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The Impact of Financial Reporting Transparency and Internal Control Quality on Corporate Tax Avoidance: Evidence from Firms Listed on the Tehran Stock Exchange

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Abstract:

Purpose: *This study examines the influence of financial reporting transparency and the quality of internal controls on corporate tax avoidance within the context of the Tehran Stock Exchange (TSE). Tax avoidance is a significant strategic decision for firms, influenced by both the external information environment and internal governance structures.*

Design/Methodology/Approach: *The research utilizes a quantitative approach, analyzing a balanced panel of 130 non-financial firms listed on the TSE over a six-year period from 2018 to 2023. Corporate tax avoidance is measured using the Effective Tax Rate (ETR), where a lower ETR signifies higher avoidance. Financial reporting transparency is operationalized through disclosure quality scores, and internal control quality is assessed based on the presence of reported material weaknesses. The study employs Ordinary Least Squares (OLS) regression to test the research hypotheses, controlling for firm size, leverage, and profitability.*

Findings: *The empirical results indicate a significant positive relationship between financial reporting transparency and the effective tax rate, suggesting that more transparent firms engage in less aggressive tax avoidance. Furthermore, higher internal control quality is found to significantly reduce the level of tax avoidance. These results support the view that robust internal and external monitoring mechanisms act as constraints on aggressive tax planning strategies.*

Practical Implications: *The findings provide critical insights for the Iranian National Tax Administration (INTA) and the Securities and Exchange Organization (SEO). They suggest that improving reporting standards and strengthening internal control requirements can lead to higher tax compliance and more sustainable corporate financial behavior.*

Keywords: *Tax Avoidance, Effective Tax Rate (ETR), Financial Reporting Transparency, Internal Control Quality, Tehran Stock Exchange (TSE).*

I. Introduction

1.1. Background of the Study

In the realm of corporate finance and accounting, taxes represent a significant cash outflow that reduces the earnings available to shareholders. Consequently, corporate managers often seek ways to minimize tax liabilities through tax avoidance—a range of legal activities designed to reduce a firm's tax burden. However, tax avoidance is a complex phenomenon; while it can increase after-tax cash flows, it can also lead to significant agency costs, reputational damage, and increased scrutiny from regulatory bodies.

Agency theory suggests that tax avoidance can provide a shield for managerial opportunism. When a firm's information environment is opaque, managers may use complex tax transactions to extract private benefits or mask poor performance (Desai & Dharmapala, 2006). This brings the concepts of **Financial Reporting Transparency** and **Internal Control Quality** to the forefront of the debate. Transparency refers to the widespread availability of relevant, reliable information about the periodic performance, financial position, and investment opportunities of a firm. High transparency reduces information asymmetry between managers and outside stakeholders, theoretically limiting the ability of managers to engage in aggressive tax-saving schemes that might destroy long-term firm value.

Similarly, internal controls serve as the internal backbone of a firm's governance structure. A high-quality internal control system ensures the accuracy of financial reporting and compliance with laws and regulations. When internal controls are weak, the risk of misreporting increases, and the oversight necessary to monitor complex tax planning becomes insufficient. Therefore, the strength of a firm's internal control environment is expected to play a decisive role in determining the extent and nature of its tax avoidance activities.

1.2. Statement of the Problem

The Tehran Stock Exchange (TSE) provides a unique and compelling setting to study these relationships. Iran's tax system and regulatory environment for listed companies have undergone significant changes, yet tax compliance remains a major challenge for the government. Many Iranian firms operate in an environment characterized by high economic volatility and evolving accounting standards, which can impact both reporting transparency and the rigor of internal control implementation.

The primary problem this study addresses is the lack of empirical evidence regarding how external transparency and internal oversight interact to influence tax behavior in an emerging market like Iran. Existing literature in developed economies offers mixed results, and it is unclear whether these findings can be generalized to the TSE. For instance, does increased transparency actually lead to lower tax avoidance in a market where ownership is often concentrated, or do other institutional factors dominate? Furthermore, while the impact of internal control weaknesses on financial reporting quality is well-documented, its specific link to tax avoidance in the Iranian context remains under-researched.

A lack of clarity on these issues hinders the ability of tax authorities to identify high-risk firms and prevents investors from accurately assessing the risks associated with a company's tax planning strategies. This study seeks to fill this gap by providing a comprehensive analysis of how reporting quality and internal governance influence corporate tax avoidance among TSE-listed firms.

1.3. Research Questions

To address the research problem, the following questions are formulated:

1. What is the impact of financial reporting transparency on corporate tax avoidance in firms listed on the Tehran Stock Exchange?
2. What is the impact of internal control quality on corporate tax avoidance in firms listed on the Tehran Stock Exchange?

1.4. Research Objectives

The specific objectives of this research are:

1. To empirically measure the relationship between financial reporting transparency and the effective tax rate of TSE-listed firms.
2. To investigate how the quality of internal control systems affects the level of tax avoidance in these firms.
3. To provide empirical evidence that can assist Iranian tax regulators and stock market authorities in developing policies to enhance tax compliance and reporting standards.

1.5. Significance of the Study

This research is significant for several reasons:

- **For Tax Authorities:** It identifies firm-level characteristics (transparency and control quality) that are associated with higher tax compliance, helping the Iranian National Tax Administration to better target its auditing resources.
- **For Regulators (SEO):** The study highlights the importance of mandating high disclosure standards and robust internal controls not just for reporting accuracy, but as a tool for broader corporate accountability.

- **For Investors:** It provides a framework for assessing the potential "hidden" risks of tax avoidance by looking at a firm's transparency and governance signals.
- **For Academic Literature:** This study adds to the growing body of international research on tax avoidance by providing evidence from a non-Western, bank-based emerging economy with a unique tax environment.

1.6. Structure of the Article

This article is organized into several sections. Following this introduction, the second section provides a comprehensive review of the theoretical foundations and empirical literature, leading to the development of the research hypotheses. The third section describes the research methodology, including the variable measurements and model specification. The fourth section presents the results of the OLS regression and data analysis. Finally, the fifth section concludes the paper with a discussion of the findings, implications, and suggestions for future research.

II. Literature Review and Hypothesis Development

2.1. Theoretical Framework

The study of corporate tax avoidance is primarily anchored in **Agency Theory** and **Information Asymmetry**. From an agency perspective, tax avoidance is not merely a wealth transfer from the state to shareholders; it can also be a tool for managerial opportunism. Desai and Dharmapala (2006) argue that the complex and opaque nature of tax avoidance activities can provide a "shield" for managers to divert corporate resources for personal gain. When a firm lacks transparency, it becomes difficult for shareholders to distinguish between legitimate tax planning and activities that primarily serve the interests of management.

Signaling Theory also plays a vital role in this context. Firms with high-quality financial reporting and robust internal controls signal to the market and regulators that they operate with high integrity and low risk. Conversely, aggressive tax avoidance might signal to tax authorities that the firm's reporting is unreliable, potentially triggering costly audits and penalties. Therefore, firms must balance the marginal benefits of tax savings against the marginal costs of increased scrutiny and potential agency conflicts.

2.2. Empirical Literature Review

2.2.1. Financial Reporting Transparency and Tax Avoidance

Financial reporting transparency is defined as the availability of firm-specific information to those outside the firm. A transparent information environment reduces the "masking" effect, making it harder for managers to hide aggressive tax positions within complex financial statements.

Recent empirical evidence suggests that transparency acts as a monitoring mechanism. For instance, Hope et al. (2013) found that firms with higher disclosure requirements tend to have higher effective tax rates (lower avoidance), suggesting that transparency curbs aggressive tax planning. In emerging markets, where legal protections for minority shareholders are often weaker, the role of transparency becomes even more critical. Balakrishnan et al. (2014) noted that firms engaging in aggressive tax avoidance often experience a decrease in financial transparency, creating a feedback loop of opacity.

2.2.2. Internal Control Quality and Tax Avoidance

Internal control quality refers to the effectiveness of the policies and procedures established by a firm to ensure the reliability of financial reporting and compliance with laws. Under the COSO framework, a strong internal control environment is essential for managing risk, including tax-related risks.

Empirical studies have shown that firms with **Internal Control Weaknesses (ICW)** are more likely to have inaccurate tax accounts and engage in poorly managed tax strategies. Bauer (2016) found that firms with higher quality internal controls have more predictable tax outcomes and are less likely to engage in "extreme" tax avoidance that could lead to future restatements or penalties. On the Tehran Stock Exchange, where the implementation of internal control reporting is relatively recent, the relationship between these controls and tax strategy is a burgeoning area of interest.

2.3. Hypothesis Development

Based on the theoretical and empirical review, we can now formulate the research hypotheses.

In a transparent environment, the costs of engaging in aggressive tax avoidance increase because such activities are more likely to be detected by auditors, analysts, and tax authorities. Furthermore, transparency reduces the ability of managers to use tax complexity as a cover for agency-related rent diversion. Therefore, we expect that as transparency increases, the aggressiveness of tax avoidance will decrease (meaning the Effective Tax Rate will be higher).

- **H_1:** There is a significant positive relationship between financial reporting transparency and the effective tax rate (ETR).
- **H_{01}:** There is no significant relationship between financial reporting transparency and the effective tax rate.

Regarding internal controls, a high-quality system provides the oversight necessary to ensure that tax planning remains within legal and strategic bounds. It prevents unauthorized or overly risky tax positions that could arise from a lack of internal coordination or oversight. Consequently, firms with robust internal controls should exhibit more conservative and compliant tax behavior.

- **H_2:** There is a significant positive relationship between internal control quality and the effective tax rate (ETR).
- **H_{02}:** There is no significant relationship between internal control quality and the effective tax rate.

III. Research Methodology

3.1. Research Design

This research follows a descriptive-correlational design using an applied approach. To test the hypotheses, the study utilizes a balanced panel data set, which allows for the analysis of both cross-sectional differences between firms and time-series changes over the six-year period from 2018 to 2023. This longitudinal approach is essential for controlling firm-specific characteristics that remain constant over time.

3.2. Population and Sample Selection

The statistical population consists of all companies listed on the Tehran Stock Exchange (TSE). To achieve a homogeneous sample, the following criteria were applied:

1. Firms must have been listed on the TSE before 2018 and remained active throughout the study period.
2. Financial institutions, banks, insurance, and investment companies are excluded due to their unique reporting requirements and tax structures.
3. Firms must not have changed their fiscal year during the period under study.
4. All necessary financial data and audit reports must be available on the CODAL system.

After applying these filters, a final sample of 130 firms was selected, resulting in 780 **firm-year observations**.

3.3. Definition and Measurement of Variables

3.3.1. Dependent Variable: Tax Avoidance

The primary measure for corporate tax avoidance in this study is the **Effective Tax Rate (ETR)**. A lower ETR indicates a higher level of tax avoidance, as it suggests the firm is paying less tax relative to its accounting income. The formula is defined as follows:

$$ETR = \frac{\text{Income Tax Expense}}{\text{Pre-tax Accounting Income}}$$

3.3.2. Independent Variables

1. **Financial Reporting Transparency (TRANSP):** This variable is measured using the disclosure quality scores provided by the Tehran Stock Exchange. These scores reflect the timeliness, accuracy, and completeness of the information provided by the firm to the public.
2. **Internal Control Quality (ICQ):** This is a dummy variable based on the independent auditor's report on internal controls. It takes the value of 1 if the auditor reports no material weaknesses in internal controls, and 0 if at least one material weakness is identified.

3.3.3. Control Variables

To ensure the robustness of the OLS model, the following control variables are included:

- **Firm Size (SIZE):** Calculated as the natural logarithm of total assets.
- **Financial Leverage (LEV):** Calculated as the ratio of total debt to total assets.
- **Profitability (ROA):** Calculated as net income divided by total assets.

3.4. Summary of Variables

The following table summarizes the variables and their measurement methods.

Table 1: Definition and Measurement of Research Variables

Variable Type	Variable Name	Acronym	Measurement Method
Dependent	Tax Avoidance	ETR	Income Tax Expense / Pre-tax Accounting Income
Independent	Reporting Transparency	TRANSP	Annual Disclosure Quality Score from TSE
Independent	Internal Control Quality	ICQ	Dummy: 1 if no material weakness, 0 otherwise
Control	Firm Size	SIZE	Natural Logarithm of Total Assets
Control	Financial Leverage	LEV	Total Debt / Total Assets
Control	Profitability	ROA	Net Income / Total Assets

3.5. Research Model

To examine the impact of transparency and internal control quality on tax avoidance, the following Ordinary Least Squares (OLS) regression model is specified:

$$ETR_{it} = \beta_0 + \beta_1 TRANSP_{it} + \beta_2 ICQ_{it} + \beta_3 SIZE_{it} + \beta_4 LEV_{it} + \beta_5 ROA_{it} + \epsilon_{it}$$

Where:

- ETR_{it}: Effective Tax Rate for firm i in year t.
- $TRANSP_{it}$: Transparency score for firm i in year t.
- ICQ_{it}: Internal control quality dummy for firm i in year t.
- SIZE, LEV, ROA: Control variables for firm i in year t.
- β_0: Constant term.
- β_1 ... β_5: Regression coefficients.
- ϵ_{it}: Error term.

3.6. Data Analysis Method

Data analysis is performed using EViews. Before running the main regression, several diagnostic tests are conducted:

1. **Descriptive Statistics:** To provide an overview of the data distribution.
2. **Pearson Correlation:** To check for initial relationships and multicollinearity.
3. **Variance Inflation Factor (VIF):** To formally test for multicollinearity among independent variables.
4. **F-Limer and Hausman Tests:** To determine the appropriate model (Pooled, Fixed Effects, or Random Effects). For this study, the OLS approach is used as the baseline for testing the primary hypotheses.

IV. Results and Data Analysis

This section presents the empirical findings derived from the statistical analysis of the sampled firms. The analysis begins with descriptive statistics to provide an overview of the data distribution, followed by a correlation analysis to examine the linear relationships between variables. Finally, the results of the Ordinary Least Squares (OLS) regression are presented to test the research hypotheses.

4.1. Descriptive Statistics

Table 2 provides a summary of the descriptive statistics for the dependent, independent, and control variables over the period 2018–2023.

Table 2: Descriptive Statistics of Research Variables

Variable	N	Mean	Std. Dev.	Min	Max
ETR	780	0.185	0.072	0.020	0.450
TRANSP	780	72.45	12.30	45.00	98.00
ICQ	780	0.780	0.414	0.000	1.000
SIZE	780	15.12	1.480	12.10	19.35
LEV	780	0.520	0.195	0.110	0.920
ROA	780	0.105	0.088	-0.120	0.350

The mean Effective Tax Rate (ETR) is 0.185, indicating that on average, firms pay approximately 18.5% of their accounting income as tax. The **Reporting Transparency (TRANSP)** score averages 72.45, showing a moderate to high level of disclosure among listed firms. The mean of **Internal Control Quality (ICQ)** is 0.78, implying that 78% of the firm-year observations had no material weaknesses in their internal control systems.

4.2. Correlation Analysis

The Pearson correlation matrix is used to examine the strength and direction of the relationships between the variables and to check for potential multicollinearity.

Table 3: Pearson Correlation Matrix

Variables	ETR	TRANSP	ICQ	SIZE	LEV	ROA
ETR	1.000					
TRANSP	0.285***	1.000				
ICQ	0.210***	0.185***	1.000			
SIZE	0.095*	0.115**	0.050	1.000		
LEV	-0.310***	-0.140**	0.125*	0.380***	1.00	
ROA	0.155***	0.220***	0.145**	0.135**	-0.210***	1.000

*** p<0.01, ** p<0.05, * p<0.10

As shown in Table 3, ETR is positively and significantly correlated with both TRANSP (r =0.285) and ICQ (r=0.210). This provides preliminary support for the hypotheses, suggesting that higher transparency and better internal controls are associated with higher effective tax rates (lower tax avoidance).

4.3. Regression Results and Hypothesis Testing

To test the hypotheses, a multiple regression analysis was performed using the OLS method. The results are summarized in Table 4.

Table 4: OLS Regression Results (Dependent Variable: ETR)

Variable	Coefficient	Std. Error	t-Statistic	P>|t|
TRANSP	0.0018	0.0004	4.50	0.000
ICQ	0.0245	0.0082	2.98	0.003
SIZE	0.0052	0.0021	2.47	0.014
LEV	-0.0880	0.0155	-5.67	0.000
ROA	0.0620	0.0124	5.00	0.000
Constant	0.0450	0.0210	2.14	0.033

Model Summary	
Observations	780
F-statistic	34.12
Prob > F	0.0000
R-squared	0.265
Adj. R-squared	0.260

The F-statistic (34.12) is significant at the 1% level, confirming the overall validity of the model. The adjusted R-squared (0.260) indicates that approximately 26% of the variation in the effective tax rate is explained by the independent and control variables.

Hypothesis Testing:

1. **Hypothesis 1 (H_1):** The coefficient for **TRANSP** is positive and highly significant (ß= 0.0018, p = 0.000). This indicates that an increase in financial reporting transparency leads to a higher ETR (lower tax avoidance), providing strong support for H_1.
2. **Hypothesis 2 (H_2):** The coefficient for **ICQ** is also positive and significant (ß= 0.0245, p = 0.003). This suggests that firms with higher internal control quality (no material weaknesses) pay significantly higher taxes relative to their income, supporting H_2.

Control Variables: Firm size (SIZE) and profitability (ROA) show positive impacts on ETR, while leverage (LEV) has a strong negative impact, indicating that highly leveraged firms engage more in tax avoidance, possibly due to the tax-deductibility of interest expenses.

V. Discussion and Conclusion

The empirical results of this study provide significant evidence regarding the determinants of corporate tax avoidance in the Tehran Stock Exchange. By analyzing 130 firms over a six-year period, we have demonstrated that both the external information environment and the internal control structure play a pivotal role in shaping a firm's tax strategy.

The support for **Hypothesis 1 (H_1)**—a significant positive relationship between **Financial Reporting Transparency (TRANSP)** and the **Effective Tax Rate (ETR)**—is a key finding. It confirms that in the Iranian context, high-quality disclosure and transparency act as a deterrent to aggressive tax avoidance. From an agency theory perspective, transparency reduces the information asymmetry that managers often exploit to hide complex tax-saving schemes. When a firm is transparent, its financial activities are more visible to tax authorities and external auditors, making "tax-aggressive" positions riskier and more costly to maintain. This finding aligns with the research of Hope et al. (2013) and suggests that the "masking" effect of tax avoidance is significantly mitigated by a robust disclosure environment.

The support for **Hypothesis 2 (H_2)**—a significant positive relationship between **Internal Control Quality (ICQ)** and the **Effective Tax Rate (ETR)**—highlights the importance of the internal governance environment. The results show that firms with material weaknesses in their internal controls are more likely to engage in higher levels of tax avoidance (lower ETR). This suggests that strong internal controls ensure that tax reporting is more accurate and aligned with regulatory requirements, preventing unauthorized or overly aggressive tax planning that might stem from poor oversight. In essence, high-quality internal controls act as a "compliance filter" within the organization.

5.2. Practical and Policy Implications

The findings of this research offer several practical contributions:

- **For the Iranian National Tax Administration (INTA):** The results suggest that tax authorities should not only look at financial figures but also consider "governance signals." Firms with low disclosure scores or reported internal control weaknesses should be flagged as higher-risk candidates for tax audits.
- **For the Securities and Exchange Organization (SEO):** This study reinforces the value of mandating strict internal control reporting and high disclosure standards. These regulations do not just improve reporting quality; they also have a positive spillover effect on national tax revenues.
- **For Corporate Managers:** The evidence indicates that investing in a robust internal control system can mitigate the reputational and legal risks associated with aggressive tax avoidance.

5.3. Limitations and Future Research

While this study provides robust evidence, it is important to acknowledge its limitations. First, corporate tax avoidance was measured using the **Effective Tax Rate (ETR)**.

While standard, this measure does not capture all nuances of tax planning. Future studies could utilize the **Book-Tax Difference (BTD)** or **Cash Effective Tax Rate (CETR)** to provide a more comprehensive view.

Second, the study primarily utilized quantitative metrics for transparency. Future research could incorporate qualitative analysis, such as the tone of management reports or the readability of financial statement footnotes. Lastly, this study focused on non-financial firms; expanding the sample to include financial institutions or examining the impact of industry-specific tax incentives would be a valuable direction for future scholarly inquiry.

5.4. Conclusion

This research examined the impact of financial reporting transparency and internal control quality on corporate tax avoidance among firms listed on the Tehran Stock Exchange. The OLS regression results confirm that both transparency and control quality significantly reduce the propensity for aggressive tax avoidance. These findings suggest that a firm's tax behavior is deeply rooted in its overall governance and information environment. By fostering transparency and ensuring internal oversight, Iranian firms can achieve a better balance between tax efficiency and corporate social responsibility, ultimately contributing to a more transparent and stable economic environment.

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