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EFFECT OF CORPORATE INCOME TAX ON FINANCIAL PERFORMANCE OF COMPANIES LISTED ON THE NAIROBI SECURITIES EXCHANGE IN KENYA

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Abstract

The study aims at investigating the effect of corporate income tax on financial performance of the companies listed on the Nairobi Securities Exchange in Kenya. The objective of this study was to establish the effect of corporate income tax on financial performance of the companies listed on the Nairobi Securities Exchange in Kenya. The research design used in this study was mixed research both qualitative and quantitative design. Secondary data was extracted from the NSE database, Capital Markets Authority (CMA) database, journals and other publications. A sample of fifty-nine out of a target population of sixty-nine companies publicly listed as at January, 2015 was extracted from the NSE website. This study is expected to provide empirical evidence on the profitability (financial performance) of the companies' listed Nairobi security exchange in Kenya. The key findings were that there is a positive relationship between corporate income tax and financial performance of listed companies on the NSE in Kenya. The study will assist policy makers with useful input for formulating Government policies to avert poor performance and consequently bankruptcy of listed companies.

Keywords: Capital structure, Corporate Income tax, Financial Performance

Introduction

Taxation of corporate profits, as an important component of fiscal policy, is a topical issue of great interest impacting both macroeconomic and microeconomic. By imposing taxes, the state seeks to collect financial resources to the budget. When referring to the economic, tax, representing a sampling of financial resources at their disposal to the state, have the effect of reducing economic and financial performance achieved. Jens and

Schwellnus (2008) examined the effects of corporate income taxes on two of the main drivers of growth, profitability and investment of firms in European OECD member countries over the time period of 1996-2004, through stratified sampling this is found to be true across firms of different size and age classes, except for young and small firms. The results suggest that corporate income taxes reduce investment through an increase in the user cost of capital. This may be partly explained by the negative profitability effects of corporate income taxes if there is an increase in the corporate tax rate.

Rohaya, Nor'Azem and Bardai, (2010) conducted a study on corporate income taxes and revealed an association between income tax and profitability of corporate institutions. The study related to the impact of corporate income tax liabilities on different variables of a firm as gross profit, cost of sales, expenses etc. A sample of 7,306 companies was taken from the hotels and restaurants sector, includes 6,594 in business services and 1,484 in transport manufacturing sectors, for the accounting periods 1995 to 2000. The conclusion was that corporate income tax adversely affects the profitability of corporate institutions but has a positive relationship with the firm size and age of companies. Apart from these authors, De Mooij and Ederveen, (2001) all found a negative relationship between corporate taxation and financial performance therefore it is valid to develop a hypothesis that there is a negative association between corporate tax and financial performance of firms.

According to the Modigliani-Miller, the firm is inversely proportional to the weighted average cost of capital. Therefore, changes in tax law that lowers tax rates should increase firm value. The researcher used the framework of Zeitun and Tian (2007) with the extension in their regression model by adding liquidity and non-debt tax shield and applied this regression model simultaneously on textile and food sectors of Pakistan. The findings of Zeitun and Tian (2007) indicated that leverage has a significant and negative relationship with firm's performance. They used leverage, growth, size, tax, risk and tangibility as independent variable to see their effect on firm's performance. They concluded that firm's size and tax have positive and significant relationship with firm's performance while risk and tangibility have negative and significant relationship with firm's performance

Financial performance

Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. It is the process of measuring the results of a firm's policies and operations in monetary terms (Mwangi, 2016). It identifies the financial strengths and weaknesses of a firm by establishing relationships between the items of the financial position and income statement. The term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. There are many different ways to measure firms' performance, but all measures should be taken in aggregation. Line items such as revenue from operations, operating income or cash flow from operations can be used, as well as total unit sales (Njeru, 2012). Quantitative measures of firm performance include profitability measures such as gross margin, net margin for example return on sales, return on equity economic value added, return on equity less cost of equity and return on capital employed. Other measures of performance include cash flow measures such as free cash flow over sales and growth measures for example historical revenue growth. Ideally, forward-looking measures such as expected profitability, cash flow and growth should be used to measure a firm's performance (Kiaritha, 2015). Management researchers prefer accounting variables as performance measures such as return on equity (ROE), return on investment (ROI), and return on assets (ROA). Other common measures of performance include Earnings per share (EPS); Price/Earning (P/E) ratio and net interest margin (NIM). The NIM variable is defined as the net interest income divided by total assets. Okiro (2014) use net interest margin and before tax profit/total assets as measures of financial performance. Earlier studies typically measure

accounting rates of return. These include: Return on Investment (ROI), return on capital (ROC), return on assets (ROA) and return on sales (ROS). The idea behind these measures is perhaps to evaluate managerial performance-how well is a firm's management using the assets to generate accounting returns per unit of investment, assets or sales (Memba, 2011).

The problems with these measures are well known. Accounting returns include depreciation and inventory costs and affect the accurate reporting of earnings. Asset values are also recorded historically. Return of total assets (ROA) is the ratio of net income after taxes divided by total assets and reflects how well management uses the firms real investments resources to generate profit (Ongore, 2013). Return on assets indicates how profitable a business is relative to its assets. Nyabwanga, Ojera, Otieno and Nyakundi (2013) assert that return on assets must be positive and the standard figure for return on assets is 10% -12%. The higher the ROA the better because the business is earning more money on the capital invested. ROA takes into consideration the return on investment (ROI) and indicates the effectiveness in generating profits with its available assets. Return on equity (ROE) is a frequently used variable in judging top management performance, and for making executive compensation decisions. ROE is defined as net income (income available to common stockholders) divided by stockholders equity. Return on equity (ROE) indicates the return on owners' equity, hence the higher the better. Earnings per share (EPS) indicate the dollar amount earned on behalf of each common share, thus the higher the better. Price/earnings (P/E) ratio is the amount investors are willing to pay for each dollar of earnings, that is indicates investors' confidence (Herrmann, 2008). Liquidity is also a measure of financial performance. Liquidity measures the ability to meet financial obligations as they fall due

without disrupting the operations of the firm (Mwirie et al., 2015).

Organizational performance is concerned with the overall productivity in an organization in terms of stock turnover, customers, profitability and market share (Uzel et al., 2015). When corporate profitability increases, the earnings from the production and operation would be much, and the company has more funds to return the due debt. Profitability refers to the profitability level of enterprise production and management. The more corporate profitability is, the more profits a firm gets from the production and operations, the more able to guarantee of debt due for repayment (Fu Gang, 2012). The amount of profit can be a good measure of performance of a company. So profit is used as a measure of financial performance of a company as well as a promise for the company to remain a going concern in the world of business (Agha, 2014). Moullin (2007) highlights performance measurement as one of the tools which helps firms in monitoring performance, identifying the areas that need attention, enhancing motivation, improving communication and strengthening accountability. It is widely believed that firm growth and profit rates are related to each other (Coad, 2009, Goddard et al., 2004). There are a number of theoretical claims that growth rates have a positive impact on profit rate. Firm growth could lead to an increase in firm size resulting to larger firms which could benefit from economies of scale and in turn enhanced profits. Sales growth shows the rate of increase in a company's sales per share, based on several periodic time periods, and is considered the best gauge of how rapidly a company's core business is growing (Javed et al., 2012). Cash flow tells you how much cash a business is actually generating in its earnings before depreciation, amortization, and noncash charges. Sometimes called cash earnings, it's considered a gauge of liquidity and solvency.

Statement of the Problem

Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. It is the process of measuring the results of a firm's policies and operations in monetary terms (Mwangi, 2016). It identifies the financial strengths and weaknesses of a firm by establishing relationships between the items of the financial position and income statement. Performance of the firms is becoming highly exposed to scrutiny by potential investors due to the risks involved including adverse publicity brought about by collapsing of some firms and others are under receivership. Namusonge, Kabare & Mutua (2012). Kenya has been experiencing turbulent times with regard to its organizational practices in the last two decades. This resulted in generally low profits across the economy.

This is mainly a protection mechanism put in place to ensure companies decision making process on matters such as the capital structure and investments are made by a board constituted with persons of different experiences, skills and perceptions of business operation. Capital structure have a great effect on corporate governance adopted by a firm and according to Miring'u & Muoria (2011) the governance structure of any corporate entity affects the firm's ability to respond to external factors that have some bearing on its performance, survival and growth.

According to Franks & Mayer (2013) systematic and conclusive evidence on the financial performance affects various ownership structures remains sparse, notably in emerging markets and developing economies. However, the companies listed on the NSE have returned different levels of financial performances with some companies performing better than others over the years based on their investments. This is the case across all industries of companies listed. This variation in financial performances for listed firms on the NSE has raised queries on the board composition of these listed firms which are meant to make investment decisions for this firms. For example, studies by Manaseer, (2012) and Lin (2011) not the unevenness of board composition. The capital structure policy of the listed firms which is heavily influenced by the board's decisions is therefore hypotheses to be a major problem for these companies affecting their financial performance (Majumdar, 2010). Studies investigating on corporate income tax on financial performance have been limited to only two variables. For example, existing studies such as the studies by Onaolapo and Kajola (2010), Zheka, (2010), Zeitum (2014) and Rajangan *et at* (2014) examined the effects of corporate income tax and financial performance. It is on the background of the above mixed reports and the fact that the Kenyan economy is undergoing transition from emerging to developed market opening opportunities for small investors that this study sought to investigate the effect of corporate income tax on financial performance of firms listed on the NSE and spill over effects to economy at large and shed new light into corporate finance.

Research Objective

To establish the effect of corporate income tax on financial performance of the companies listed on the Nairobi Securities Exchange in Kenya.

Research Question

Does corporate income tax affect financial performance of companies listed on the Nairobi Securities Exchange in Kenya?

Null Hypotheses

H_{01}: Corporate income tax does not significantly effect on the relationship between capital structure and financial performance of Companies listed on the NSE in Kenya

Related Literature to the Study

Trade-Off Theory

The trade –off theory's main idea is that benefits and costs of debt financing yield an optimal debt-to- assets ratio for a company. This theory came as a result to "correct" the Miller and Modigliani's proposition 1. There has to be both positive and negative effects of debt financing for there to be a trade-off result. Wu & Wang (2005), the proponents of static trade-off model argue that firms balance debt and equity positions by making trade – offs between the value of tax shields on interest, and the cost of bankruptcy or financial distress. Scott (1977) postulates that increase of debt as opposed to equity enhances the financial position of the firm in that, debt is tax deductible whereas equity is not.

The trade-off theory has contributed a lot in finance. It yields an intuitively pleasing interior optimum for firms and gives a rationale for cross-sectional variation in corporate debt ratios i.e. firms with different types of assets will have different bankruptcy and agency costs and different optimal debt ratios. However, the theory has limitations i.e. debt ratios as produced by this theory are significantly higher than observed. Secondly, in many industries, the most profitable firms often have the lowest debt ratio, which is the opposite of what the tradeoff theory predicts (sunder & Myers, 1999). According to Myers (1984) the trade-off theory also fails to predict the wide degree of cross-sectional and time variation of observed debt rations.

Pecking Order Theory

In contrast to the trade-off theory of capital structure, the pecking order theory is based on the premise the dilution associated with issuing equity is so large that it dominates allot her considerations. It states that companies have a preferred hierarchy for financing decisions and maximize value by systematically choosing to finance new investments using the cheapest available source of funds. Myers (1984) in the "capital structure puzzle journal of finance suggests that companies would only issue equity as a last resort when debt capacity has been exhausted. This theory is based on the two assumptions about financial managers i.e. that there is asymmetric information where managers know more about the firm's current earnings and future growth opportunities that do outside investors and there is a strong desire to keep such information proprietary. Secondly, managers will act in the best interests of existing shareholders they will forgo a positive NPV project if raising fresh equity would give more of the projects value to new rather than existing shareholders (Myers & Majluf 1984).

Leverage "Irrelevance Theory"

This theory's proponents are Villamil (2008) in their seminar paper "The cost of capital, corporation finance, and the theory of investment" (Kumar, 2008). They postulated that the firm value is independent of its leverage as long as there are no tax subsidies on interest payment, no transaction costs, and the interest rate on borrowing is the same for Corporations and individuals. Villamil (2008) challenged the traditional held notion that a firm could increase its value by using debt as part of its capital structure. In their proposition they explain that the investors can create any leverage that they wanted but were not offered, or the investors can get rid of any leverage that the firm took on but was not wanted. As a result, the leverage of the firm has no effect on the market value of the firm.

Agency Theory

Agency relationship is one in which one or more persons (the principal(s)) engages another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. Jensen and Meckling (1976) developed agency theory where agency costs are

defined as the sum of the monitoring expenditures by the principal, bonding costs by the agent, and a residual loss. The existence of agency problem will arise due to the conflicts either between managers and shareholders (agency cost of equity) or between shareholders and debt holders (agency costs of debt).

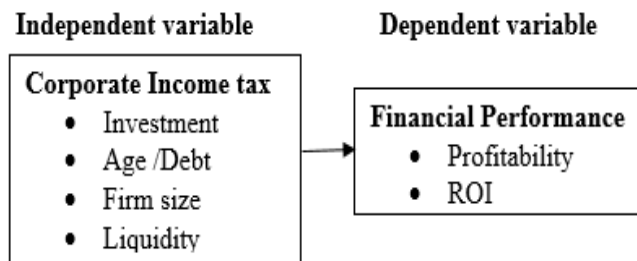## Conceptual Framework

Conceptual Framework

Figure 1 Conceptual Framework

Research Methodology

The research design used in this study was mixed research designs both qualitative and quantitative design. Secondary data was extracted from the NSE database, Capital Markets Authority (CMA) database, journals and other publications. Primary data was acquired through administering questionnaires and interviews to a purposive sample of Chief Executive Officers, Chief Financial Officers and Financial Managers of companies publicly listed on the NSE as at 2015. A sample of fifty nine out a target population of sixty nine companies publicly listed as at January, 2015 was extracted from the NSE website.

Company sector

Sector	Frequency	% Frequency
Agriculture	5	8.5
Automobile & Accessories	8	13.6
Banking	11	18.6
Commercial & Services	7	11.9
Construction and Allied	5	8.5
Energy and Petroleum	9	15.3
Insurance	5	8.5
Investment	2	3.4
Manufacturing and Allied	3	5.1
Telecommunication and Technology	4	6.8
Total	**59**	**100.0**

The study indicates that (8.5%) of the respondents were from Agricultural sector, (18.6%) from the Banking sector, (15.3%) from Energy and Petroleum sector, (13.6%) from Automobile and Accessories. (11.9%) were from Commercial & services, (8.5%) from Construction and allied, (15.3%) from Energy and Petroleum, (8.5%) from Insurance and 2(3.4%) from Investment. (5.1%) were from Manufacturing and allied sector and (6.8%) Telecommunication and Technology. The respondents were from varied sectors, both service providers and commodity providers, hence a good reflection of the overall financial performance across all sectors.

Research Findings And Discussion

Table 1: Corporate Income tax

Item	SA(%)	A(%)	N(%)	D(%)	SD(%)	Mean (SD
The investment made by the firm over the last 10 years have been affected by taxes paid	(8.5)	(49.2)	(33.9)	(8.5)	(0)	2.4 (0.8)
Debt of the company is on the rise	(5.1)	(10.2)	(45.8)	(33.9)	(5.1)	3.2 (0.9)
The firms growth is limited by taxation	(3.4)	(22)	(47.5)	(23.7)	(3.4)	3.0(0.8)
Liquidity position of the firm has been stable for the last 10 years	(10.2)	(62.7)	(27.1)	(0)	(0)	2.2(0.6)

The study indicates that the investment, (49.2%) agreed that the investment made by the firm over the last ten years have been affected by taxes paid, (33.9%) were undecided while (8.5%) strongly agreed and the same proportion disagreed. On average, the respondents agreed that the investment made by the firm over the last ten years have been affected by taxes paid. Regarding the item that debt of the company is on the rise, (45.8%) were undecided, (33.9%) disagreed, (10.2%) agreed and (5.1%) strongly agreed. On average, they were undecided (mean 3.2 (SD 0.9). (47.5%) were decided on whether the firm's growth is limited by taxation, (23.7%) disagreed, (3.4%) strongly disagreed. Only (3.4%) strongly agreed while (22%) agreed. Liquidity position of the firm being stable for the last ten years was agreed by (62.7%) of the respondents, strongly agreed by (10.2%) while (27.1%) were undecided. On average, they agreed that liquidity position of the firm has been stable for the last ten years (mean 2.2 sd. 0.6).

Financial performance

The study sought to establish the effect of Return on Investment (ROI) and profitability on financial performance of the companies listed on the Nairobi Securities Exchange. The results are depicted in table 2.

Table 2: Financial Performance

Item	SA(%)	A(%)	N(%)	D(%)	SD(%)	Mean (sd)
ROI is the main indicator of financial performance	(37.3)	(54.2)	(8.5)	(0)	(0)	1.7(0.6)
Profitability of the firm is the net income to average assets of the firm	(27.1)	(57.6)	(13.6)	(1.7)	(0)	1.9(0.7)
Profitability is used to measure the financial performance of the firm	(39)	(54.2)	(5.1)	(1.7)	(0)	1.7(0.7)
The higher the assets turnover, the higher the Profitability of the firm	(30.5)	(66.1)	(3.4)	(0)	(0)	1.2(0.5)
ROI as a ratio is used to measure the financial performance of the firm	(33.9)	(52.5)	(13.6)	(0)	(0)	1.8(0.7)

The study indicates that more than half of the respondents (54.2%) agreed that ROI is the main indicator of financial performance while (37.3%) strongly agreed. In addition (8.5%) were undecided. On average, the respondents agreed that ROI is the main indicator of financial performance means1.7 (sd 0.6). Regarding profitability of the firm (57.6%) agreed that it is the net income to average assets of the firm, (27.1%) strongly agreed while (13.6%) were undecided and (1.7%) disagreed. On average, they agreed that it is the net income to average assets of the firm, mean1.9 (sd 0.7). (54.2%) agreed that profitability is used to measure the financial performance of the firm while (39%) strongly agreed. (5.1%) were undecided while (1.7%) disagreed. On average, they agreed that profitability is used to measure the financial performance of the firm, mean 1.7(sd 0.7). (66.1%) agreed that the higher the assets turnover, the higher the Profitability of the firm and (30.5%) strongly agreed. Only (3.4%) were undecided. On average, the respondents agreed that the higher the assets turnover, the higher the Profitability of the firm, mean 1.2(sd 0.5). Slightly more than half (52.5%) agreed that ROI as a ratio is used to measure the financial performance of the firm, (33.9%) strongly agreed while (13.6%) were undecided. On average, they agreed that ROI as a ratio is used to measure the financial performance of the firm, mean 1.8(sd 0.7). (64.4%) strongly agreed that the board has a balanced ratio in terms of gender, (23.7%) agreed while 2(3.4%) were undecided. Still (6.8%) disagreed and (1.7%) strongly disagreed. (45.8%) strongly agreed that the board has a balanced distribution in terms of age, (35.6%) agreed and (11.9%) were undecided. Only (6.8%) disagreed. On average, they agreed that the board has a balanced distribution in terms of age, mean (sd 1.0). (49.2%) strongly agreed that board has a balanced ratio in terms of executive versus non-executive members. (20.3%) agreed while (18.6%) were undecided and (11.9%) disagreed. On average, they

agreed that board has a balanced ratio in terms of executive versus non-executive members, mean (sd 1.1). The board having a policy on CEO duality was strongly agreed upon by (44.1%), (35.6%) agreed while (13.6%) were undecided and only (6.8%) disagreed. (45.8%) of the respondents strongly agreed that the board independence has an effect on financial performance, (33.9%) agreed. (13.6%) were undecided and only (6.8%) disagreed? On average, they agreed that board independence has an effect on financial performance, mean1.8 (sd 0.9).

Table 3: The extent to which corporate income tax influences financial Performance

Corporate Income tax	SA(%)	A(%)	N(%)	D(%)	SD(%)	N
Very high extend	(42.9)	(20.4)	(30.6)	(2.0)	(4.1)	49
High extend	(0)	(52.3)	(40.9)	(6.8)	(0)	44
Moderately	(2.5)	(12.5)	(77.5)	(7.5)	(0)	40
Low extend	(0)	(7.7)	(53.8)	(35.9)	(2.6)	39
Very low extend	(5.1)	(43.6)	(15.4)	(35.9)	(0)	39

The study indicates that (42.9%) of the respondents strongly agreed that corporate income tax influences financial performance of firms listed on the NSE to a very high extend, (52.3%) that to a high extend. (43.6%) agreed that corporate income tax influences financial performance of firms listed on the NSE to a very low extend.

Discussion Of The Key Findings

Corporate income tax was measured by four constructs and the results found a positive relationship between corporate income tax and financial performance of companies listed on the NSE in Kenya. The individual constructs of corporate income tax were tested and it was evident that most of the firm's investment made over the last ten years has been affected by the taxes paid. The results agree with the findings by Jens and Schellnus (2008).

Conclusions

The conclusions were based on the objectives of the study that corporate income tax had a significant influence on financial performance. The focus of this study was on financial performance of companies listed on the NSE in Kenya since the sector is expected to play a critical role in propelling the economy to a 30% growth rate. The results established that corporate income tax was found to significantly and positively influence financial performance of companies listed on the NSE in Kenya to a very high extend. In addition, the findings indicate that the ratios of firm's profitability has the most significance in determining the financial performance of companies listed on the NSE in Kenya. When corporate income tax stated hypotheses was tested in the regression model it was found to have a significant relationship between itself and financial performance of listed companies on the NSE in Kenya. The findings of the study established that Taxation of corporate profits, as an important component of fiscal policy, is a topical issue of great interest impacting both macroeconomic and microeconomic. By imposing taxes, the state seeks to collect financial resources to the budget. The companies that pay corporate income tax in advance, on installment or on due date, enhances the collection of taxes and this improves the financial performance of companies listed on the NSE in Kenya.

Recommendations

The researcher recommends the adoption of corporate income tax in order to improve financial performance of companies listed on the NSE in Kenya. The study findings support the view that corporate income tax has a significant effect on financial performance. Policies should ensure that companies pays their corporate income tax promptly and consequently better financial performance of companies listed on the NSE in Kenya. The study recommends that there is need to identify policy makers with useful input for formulating Government policies to avert poor

performance and consequently bankruptcy of listed companies and enlighten the investors who will be interested in the study as they will be in a position to protect their investments and direct them to the best performing companies at the securities exchange which will in turn spur economic growth in the long-term. Secondly, the study recommends that other researcher to identify policy makers with useful input for formulating Government policies to avert poor performance and consequently bankruptcy of listed companies and enlighten the Investors who will be interested in the study as they will be in a position to protect their investments and direct them to the best performing companies at the securities exchange which will in turn spur economic growth in the long-term.

Areas of further research

The study suggests more variables to be carried out taking into account the prevailing macro-economic variables as the control variables since they play a major role in decisions making among the board of directors. Other studies should be carried out taking into account other performance variables such as Return on Equity and Return on Asset as opposed to the current study which only considered profitability and Return on Investment as a means of financial performance. The study found out that corporate income tax improves financial performance. However, the study did not come up with any optimum point at which the firms should employ it. It is on the above basis that this study recommends further studies to establish other determinants of financial performance. Further studies could be carried out to identify the effect of corporate income tax on financial performance of companies listed on the NSE in East Africa. Therefore, further research is therefore recommended on the influence of other determinants of financial performance that have not been addressed in this study.

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