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Effect of Capital Deductions on the Financial Performance of Listed Companies at the Nairobi Securities Exchange in Kenya

Mwangi Esther Wambui[1], Dr. John K. Tarus[2] & Dr. Jones Bor[3]
[1]Department of Accounting and Finance, Kenya School of Revenue Administration
[2,3]School of Business and Economics, Moi University
Corresponding email: mwangirafina@gmail.com

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Abstract

Purpose: Shareholders' wealth maximization is a priority objective of every corporate entity. The issue of corporate tax planning and firm value is gaining relevance following the recent financial crises which resulted in the increasing collapse of global and local companies. The purpose of this study was to investigate the effect of capital deductions on the financial performance of companies listed at the Nairobi Securities Exchange (NSE) in Kenya. The study was anchored on signaling theory.

Methodology: The study adopted both explanatory and longitudinal research. Secondary data for the study for the period between 2013-2022 was extracted from annual financial statements of 57 listed firms targeted for analysis. The data for the study was analyzed through descriptive and inferential statistics using statistical techniques including Pearson correlation coefficient and regression analysis. All the analyses were done using the STATA version 13.0 Pearson correlation results revealed a significant association between study variables and financial performance. Multiple Linear regression model was used to analyze relationships and the effect of the study variables.

Results: The study findings established that capital deductions ($\beta = 0.844$, p-value = 0.000, <0.05) have a positive and significant effect on financial performance. The study contributes to knowledge by revealing new insights that tax planning has a significant effect on financial performance of listed firms in Kenya. Specifically, it was established that capital deductions have a significant effect on financial performance of listed firms.

Conclusion: The study concludes that a holistic approach to tax planning and an optimal mix of tax planning strategies are important determinants and have a positive contributory effect on firm performance. The study recommends that companies' management should strive to have an in-depth understanding of tax laws to take advantage of every opportunity that will reduce their tax liability thereby increasing their returns and value. The future researchers should explore the effect of Indirect tax incentives on financial performance.

Keywords: *Capital deductions, financial performance, Nairobi Securities Exchange*

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1.0 Introduction

One of the major objectives of any organization is to enhance financial performance and shareholders' wealth. Financial performance reflects ability of an organization to effectively

utilize financial and production factors to generate revenue for shareholders has been the major focus of profit-making organizations (Kayode & Folajinmi, 2020). Companies listed at the Nairobi Securities Exchange are not an exemption from enhancing their financial performance to improve their return on investment. This in return increases the reputation of listed companies hence attracting investors into their portfolios. Capital deductions play a significant role in taxation as they allow businesses to deduct capital expenses associated with the production or acquisition of assets, such as machinery, equipment, or property, thereby reducing their taxable income (Smith, 2018). This deduction process leads to reduced tax liabilities and provides businesses with the opportunity to recover their investments gradually (Johnson, 2021). By encouraging capital expenditure, capital deductions contribute to stimulating economic growth and development (Davis, 2019).

The significance of capital deductions lies in their ability to reduce taxable income for organizations, enabling them to strategically manage their tax liabilities while complying with tax laws and regulations (Smith, 2018). When businesses incur capital expenses, such as purchasing new machinery or equipment, they can deduct a portion of the cost from their taxable income, leading to lower tax obligations (Johnson, 2021). This deduction not only facilitates investment recovery but also acts as an incentive for businesses to engage in capital spending and innovation.

Capital deductions have broader implications on the overall economy, as they encourage businesses to invest in long-term assets, such as machinery or equipment, thereby enhancing productivity and efficiency (Smith, 2022). These investments often lead to streamlined operations, improved manufacturing processes, and technological advancements, driving economic growth (Smith, 2022). Moreover, by providing businesses with financial relief, capital deductions foster innovation, enabling them to allocate resources toward research and development initiatives (Smith, 2022).

The utilization of capital deductions benefits businesses by enhancing cash flows and profitability, as they can allocate resources more efficiently toward investments and expansion (Smith, 2018). Additionally, businesses that take advantage of capital deductions are more likely to invest in advanced technologies, leading to higher productivity levels and improved product quality, thus increasing their competitiveness in the market (Davis, 2019). Case studies on the impact of capital deductions further highlight their significance. For example, in Kenya, KenGen, the largest power producer, demonstrated the effectiveness of tax planning strategies through a significant increase in net profit from Ksh 13.9 billion in 2019 to Ksh 18.3 billion in 2020, representing a substantial year-on-year growth of approximately 31.7% (Kenya Electricity Generating Company, 2021). Effective utilization of capital deductions positively impacted KenGen's financial performance, leading to increased profitability and investor confidence.

On the other hand, Safaricom plc, the leading telecommunications company in Kenya, faced allegations of engaging in aggressive tax planning strategies (Ochieng, 2022). These accusations resulted in a loss of public trust and criticism for failing to fulfill its tax obligations, negatively impacting the company's financial performance. Safaricom's case emphasizes the importance of responsible tax planning and adherence to tax regulations to avoid potential reputational and financial risks associated with aggressive tax avoidance strategies.

In conclusion, capital deductions are a crucial tool for businesses to strategically manage their tax liabilities while promoting economic growth and innovation (Smith, 2018). By allowing businesses to deduct capital expenses associated with the production or acquisition of assets, governments incentivize investments in long-term assets, leading to enhanced productivity and

competitiveness (Davis, 2019). The availability of capital deductions fosters innovation and sustainability by providing businesses with financial relief for research and development initiatives (Smith, 2022).

Responsible tax planning practices are essential for businesses to optimize their financial performance while complying with tax laws and regulations (Smith, 2018). Policymakers must continually review and revise tax policies to strike a balance between fostering investment, and economic growth, and ensuring fair and sustainable revenue collection (Smith, 2018). Overall, capital deductions play a vital role in tax planning, with significant implications for individual businesses and the broader economy.

1.1 Problem statement

The financial performance of companies has become a critical concern for shareholders and stakeholders, particularly amidst the collapse of global and local firms. The measurement of financial performance is a debated issue, with metrics like return on assets, profitability, and sales turnover offering varying insights. This study focused on the relationship between tax planning and the financial performance of NSE-listed companies in Kenya. Effective tax planning can enhance a company's competitiveness, increase cash flows, and optimize shareholder returns. The research highlights the case of KenGen, Kenya's leading power producer, which saw significant net profit growth from Ksh 13.9 billion in 2019 to Ksh 18.3 billion in 2020, attributed to its successful tax strategies. Conversely, Safaricom, a major telecommunications firm, faced financial decline due to aggressive tax planning allegations, leading to a loss of public trust and a significant net loss in 2021 and 2022 after years of profits. Understanding the nuanced relationship between tax planning and financial performance is essential for sustainable growth in Kenyan companies. The study aims to provide valuable insights for policymakers, investors, and market participants by rigorously analyzing the interplay between capital deductions and the financial health of companies in Kenya.

2.0 Literature Review

2.1 Theoretical Review

2.1.1 Signaling Theory

Signaling Theory is relevant to financial performance as it sheds light on how tax exemptions serve as effective signals of a company's alignment with government priorities and commitment to responsible tax planning. When companies claim tax exemptions, they communicate their willingness to engage in government-supported activities and demonstrate dedication to sustainable growth and responsible financial management (Hickson & Holm, 2015). The act of claiming tax exemptions becomes a powerful communication tool, signifying that the company's operations are in line with government objectives.

Tax exemptions, as provisions that exclude certain income or transactions from the taxable base, play a vital role in strategic fiscal policy. Governments grant tax exemptions to encourage specific behaviors or investments that align with their policy objectives, stimulating economic growth, promoting socially responsible activities, and attracting investments in targeted industries or regions (Abugre, 2018). By providing incentives to individuals and businesses, tax exemptions create an environment that fosters economic development and societal welfare. By utilizing tax exemptions in targeted sectors, companies signal their commitment to participating in activities that the government deems crucial for economic development. This alignment fosters a positive relationship between the private sector and the government, promoting a cooperative environment for mutual progress (Hickson & Holm, 2015). Moreover, claiming tax exemptions can be seen as a proactive step in managing tax liabilities, reflecting a company's dedication to responsible tax planning and financial management.

Furthermore, tax exemptions serve as signals of a company's dedication to sustainable growth. Companies that invest in priority sectors or engage in socially responsible activities often qualify for tax exemptions. By claiming these incentives, companies demonstrate their commitment to environmentally friendly initiatives, job creation in disadvantaged regions, or community development projects (Abugre, 2018). This signaling effect enhances a company's reputation as a responsible corporate citizen, potentially attracting socially conscious investors and positively influencing consumer perceptions. The signaling effect of tax exemptions extends beyond the private sector and reaches investors and financial markets. Observing a company claim tax exemptions strategically, investors may interpret it as a positive signal of the company's financial strength and prudent management (Hickson & Holm, 2015). The perception that a company is taking advantage of tax incentives responsibly and strategically can enhance investor confidence and potentially attract more investment. This positive impact on investor sentiment may lead to increased stock prices and market valuation for the company.

2.2 Empirical Review

2.2.1 Capital deductions and financial performance

Capital deductions, such as Wear and Tear Allowances (WTAs) and Investment Allowances (IA), are pivotal in shaping the financial performance of businesses by reducing taxable income and enhancing cash flow. WTAs, which allow companies to deduct a portion of the cost of tangible assets over their useful life, help businesses manage operational costs and reinvest in essential projects, thereby boosting productivity and efficiency (Grubert & Mackie, 2020). Studies have shown that companies effectively utilizing WTAs tend to experience significant tax savings, which, in turn, leads to improved financial outcomes and increased reinvestment in modernizing assets (Johnson et al., 2018).

Investment Allowance (IA) further incentivizes businesses to direct funds toward new capital assets by offering tax deductions based on a percentage of the total investment. IA is instrumental in promoting economic growth and fostering innovation by enabling companies to allocate resources more strategically toward growth-oriented initiatives. Smith and Brown (2019) demonstrated that businesses claiming higher IA were more inclined to invest in new equipment and technologies, leading to enhanced productivity and long-term financial success. This tax incentive structure supports innovation and expansion, driving businesses toward higher profitability and competitive advantage.

The overall impact of capital deductions, particularly IA, lies in their ability to optimize a company's cash flow, reduce tax liabilities, and provide financial flexibility. By alleviating the tax burden, IA empowers businesses to invest in strategic projects, bolster research and development, and improve operational efficiency (Peterson et al., 2020). Consequently, such tax policies contribute to sustainable economic growth and enhanced business performance, underscoring the need for policymakers to consider the benefits of capital deductions when designing tax frameworks (Grubert & Mackie, 2020; Smith & Brown, 2019).

2.3 Conceptual Framework

A conceptual framework serves as a fundamental tool for researchers, providing a structured understanding of the relationships between various concepts in a study. According to Tromp (2009), a concept is an abstract or general idea inferred from specific instances, while Smith (2004) defines a conceptual framework as a hypothesized or postulated model. In the context of Kenyan researchers, Mugenda (Year) emphasizes the importance of conceptual frameworks in guiding the organization of research presentations. The conceptual framework assists in clarifying the relationship between independent and dependent variables. Kothari (2004) suggests that the dependent variable represents the phenomenon under investigation, while the

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independent variables are the presumed causes of change.

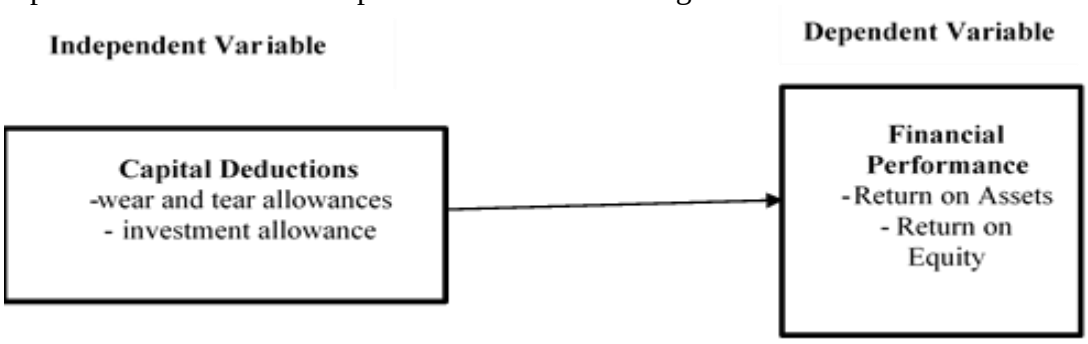

Figure 1: Conceptual Framework

3.0 Methodology

Kothari (2004) defines a research design as the conceptual framework that guides the gathering, measurement, and analysis of data. The elements comprising a research design include processes for sampling, strategies for conducting research, devices for data collection, and techniques for analyzing data and presenting findings. The population for this study consisted of all 63 firms that are listed at the NSE. However, only companies that had complete data sets were included in the inclusion criteria making the total number of study 57 firms. This study utilized an explanatory and longitudinal research approach. Explanatory research design aims to identify the cause-and-effect relationship between variables (Kosla, 2021). The design was used to investigate patterns and trends in existing data that haven't been previously investigated. Longitudinal study is deemed appropriate since its research is conducted over an extended period. It's used to study the same subjects over a period of time, observing how they change or develop across different points in time.

4.0 Results and Discussion

4.1 Descriptive statistics

4.1.1 Capital Deductions

Table 1: Descriptive statistics Capital Deductions

Variable	Obs	Mean	Std. Dev.	Min	Max
Capital Deduction	570	0.253	0.157	0.000	0.714

Table 1 showed that the mean for capital deduction was 0.253 the standard deviation was 0.157, indicating a low deviation from the mean ratio. Minimum was 0.000 implying the lowest capital deduction ratio and maximum was 0.714 indicating the highest ratio.

4.1.2 Financial Performance

Table 2: Descriptive Statistics Financial Performance

Variable	Obs	Mean	Std. Dev.	Min	Max
Financial Performance	570	0.469	0.574	-0.018	6.401

The results from Table 2 showed that financial performance had a mean of 0.469 standard deviation of 0.574 implying a low deviation of the ratios from the mean; and minimum of -0.018 the lowest return on assets ratio and a maximum of 6.401, implying the highest return on asset ratio.

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4.2 Correlation Analysis

The correlation analysis was conducted to determine the cause and effect of capital deductions on financial performance of NSE listed firms.

Table 3: Correlation Analysis

Variables	(1)	(2)
(1) Financial Performance	1.000	
(2) Capital Deductions	0.204*	1.000
	0.000	

Table 3, showed that capital deductions were found to have a positive and statistically significant correlation (r= 0.204, p<0.05) with financial performance. Indicating that improving capital deductions significantly improves financial performance of NSE listed firms.

4.3 Hausmann Test

The study utilized a Hausmann test to determine whether a fixed or random effects model was to be used and concluded that fixed model was sufficient in explaining the effects of capital deductions on financial performance as shown in a table. The null hypothesis asserts that REM is efficient, while the alternative hypothesis shows that FEM is effective (Hausman, 1978). Rejecting the null (ρ-value < 0.05) implies that the fixed effect model is preferred (Green, 2008).

Table 4: Hausmann Test

Correlated Random Effects - Hausman Test
Equation: Untitled
Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	8.757517	3	0.0305

Cross-section random effects test comparisons:

Variable	Fixed	Random	Var (Diff.)	Prob.
Capital Deductions	0.844	0.742	0.1000	0.000

Based on the results in Table 4, the null hypothesis was rejected (that the difference in coefficients was not systematic) since the ρ- value = 0.0305 of the chi-squares was less than 0.05. Accordingly, the study used the fixed effect regression model to test direct hypotheses.

4.4 Fixed Effect Model Results

The study model summary Table 5 found that 10% variation in financial performance was caused by capital deductions R^2 = 0.100. The remaining 90% was caused by factors not included in the fixed effect model. F static of 18.909 and p-value of 0.000<0.05 implied that the model was significant in explaining the variation.

4.4.1 Regression Results

The regression coefficient results were summarized in Table 5 through the equation below

$$FPit = 0.399 + 0.844CD_{1it}$$

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Table 5 Fixed Effect Model

Fixed-effects (within) regression		Number of obs =	570
Group variable: ID		Number of groups =	57
R-sq: within = 0.1001		Obs per group: min =	2
between = 0.0154		avg =	10.0
overall = 0.0757		max =	10
	F(3,510)	=	18.19
corr(u_i, Xb) = -0.2333		Prob > F	= 0.000

FP	Coef.	St. Err.	t-value	p-value	[95% Conf	Interval]
Capital Deductions	0.844	0.190	4.44	0.000	-0.448	0.202
Constant	0.399	0.186	2.15	0.041	-3.497	0.331

Mean dependent var	0.469	SD dependent var	0.574
R-squared	0.100	Number of obs	570
F-test	18.909	Prob > F	0.000
Akaike crit. (AIC)	800.533	Bayesian crit. (BIC)	817.915

*** $p<.01$, ** $p<.05$, * $p<.1$

CD-Capital Deduction, FP- Financial Performance

Table 5 found that capital deduction had a positive and significant effect on financial performance (β= 0.844, ρ<0.05). With a unit change in capital deduction, financial performance increases by 0.844.

4.5 Discussion of Findings

The study objective was to determine the effect of capital deductions on the financial performance of listed companies at the Nairobi Securities Exchange in Kenya. The study found that there was a positive and significant correlation between capital deductions and financial performance r=0.204 p<0.05, this indicates that as capital deductions increase, financial performance tends to improve. Further investigation found that capital deductions positively influence financial performance β=0.844 p<0.05, suggesting that for every unit increase in capital deductions, financial performance significantly increases by 0.844 units. This highlights the importance of capital deductions in enhancing financial outcomes. This study concurred with Johnson et al. (2018) who conducted a comprehensive study analyzing data from 150 manufacturing companies. The findings revealed a positive association between the effective utilization of WTAs and reduced taxable income.

5.0 Conclusion

The study concluded that capital deductions had a positive and significant effect on financial performance. This implied that unit changes in capital deductions resulted in a subsequent significant improvement in financial performances of NSE listed firms. These study findings

have significant implications for both managerial practitioners and academic researchers. The study provided evidence that corporate tax planning predicts financial performance in listed firms in Kenya. This means that listed and all firms in general should practice corporate tax planning that will lead to an increase in financial performance because this translates to improved shareholder wealth which is the main goal of a firm.

6.0 Recommendations

This study therefore recommends that adequate measures should be put in place by management of the listed firms to improve their financial performance through improving the use of capital deductions. Listed firms in general should practice corporate tax planning.

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