identify tax opportunities, reduce doubts about the payoffs of particular tax planning strategies, and help with forecasting over a wide range of potential tax outcomes.

Finally, we examine the effect of IIQ on tax risk, which we define as the firm's uncertainty regarding its tax liability. We expect that high-IIQ firms are able to pursue more favorable tax avoidance outcomes without taking more risk, because a better IIQ can support improved and sustained tax planning and documentation, which in turn can reduce the likelihood that particular tax strategies will be disallowed. Firms with lower tax risk are likely to experience less volatility in tax outcomes. Thus, we use the standard deviation of *Cash ETR* over five years as a measure of tax risk (Guenther et al., 2012). We document that *ETR* volatility is substantially lower in high-IIQ environments, consistent with a higher IIQ leading to lower tax risk.

Our results suggest that high-IIQ firms achieve both increased tax avoidance and decreased tax risk. This finding sheds light on the difficulty of conceptually defining tax aggressiveness (Hanlon and Heitzman, 2010). Referring to the model by Mills et al. (2010), both Frischmann et al. (2008) and Rego and Wilson (2012) define aggressive tax reporting as pursuing significant tax strategies with *relatively weak supporting facts*. Hence, the aggressiveness of a firm's tax position is a function of its IIQ. Our findings indicate that when a firm has high-quality information to support its tax planning strategies, it is not taking on more risk or behaving more aggressively when reducing its *ETR*.

Of course, it is likely that certain characteristics of the firm, such as the presence of foreign operations, are associated with both a higher IIQ and greater tax avoidance opportunities. Furthermore, both IIQ and tax avoidance are choices of the firm, suggesting that endogeneity is a concern. We conduct a battery of additional tests that we believe mitigate concerns about our results being partly attributable to correlated omitted variables and endogeneity. First, we use an extensive set of control variables and industry fixed effects in our analyses. Second, our inferences are unaffected if we employ first-difference, firm fixed-effect, and lead-lag specifications. Third, our findings hold in two analyses that exploit the shock to firms' IIQ caused by the Sarbanes-Oxley Act of 2002. Finally, we show that our results are robust to employing a five-year *ETR* specification and additional control variables.

Our study aims to shed light on the role of an important aspect of the inner workings of a firm in tax avoidance outcomes, which is of interest to academics and non-academics alike. We document that IIQ is related to the ability to engage in tax avoidance, and we provide evidence that IIQ plays a stronger role in tax avoidance for firms with greater coordination needs and uncertainty. Finally, we find support for the hypothesis that a high IIQ allows firms to engage in

<sup>1</sup> We employ *Cash ETR* as our primary proxy for tax avoidance in order to capture the effect of IIQ on the reduction of explicit taxes. Prior research has suggested that managers value both cash flows and book earnings when making tax planning decisions (Graham et al., 2011). While our main analyses use the firm's *Cash ETR* as the empirical proxy for tax avoidance, we document in Section 6 that our findings are robust to employing the firm's book effective tax rate (*GAAP ETR*). We list particular tax strategies that the firm is able to carry out because of high IIQ in Appendix A. Ideally, we would like to empirically document the link between IIQ and such tax strategies but this is extremely difficult. Firms generally do not report specific tax avoidance strategies publicly (Lenter et al., 2003).

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