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Effect of Tax Benefits on Value of Firms Listed in Nairobi Securities Exchange

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Abstract
This study measured the effect of financing decisions determinant of tax benefits on the value of the firm utilizing financial statements of listed firms which covered a period of 10 years from January 2008 to December 2017. The study was anchored on Net income approach and Modiglini-Miller theories of finance. Positivisim research philosophy was adopted while cross sectional and explanatory research designs were applied. Document guide analysis was used to extract secondary data from published financial statements of the respective companies for the period of study. Face validity of the research instrument was ensured through peer reviews while content validity was ensured by using the expert opinion of the University Supervisors. Data was analyzed using descriptive statistical methods of mean, percentages and standard deviation. Inferential statistical methods of stepwise regression analysis was adopted in analysis of the panel data. The results were presented in the form of tables. The findings revealed that tax benefit had significant effect on value of the firms listed in Nairobi Securities Exchange. In conclusion however tax benefits as measured by depreciation tax benefit had more impact on the value of listed firms in agricultural, energy and petroleum sectors however when interest tax benefit is the indicator for tax benefits then firms in commercial and services, construction and allied, insurance, investment and telecommunication sectors revealed greater effect of tax benefit on value of firm. It was recommended that tax benefits be traded off with interest expense and corporate taxes be evaluated against interest rates to optimize tax benefits.
Keywords: Tax benefits, value of firm, depreciation tax benefit, interest tax benefit
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1.0 INTRODUCTION

The relationship between financing decisions and value of the firm is a subject that has attracted attention in corporate cycles and academic world over the recent past all in an effort to determine the optimal financing patterns to be adopted by companies. Koroti (2013) affirms that financing decisions negatively affect financial performance of sugar companies Karachi Stock Exchange. Efni (2017) found out that the company's risk and investment decisions can increase the value of the company while dividend policy and funding decisions cannot increase the value of the company. Companies affected by interest rate barrier reduce their leverage by 4.7% points more than the unlevered firms and upon considering tax effects of debt it becomes the preferred choice to equity thus levered firms are expected to have a higher value than the unlevered firms. Further the study revealed that tax shields have substantial effect on the financing choice between debt and equity and tax shields correlate positively to the debt policy but have a negligible effect on marginal tax rates of firms (Alberterst & Sloane , 2016)

Value of a firm on the other hand constitutes of the net worthy of a firm or the net sellable value of a firm. Purwanto, Agustin and Jillian (2017) established that value of firm is a reflection of the firm's performance and these affects investor's perception towards the firm. Lawal ,Edwin, Monoca and Adisa (2014) affirmed that there is a negative relationship between total debts, long term debt to capital employed and a relationship exists between debt, equity ratio and firm performance. Some scholars have argued that small firms have higher risk adjusted returns that larger firms and then the size effect is not linear in the market value. This position was postulated by Benz in 1981 in his article. Murekefu & Ouma (2017) found a positive correlation between dividend payout and firm performance and dividend relevancy in determination of value of the firm. This contradicts the findings of Modigliani Miller's view of dividend irrelevance. Ernest & Oscar (2014) argued that earning per share is the most considered information by investors when settling on the share price. Further financial information in the oil and gas sectors is more value relevant than financial information disclosures in banking sector.

Financing decisions forms a critical role of any financial manager in a corporate setting. These decisions must be rational and objective to serve the interest of all stakeholders though maximizing returns and generating wealth. Many a times managers and shareholders have made decisions that end up serving their specific interests but detrimental to other stakeholders like debt holders, creditors, suppliers and even customers. Desai (2007) asserts that firms in similar risk class are likely to have high cost of capital when the debt levels are high and firms with high leverage are more risky and are valued lower than those firms with low leverage. It is in the interest of this

study that management makes optimal financing decisions that yields maximum returns but at manageable risks for the common good of all stakeholders in the firm. The researcher will use tax benefits, agency costs, bankruptcy costs and information symmetry as the proxies of financing decisions determinants in firms.

Tax benefit is the interest tax shield that accrues to a firm when it uses debt in its capital structure. Interest on debt is tax deductible expenditure in the Kenyan tax system which means that before arriving at the taxable profits interest expense is subtracted from the profits generated for a particular period. The deduction reduces taxable profits hence lower tax liability for the firm. Yangyang and Ning (2012) argued that higher tax benefit implies higher value of the firm. While previous scholars held the view that high market interest rates led to a decline in market value of the firm, this study considers that borrowing by firms can be anchored on tax benefit from debt to trade off interest expense and this will offset the likely distress costs to the firm and increase the value of the firm.

2.0 LITERATURE REVIEW

This section constitute the theories on which the study was anchored, which are Net Income approach and Modigiliani Miller Theory. Net Income Approach was propounded by Durand in 1952 and it portends that a firm can increase its total value by lowering its cost of capital through increased leverage while market price per share is maximized when a firm attains its optimum capital structure. According to this approach the capital structure decisions are relevant to the value of a firm. He argued that to reduce the average cost of capital a firm must use more debt capital and that this translates to increase in value of the firm. He believed that debt is the cheapest form of financing because interest on debt is tax deductible when deriving taxable income. Due to this, there is a tax shield that accrues to the firm which in turn increases the firm value (Reilly & Brown , 2006). Critics of Net Income theory such as Myer 1984 in trade off theory and Shyam and Myer 1999 in static trade off theory argued that an optimal financial leverage can be found when a trade-off between tax shield benefits of debt and the cost of servicing the debt is determined. Debt in the financial mix causes a deduction of the interest expense from the taxable profits of the firm, resulting to lower taxable profits and reduced corporate taxes. In effect the value of the firm increases with the increase in amount of tax shield. A firm that follows the tradeoff theory sets a target debt to value ratio and gently approaches that target. Then a balance is struck by trading off tax shield and costs of bankruptcy (Brigham and Ehrhardt, 2008).

Franco Modigliani and Merton Miller in their seminar article in 1958 prompted the modern capital structure theory. M-M argued that the cost of capital is not dependent on the degree of leverage irrespective of the debt-equity ratio. This implies that the total market value of the firm and the cost of capital are independent of the capital structure. Modigiliani and Miller 1958 and 1963 articles made three basic propositions in relation to cost of capital, capital structure and total value of the firm. First the cost of capital and the total market value of the firm are independent of its capital structure. The cost of capital is the capitalization rate of equity stream and market value is obtained by capitalizing the expected return at a specific rate of discount for the respective risk class. This implies that the total value of the firm is absolutely unaffected by the capital structure when corporate tax is ignored. Their second proposition portend that the expected yield on a share is equal to capitalization rate of a pure equity stream for that specific class combined with premium for financial risk. This is equivalent to the difference between the pure equity capitalization rate and the yield on debt. In effect this means that rise in Cost of Equity is exactly offset by the use of cheaper debt. Their third proposition provides that the cut off point for investment is always the capitalization rate that is independent and unaffected by the assets invested in (Pandey, 2010). Criticisms on this theory have questioned the practical applicability of the assumptions made. For instance a perfect capital market is an ideal situation which can be achieved when every condition is favorable, a position not tenable. While developed countries have moved closer to attaining perfection, absolute perfection has not been achieved. Secondly all firms in an industry cannot have uniform risk levels because factors which trigger change in risk levels are unique to each firm. Investor expectations are as diverse and unique as the individual investors themselves and this downplays Modigliani-Miller assumption of homogeneous expectations on a firm's net operating income. (Ahmeti & Prenaj , 2015).

Soufiene, Khaoula and Ali (2016) found out that value of a firm increases through increased investment and tax benefits . Also large firms had higher firm value due to their financial flexibility as supported by high value of tangible assets which form collateral security. Adelegan (2006), studying on the effects of taxes financing decisions on firm value in Nigeria, measured the effect of taxing dividends and interest on value of the firm. The scholar confirmed that there exists a positive correlation between dividend and value of the firm and negative correlation between debt and firm value.

Frederic, Franco and Pablo (2015) established that capital structure responds to changes in tax incentives and that equity ratios increased drastically for large firms from years 2006 unlike small firms. This imply that large firms are able to align themselves with the notional interest deduction and adjust their capital structures appropriately. Also reducing tax variations which favour use of debt financing translates to increase in funding for firms. George (2007) portends that high taxes on corporate profits causes a reduction in firm value and that there is a positive relationship between taxation and the use of corporate debt. Yangyang and Ning (2012) studied the

impact of taxes on firm value and the trade-off theory of capital structure. They established that rise in corporate tax rate results to a decline in market value of a firm because a firm could wish to raise more debt as the tax shields increase however, on the process it becomes constrained financially because of decline in market value. This study made an empirical support for the non-linear relationship between the corporate tax rate and market leverage ratio.

Sritharan (2015) sought to address the question as to whether tax shields of debt and non debt impact on firms' performance in Sri Lankan land and property sector. The study revealed that debt tax shield as well as non debt tax shield relate negatively to performance measure of return on assets when fixed effect and random effect regression models are used. Abraham, Tobias, Mbithi and Clive (2017) findings affirm that high debt tax shield causes an increase in debt of the firms. Jose and Francisco (2017) carried out a study to establish how much tax benefits of debt add to firm value basing the evidence of Spanish listed firms. It was realized that the value of gross interest deduction is approximately 6 percent of the market value of the firm while net debt tax benefit was estimated to be 2.1 percent.

The foregoing arguments support the trade-off theory that opines that firms increase their debt level to take advantage of tax benefits until expected marginal benefits are equal to expected marginal costs of debt. Existing literature points at a positive relationship between the amount of debt a firm holds and the corporate tax rate, implying that tax rates dictate the levels of debt in firms. This affirms the fact that increase in market interest rates cause decline in value of the firm due to higher corporate tax rates applied on taxable profits.

However due consideration should be taken on the utilization of these funds in terms of investment in viable projects. Further the tax shield obtained from the use of debt as a source of funds by the firm is a clear benefit derived from the use of debt and this can trade off the interest expense. Equally, higher interest rate is a deterrent to excessive borrowing by the firms and rational firms minimizes borrowing to maintain the value of the firm at optimal levels. It is on the basis of the aforementioned rationale that this study forms a departure from the existing perception that higher market interest rates causes a decline in value of the firm and proposes that motivation to borrow could be based on tax benefit that can be traded off with the interest expenses of the firm because interest is a tax deductible expense and the higher the tax benefits the higher is the value of the firm should the funds be optimally invested in potentially viable investments. This led to the hypothesis that tax benefits have no significant contribution to the value of the firm which was tested in this study.

3.0 RESEARCH METHODOLOGY

This section addresses the research philosophy and design, data collection procedures and instrumentation as well as the techniques of data analysis and presentation employed in the study

3.1 Research Philosophy and Design

This study used the ontological position of realism, that is, the view that objects actually exist independent of what the researcher knows. Epistemological position of objectivism was employed in this study. Pojman and Fieser (2011) posits that the researcher should categorize what is intrinsic good and instrumental good, that is, goodness due to the nature of an object and effective means of obtaining the intrinsic good and this approach was employed in the study. Cross sectional research design was compatible to this study because it covers different sectors of companies listed at NSE and the design facilitates collection of a considerable amount of data quickly, efficiently and accurately (Oso & Onen, 2005). Explanatory research design was used to point out the relationships between the variables used in the study and generate models for these particular relationships (Saunders & Thornhil, 2007).

3.2 Data Collection Procedures and Instrumentation

A document analysis guide was employed to derive secondary data particularly from published statements of financial performance and statements of financial position for the period 2008 to 2017. Kahn (2006) portend that document review is concerned with deriving information by cross examining written documents while Denscombe (2010) revealed that exist advantages associated with the use of document review such as their cheap and easy accessibility and permanent availability of data in a form that can easily be cross checked and open to public scrutiny. The published financial statements used to derive secondary data for this study are public documents available for scrutiny. The research instrument in this study was refined and modified according to the purpose of the study and the items in the instrument were aligned with the conceptual model and objectives of the study. Face validity was ensured through peer reviews while content validity was ensured by using the expert opinion of the University Supervisors

3.3 Data Analysis and Presentation

Data extracted was processed for analysis by editing, coding, categorizing and recording. Data was analyzed using descriptive statistical methods of mean, percentages, and standard deviation. According to Kothari (2004), regression analysis is concerned with the study of how one or more variables affect changes in another variable. Stepwise regression tool was used to determine the effect of tax benefits on value of firm. Model summary and

Analysis of variance were used in testing the hypothesis that tax benefits have no statistically significant effect on value of firms listed in NSE.

4.0 DATA ANALYSIS AND DISCUSSION OF FINDINGS

This section contains the analysis of data and discussion on various findings of the study. The first part details the descriptives of the constructs adopted while the second part has inferential analysis of the panel data.

4.1 Effect of Tax Benefits on Value of Firms

The study sought to determine the effect of tax benefits on the value of firms listed in NSE. To measure this effect depreciation tax benefits and interest tax benefits were used as proxies of tax benefits variable while price to book value was the indicator to value of firms variable. Both descriptive statistical methods and inferential techniques were used in the analysis.

4.1.1 Decriptive Statistics on Tax Benefits and Value of Firm

Descriptives statistical methods of mean, minimum, maximum, standard deviation and skewness were used to understand the behaviour of the variables. Table 4.2 provides the results.

Table 4.1 Descriptive Statistics on Tax Benefits and Price to Book Value

	N	Minimum	Maximum	Mean	Std. Deviation	Skewness	
	Statistic	Statistic	Statistic	Statistic	Statistic	Statistic	Std. Error
DepTaxB	400	516	8764588	356985.24	949302.77	5.575	.122
InterestTaxB	380	510	5144393	532058.7	870429.2	2.593	.125
PriceBkVal	400	.04	2509.00	39.5955	228.0428	7.170	.122

Source: Field 2019

Table 4.1 indicates that the minimum depreciation tax benefit was Kshs. 516 while the maximum was Kshs. 8764588 and mean Kshs. 356985.24 for companies which have been constantly quoted at the Nairobi Stock Exchange for the period 2008 to 2017. This is a substantial amount of mean for consideration by management of corporate companies in making decisions in relation to investment in tangible assets. Depreciation tax benefit can be a motivator for companies to increase their asset base. However, interest tax benefit returned the highest mean value of Kshs.532058.76 which shows that companies engage more in external borrowing than they do in investing in tangible assets. The standard deviation of Ksh 949302.774 for depreciation tax benefit is higher than that of interest tax benefit. This implies that the multi-sectorial variation in investment in tangible assets is higher than the variation in external borrowing in those sectors over the study period. Price to book value had a minimum of 0.04 and maximum of 2509 while its mean was 39.5955 for all listed companies over the study period. Standard deviation of 228.04283 for value of the firm depicted that the variation in value of the firms listed in NSE was low compared to variations in investment in tangible assets and that of external debts utilized by those firms. The skewness is a measure of the nature of symmetry on the distribution. Table 4.2 shows that the distribution is a standard normal distribution

4.2 Regression Assumptions Diagnostics

Various regression analysis assumptions were tested to ensure that the data is suitable for regression analysis. These were test of normality, multi-collinearlity test, homoscedasticity test and test for autocorrelation.

4.2.1Test for Normality

To test for normality of the data sets the researcher used one sample Kolmogorov-Smirnov and Shapiro-Wilk tests. The results are as presented in table 4.1.

Table 4. 2 Test of Normality

	Kolmogorov-Smirnov[a]			Shapiro-Wilk		
	Statistic	Df	Sig.	Statistic	df	Sig.
DepTaxB	.021	359	.200	.994	359	.125
InterestTaxB	.012	359	.200	.999	359	.999
PriceBkVal	.015	359	.200	.999	359	.991

*. This is a lower bound of the true significance.

a. Lilliefors Significance Correction

The results indicate that the value of p is greater than 0.05 level of significance in Kolmogorov-Smirnov test with and exception of expense ratio which has a p=.032. When p>.05 it implies that there is statistically insignificant difference between the data elements and mean, hence the data is considered to have a normal distribution. Shapiro-Wilk test also returned all p values higher than 0.05 significance level, which means insignificance variance between the mean and the data elements. The p value for expense ratio as per Shapino-

Wilk is .107 thus greater than .05 threshold. In case of conflict between the p values of Kolmogorov-Smirnov and Shapiro-Wilk tests then the result of Shapiro-Wilk test supersedes Kolmogorov-Smirnov. In this case p value of .107 is adopted for expense ratio and considered to have a statistically insignificant variation between its data elements and its mean, confirming normality.

4.2.2 Multi Collinearity Test

To test for multi collinearity among the independent variables the reseacher used torelance levels and Variance Inflation Factors. The threshold level for the test was 3 variance inflation factor, such that if VIF was less than 3 then multicollinearity did not exist but if VIF was higher than 3 then multicollinearity existed. According to the tests conducted it revealed that all VIF values were less than 3 indicating that the data did not suffer from multicollinearity issues

4.2.3 Homoscedasticity Test

The researcher tested for homoscedasticity to confirm the correlation between the error terms across observations in the data. To test this Levine's Test of Equality of Error Variances was used to verify the null hypothesis that the data does not suffer from homoscedasticity. If the reported p value from the test was greater than the critical p-value of 0.05 then the variance between data items is insignificant and therefore the data is largely homoscedastic but if p<.05 significance level then the variance between the data elements is statistically significant thus heteroscedastic. The results are as presented in appendix III part (iii). The Lavene's Test of eqaulity of error variances indicates that the p values for the variables were greater than 0.05 level of significance. This means that the variation between the data elements is insignifcant , therefore the data is largely homoscedastic.

4.2.4 Test for Autocorrelation

To test for serial corelation in the data the researcher used Durbin-Watson coefficient. In this test if the coefficient return a value between 0 to 1.5 then, a strong positive autocorrelation between the resduals of the variables exist but if the coefficient is greater than 2.5 but less than 4 then, a strong negative autocorrelation between the residuals of the variables exist. However if its between 1.5 and 2.5 then there is no autocorrelation between the residuals. Auto correlation is a common situation in time series panel data and its dealt with by applying Cochrane-Orcutt and Prais Winsten procedures. The Darbin-Watson returned a value of .523 which indicate that positive autocorrelation existed. This was resolving by applying the Cochrane-Orcutt and Prais Winsten procedures . On application of these procedures a Darbin-Watson coefficient of 1.937 was derived which implied that data was independent of the serial correlation.

4.3 Regression Results on Tax Benefits and Value of Firms Listed in NSE

To determine the effect of tax benefits on value of firms listed in NSE linear regression model of the form $Y=\beta_0+ \beta_1X_1+ \beta_2X_2+e_i$ was used. The results are as shown in table 4.3

Table 4.3 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.125[a]	.016	.011	224.698080584

a. Predictors: (Constant), InterestTaxB, DepTaxB

Source: (Field data 2019)

The value of R square in the model summary depict that interest tax benefit and depreciation tax benefits can explain 1.6% of the variation in the value of listed firms. The variation is statistically significant since it's associated with a p value of .044 which is less than .05 significance level

Further the ANOVA table 4.4 was used to test the hypothesis that tax benefits have no significant effect on the value of firms listed in NSE

Table 4.4 ANOVA on Tax Benefits and Value of Firm

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	318518.710	2	159259.355	3.154	.044[b]
	Residual	20044223.285	397	50489.227		
	Total	20362741.995	399			

Source: Field Data 2019

Table 4.4 indicate that F=3.154 and p= 0.044 which is less than 0.05 level of significance. This result demonstrate that tax benefits have a statistically significant contribution to the value of the firm. This result directs that the null hypothesis that tax benefits have no significant contribution to the value of listed firms at Nairobi Securities Exchange is rejected. Therefore tax benefits are confirmed to have a significant effect on the value of a firm. This finding is in agreement with the work of Soufiene, Khaoula and Ali (2016) who found out that value of firm increases through increased investment and tax benefits. Their argument held that if tax benefits are high the firm value will also be high, however this situation is more apparent.

The study of Sritharan (2015) addressed the question of impact of of debt and non debt tax shields on firms' performance in Sri Lankan land and property sector and it affirmed that both debt tax shield and non debt tax shield relate negatively to performance measure of return on assets when fixed effect and random effect regression models are used. The study argued that total debt ratio relates negatively to performance. Furher debt tax shields and non debt tax shields have a significant impact on the performance of a company. This position suffices the argument in the current study that tax benefits have a statistically significant effect on the value of the firm.

Abraham, Tobias, Mbithi and Clive (2017) study on influence of tax shield on capital structure of private manufacturing firms in Kenya, portend that high debt tax shield causes an increase in debt of the firms. This is the case because tax shield motivates firms to seek more external funds which may not be absolutely necessary thus driving the debt levels higher. Secondly, the study argued that higher tax shield translates to higher tax advantage as derived from interest on debt. This study concurs with the opinion of these scholars and further points out that the rational use of these external funds should be taken into consideration

The coefficient table 4.5 indicate that the regression model was $Y=36.932+3.145X_1-3.270X_2$ The model implies that a unit change in interest tax benefit causes an increase of 3.145 shillings in value of the firm, however a unit change in depreciation tax benefit causes a decrease of 3.27 shillings in value of the firm.

Table 4.5 Coefficients of Tax Benefits and Firm Value

	B	Std. Error	Beta	T	Sig
1(Constant)	36.932	13.168		2.805	.005
InterestTaxB	3.145	.000	.118	2.017	.044
DepTaxB	-3.270	.000	-.136	-2.332	.020

Source: Field 2019

Table 4.5 indicates that if depreciation tax benefit is held constant interest tax benefit can explain 11.8 % of the variation in the value of the firm and if interest tax benefit is held constant depreciation tax benefit can explain 13.6 % of the variation in value of the firm. In both cases this value is considered statistically significant with p values less than .05 significance level (p=.044, p=.020). This means that the effect of interest tax benefit and depreciation tax benefit on the value of listed firms is significant.

Industry based analysis indicated that depreciation tax benefits had significant effect on the value of firm in manufacturing and allied firms because it could explain 48% of the variation in value of firm with a p=.026. In the energy and petroleum firms it was established that depreciation tax benefit could explain 43.6% of the variation in the value of firm. In banking and manufacturing sectors the two indicators accounted for 2.8% of the changes in the value of firms which is statistically insignificant. R square analysis depicted that interest tax benefit had a significant effect on the value of firm in commercial and services, construction and allied, and telecommunication sectors. The levels of influence of interest tax benefit of value of firms were 27.4% p=.045, 14.1% p=.019, and 60.4% p=.019 respectively for the aforementioned firms.

5.0 CONCLUSION

Interest tax and depreciation tax benefits could explain a significant proportion of the variation in the value of firms listed in NSE generally, though the explanatory power of different sectors could differ from each other. This means that tax benefit has a significant positive effect on the value of listed firms. In the agricultural sector depreciation tax benefit could explain a more significant proportion while interest benefits accounted for a negligible value change.This implies that the agricultural firms listed are capital intensive, that is, they use more of machineries and other depreciable assets thus attracting high depreciation tax benefits. Similar situation obtains in energy and petroleum firms listed in NSE.

Tax benefits did not have a significant effect on the value of firms in banking and manufacturing firms. This situation could be attributed to the fact that banking sector does not use highly depreciable assets and has stringent control measures on its borrowing while the manuafcturing sector attracts government subsidies for investment undertakings thus minimal depreciation charges and external borrowings. However, if other indicators of tax benefits could be used the results may be different.

Interest tax benefits accounted for a highly significant proportion of the variation in the value of listed firms in commercial and services, construction and allied, insurance, investment and telecommunication sectors. This infers that external borrowing for investment in these sectors is high due to the nature of activities undertaken by the firms. The motivation to borrow could be dicted by the available and potential investment opportunities and the tax incentives derived from the borrowing and investment.

The findings in this study revealed that tax benefits motivates firms to increase their debt level to take advantage of tax benefits to the point where expected marginal benefits are equal to expected marginal costs of debt. Literature points at a positive relationship between the amount of debt held by a firm and the corporate tax rate. A traded off between tax benefits and interest expense of the firm reduces the distress on the firm. Therefore when corporate tax rates are higher than market interest rates, tax benefits will leverage against the interest expenses thus increasing the value of firms. However this study did not examine the relationship between corporate

tax rate and tax benefits accruing to a firm thus an area recommended for further exploration.

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Conflict of Interest declaration

1. Dennis Nyamasege
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2. Professor Christopher Ngacho
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