

Influence of Tax Shield on Capital Structure of Private Manufacturing Firms in Kenya

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Abstract: *The main objective of the study was to determine the influence of tax shield on capital structure of private manufacturing firms in Kenya. The measure of tax shield for this research is corporation tax on interest on debt. Ascertaining and attaining an optimal capital structure for many firms is not an easy task. In Kenya many manufacturing firms are struggling to operate while others have been compelled to shut down. This study used descriptive survey design on a population of 853 firms as per KAM members' directory of 2015. Using simple random sampling a sample of 208 CFOs of private manufacturing firms were selected from a target population of 455 CFOs of firms situated in Nairobi and its surrounding areas. The researcher collected primary data using self-administered questionnaire to obtain financial measures from the chief finance officers (CFOs) of these firms and secondary data was collected through a data survey sheet and document review form. Data was analyzed using Statistical Package for Social Sciences (SPSS) version 22. Descriptive and inferential statistics were employed. Under descriptive statistics percentages of responses and means of items was computed. In quantitative analysis Karl Pearson's correlation, multiple linear regression, ANOVA and E-Views were used. The study concluded that high debt tax shield cause increase in debt. The results also revealed that the higher debt tax shield the higher tax advantage from debt interest to the firm. In addition, the results revealed that with high tax rate, the firm uses more debt and has more income to shield from tax.*

Keywords: *Tax Shield, Capital Structure, debt interest*

I. Introduction

Decisions on capital structure are important for every business firm. In the corporate world it is the task of Board of Directors and Management to make capital structure decisions in a manner that will optimize the value of the firm or company (Sheikh & Wang, 2011). However optimization of the firm's value is not an easy task since it involves the selection of debt and equity shares in a balanced percentage keeping in mind various costs and associated benefits. It is noted that a wrong decision or choice may cause a company financial distress that may eventually lead to bankruptcy. The move towards a free or liberal market from 1992 made the operating environment change thereby giving financial managers flexibility in choosing the firm's capital structure. Capital structure is a vital management decision variable because it greatly affects and influences risk and return which in turn affects the firm's market value. Whenever funds are supposed to be raised for various projects a capital structure decision has to be made (Salawu, 2007).

Tax shield is believed to be as important as it affects the amount of debt held (Barclay & Smith, 1999). To avoid paying more tax firms prefer to take more debt. Interest multiplied by the corporation tax rate yields tax shield which is a benefit to the firms. This benefit is promoted by static trade off theory which predicts that the more tax amounts that a firm has to pay the greater the debt it will have in its capital structure. Firms with higher non debt tax shields are likely to use less debt (Fisseha, 2010).

Many commercial entities including private manufacturing firms have a deficit in their funding. This constrains their capital structure where the mix of debt and capital is not sufficient to meet all their viable investment needs. These firms therefore employ prudent measures to enable optimal use of financial resources (Turere, 2012). Firms may therefore face the challenges of capital structure by taking more loans, arranging for loan restructuring; negotiating longer repayment periods and increasing equity base. Firms choose alternative capital structures; they can issue a large amount of debt or very little debt, it can arrange lease financing, use warrants, issue convertible bonds, sign forward contracts and swaps in setting a capital structure that maximizes overall market value of firms (Ngugi & Afande, 2015).

Various studies undertaken in Kenya (Kiogora, 2000; Chode, 2003; Kinyua, 2005; Kuria, 2010; Turere, 2012; Wachilonga, 2013; Muema, 2013; Kiajage & Elly, 2014; Kariuki & Kamau, 2014; Ngugi & Afande, 2015; Wahome, Memba, & Muturi, 2015) remain silent on the optimal capital structure of private manufacturing firms in Kenya. It is for this reason that this study seeks to determine the influence of tax shield on capital structure of private manufacturing firms in Kenya.

1.2 Specific Objective

To establish the influence of tax shield on the capital structure of private manufacturing firms in Kenya.

1.3 Research Hypothesis

H_{a1} Tax shield has a significant influence on capital structure of private manufacturing firms in Kenya

II. Literature Review

Numerous empirical studies have looked at the influence of debt tax shield on corporate financing decisions in major industrialized countries and there are other tax shields on depreciations, research and development expenses and investments allowances that could substitute for debt tax shield. A firm with high non debt tax shield is less likely to finance with debt because tax shields lowers the effective marginal tax rate on interest deduction (Fisseha, 2010).

According to Graham (1999) taxation does affect capital structure but the magnitude of the effect is mostly not large enough. Static trade off theory predicts a positive relationship between corporate tax and capital structure or leverage. This is because interest on debt is allowable deduction for tax purposes as opposed to dividend payments which do not provide a tax advantage for debt (Köksal *et al.*, 2013). The influence of taxes on debt ratios has been difficult to clearly identify and available evidence is rather mixed (Frank & Goyal, 2008; Antoniou *et al.*; 2008). This could be explained by the uncertainty about what would constitute a good proxy for tax shield and also transaction costs makes it difficult to identify tax effects.

According to Köksal *et al.* (2013) firms with high amounts of no- debts tax shields will choose to have a lower debt, the same is true where true high debt tax shield will make firms chose higher debts. Thus the static trade off theory predicts a negative relationship between capital structure and non-debt tax shield. Taxation and its relation to capital structure are explicitly linked to the applicable tax regime, and under the Japanese classical tax system tax deductibility of interest is expected to induce preference for debt who formalized a framework in which tax deductions that are not associated with debt act as substitute for interest deduction. These non debt tax shields compete with interest as tax deductions. Firms with higher non debt tax shields are expected to have lower debt ratio. Thus non debt tax shields are negatively related with capital structure (Akhtar & Oliver, 2005).

Tesfaye and Minga (2013) asserts that relationship between non –debt tax shield and capital structure depends on which debt type, while it negatively influence short term debt and total leverage ratios it positively influence long term debt ratio. This finding partially supports the argument that the higher non debt tax shields the lower tax advantage that arises from interest deduction. While the inverse relationship corroborate findings reported by (Deesomsak *et al.*, 2004).

Some empirical studies confirm theoretical prediction for instance depreciation has a significant negative coefficient, consistent with the fact that depreciation is an effective tax shield and thus off sets tax shield benefit of debts. A negative influence between non debt tax shield and debt is found however observed a positive relationship between non debt tax shield and leverage (Amer *et al.*, 2013).

According to Mbulawa (2014) firms with a high tax shield and marginal tax rate use practically less debt in the financing structure. In other studies tax was found to have statistically significant positive relationship with short term debts ratio for small firms suggesting that high tax rate signifies more short term debts. According to trade off theory a firm with high tax rate should use more debt and hence have more income to shield from tax.

1. Conceptual Framework

A concept is an abstract of general ideas deduced from given instances and needs not to be discussed and understood like the case of a theory (Kombo & Tromp, 2009). It is a set of principles and ideas from a relevant field of study acting as a research tool to aid the researcher to develop and understand the situation under study (Ngumi, 2013). When the frame work is properly articulated it assists researchers derive meanings of their findings and that it forms the basis of negotiations to be tested and scrutinised (Symth,2004).

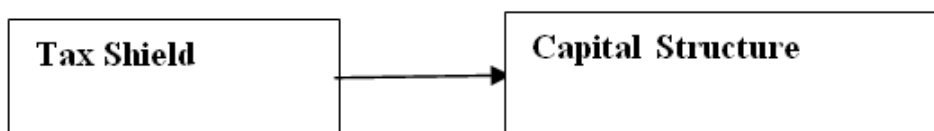


Fig 1.Conceptual framework

III. Research Methodology

3.1 Research Design

This study used descriptive survey design as it entails finding out what, who, where when and how of the firm characteristics (Kariuki *et al.*, 2015). Lavrakas (2008) describes a descriptive survey research design as a systematic research method for collecting data from a representative sample of respondents. Kariuki, Namusonge and Orwa (2015) stated that a good design is guided by an overarching consideration of whether the design answers the research questions and hypotheses *A research design guides the choice of population, sampling procedure methods of measurement and plan for data collection processing and analysis* (Sekaran & Bougie, 2010). *A research design is a structure, or the blueprint, of research that guides the process of research from the formulation of the research questions and hypotheses to reporting of the research findings* (Ngumi, 2013).

3.2 Target Population

Lavrakas (2008) defines a population as any finite or infinite collection of individual items. According to Zikmund, Babin, Carr and Griffin (2010) a population refers to all items in any field of inquiry and is also known as the ‘universe’. Polit and Beck(2003) refers to population as the aggregate or totality of those conforming to a set of specifications. The population for this study was 853 registered private manufacturing firms as per KAM members’ directory (KAM, 2015). The target population which formed the sampling frame for this study consisted of all the 455 chief finance officers of registered manufacturing firms in Nairobi County and surrounding areas registered with KAM in the members’ directory of 2015. This excludes chief finance officers of service and consultancy firms who are members and the reason for their exclusion is that these firms don not engage in manufacturing (KAM, 2015).

3.3 Sampling and Sample Size

A sample is part the population to be studied. Lavrakas (2008) describes a sample in a survey research context as a subset of elements drawn from a larger population. Kombo and Tromp (2009) also describe a sample as a collection of units chosen from the universe to represent it. A study that collects excessive data is also wasteful. Therefore, before collecting data, it is imperative to determine the sample size requirements of a study (Ngumi, 2013). The sampling technique used was simple random sampling where every member of the target population was given an equal chance of being selected. The 455 CFOs were allocated numbers from 1 to 455 and using a table of random numbers the sample 208 was selected.

3.4 Data Collection Procedures

Primary data was collected through the administration of questionnaires to respondents. Research assistants were engaged to follow-up on the administered questionnaires. Saunders, Lewis and Thornhill (2009) describe primary data as data collected by the researcher himself as opposed to secondary data which is collected from other sources. Secondary data was collected through a data survey sheet. Websites of 80 different manufacturing firms, firms’ offices and registrar of companies were used to provide secondary data to be entered on the survey sheet. The data covered a period of 5 years from 2011 to 2015 a period where latest data was available.

Table: 1 Operationalisation and Measurement of Study Variables

Variable	Name of Variable	Operationalisation	Measurement
Dependent variable	Capital Structure	Debt Ratio	Total Debt/Total Assets
Independent variable	Tax Shield	Debt Tax Shield	Corporation tax rate x debt interest

3.5 Data Analysis and Presentation

3.5.1 Descriptive Statistics

Data analysis involved both descriptive and inferential statistics. The respondents were requested to indicate their level of agreement on the statements on Earnings. Results were presented in Table 2

Table 2: Tax Shield and Capital Structure

Statements	strongly disagree	disagree	neither agree nor disagree	agree	strongly agree	Mean	Std. Dev
The firm will take more debt when debt tax shields are high	1.40%	13.90%	17.40%	44.40%	22.90%	3.74	1.01
The firm prefers debt to gain from debt tax shields	2.10%	19.40%	13.90%	42.40%	22.20%	3.63	1.10
The firm’s debt tax shields guarantees high debt	4.00%	20.30%	25.70%	30.60%	19.40%	3.55	1.06
Increase in debt tax shields will make the firm increase in use of debt	3.60%	20.60%	25.00%	37.50%	13.90%	3.42	1.00
The higher debt tax shield the higher	0.00%	13.20%	32.60%	43.80%	10.40%	3.51	0.85

tax advantage from debt interest to the firm							
With high tax rate, the firm uses more debt and has more income to shield from tax	1.40%	18.10%	2.80%	36.10%	40.70%	3.91	0.82
Average						3.63	0.97

Results in table 2 revealed that majority of the respondents who were 67.30% agreed that the firm will take more debt when debt tax shields are high. These findings agree with that of Köksalet *et al.* (2013) who found that firms with high amounts of no- debts tax shields will choose to have a lower debt, the same is true where true high debt tax shield will make firms chose higher debts. The results also revealed that 64.60% agreed that the firm prefers debt to gain from debt tax shields. These findings agree with that of Muema (2013) who found that profitable firms prefer debt to benefit from tax shields if past profitability and earnings is a good proxy for future profitability and earnings. Results also revealed that 50.00% agreed that the firm's debt tax shields guarantees high debt.

Further the results revealed that 51.40% agreed that Increase in debt tax shields will make the firm increase in use of debt. These findings agree with that of Mbulawa (2014) who found that a firm with high tax rate should use more debt rate therefore should have more income to shield from tax. The results also revealed that 54.20% agreed that the higher debt tax shield the higher tax advantage from debt interest to the firm. In addition, the results revealed that 76.80% agreed that with high tax rate, the firm uses more debt and has more income to shield from tax. These findings agree with that of Mbulawa (2014) who found that a firm with high tax rate should use more debt rate therefore should have more income to shield from tax.

3.5.2 Correlation Analysis

Correlation analysis was conducted between tax shield (independent variable) and capital structure (dependent variable). Results are presented in Table 4.10.

Table 3: Correlation Matrix

		Capital structure	Tax shield
Capital structure	Pearson Correlation	1.000	0.577**
	Sig. (2-tailed)		0.000
Tax shield	Pearson Correlation	0.577**	1.000
	Sig. (2-tailed)	0.000	
** Correlation is significant at the 0.01 level (2-tailed).			

Results in Table 4.10 indicated that there was a positive and a significant association between tax shield and capital structure ($r=0.577$, $p=0.000$). These findings agree with that of Tesfaye and Minga (2013) who found that tax shield and capital structure are positively related.

3.5.3 Regression Analysis

The results presented in table 4.11 present the fitness of model used of the regression model in explaining the study phenomena. Tax shield was found to be satisfactory variable in explaining capital structure. This is supported by coefficient of determination also known as the R square of 33.3%. This means that earnings explain 33,3% of the variations in the dependent variable which is capital structure.

Table 4: Model Fitness

Variables	Coefficients
R	0.577
R Square	0.333
Adjusted R Square	0.329
Std. Error of the Estimate	0.44133

Table 4 provides the results on the analysis of the variance (ANOVA). The results indicate that the overall model was statistically significant. Further, the results imply that the independent variable is a good predictor of capital structure. This was supported by an F statistic of 70.959 and the reported p value (0.000) which was less than the conventional probability of 0.05significance level.

Table 5: Analysis of Variance

	Sum of Squares	df	Mean Square	F	Sig.
Regression	13.82	1	13.82	70.959	0.000
Residual	27.657	143	0.195		
Total	41.478	144			

Regression of coefficient results is presented in Table 6

Table 6: Regression of Coefficients

	B	Std. Error	t	sig
(Constant)	1.987	0.172	11.542	0.000
Tax shield	0.406	0.048	8.424	0.000

Regression of coefficients showed that tax shield and capital structure were related ($r=0.406$, $p=0.000$)

3.6 Response rate

The number of questionnaires that were administered was 208 and a total of 144 questionnaires were properly filled and returned where as some of the respondents returned the questionnaires half-filled others refused to return them completely despite a lot of follow up. The response rate result is shown in Table 7

Table 7: Response Rate

Response	Frequency	Percent
Returned	144	69.23%
Unreturned	64	30.77%
Total	208	100%

The response rate was 69.23% as shown on Table 7 This represented an overall success according to Mugenda and Mugenda (2003) and also Kothari (2004) a response rate of above 50% is adequate for a descriptive study. Cooper and Schindler (2003) also argues that a response rate exceeding 30% of the total sample size provides enough data that can be used to generalize the characteristics of a study problem as expressed by the opinions of few respondents in the target population Based on these assertions the response rate of , 69.23% was adequate for the study.

Table 8: Descriptive statistics

	CAPITAL STRUCTURE	TAX SHIELD
Mean	0.845536	6998.745
Median	0.831812	6355.356
Maximum	1.756551	23773.20
Minimum	0.124304	486.7650
Std. Dev.	0.304868	5385.773
Skewness	0.243648	0.776660
Kurtosis	3.083359	2.878557
Jarque-Bera	4.073442	40.45917
Probability	0.130456	0.000000
Sum	338.2142	2799498.
Sum Sq. Dev.	37.08483	1.16E+10

From the table 8 above, the mean of the capital structure for the 80 firms running between 2011 and 2015 is 0.845536 with standard deviation of 0.304868. Its minimum and maximum were 0.124304 and 1.756551 respectively. In addition the mean of earnings was 65261.91 with standard deviation of 37846.05. Its minimum and maximum were 1762.600 and 139883.8 respectively.

3.7.1 Trend Analysis

Capital Structure

1

Tax Shield

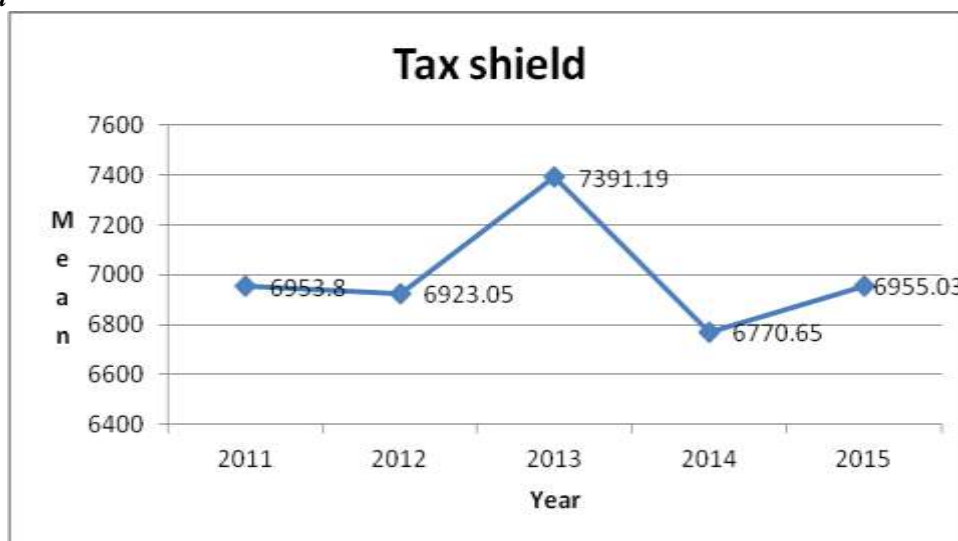


Figure 4.8: Trend Analysis for Tax Shield

The results revealed that the tax shield in the year 2011 was 6953.8, in the year 2012 the tax shield was 6923.05, in the year 2013 the tax shield was 7391.19, in the year 2014 the tax shield was 6770.65 while in the year 2015 the earnings were 6955.03.

IV. Summary Of Findings

The objective of the study was to determine the influence of tax shield on the capital structure of private manufacturing firms in Kenya. Results revealed that majority of the respondents agreed that the firm will take more debt when debt tax shields are high. These findings agree with that of Köksal *et al.* (2013) who found that firms with high amounts of no- debts tax shields will choose to have a lower debt, the same is true where true high debt tax shield will make firms chose higher debts. The results also revealed that the firm prefers debt to gain from debt tax shields. These findings agree with that of Muema (2013) who found that profitable firms prefer debt to benefit from tax shields if past profitability and earnings is a good proxy for future profitability and earnings. Results also revealed that the firm's debt tax shields guarantees high debt. Further the results revealed that Increase in debt tax shields will make the firm increase in use of debt. These findings agree with that of Mbulawa (2014) who found that a firm with high tax rate should use more debt rate therefore should have more income to shield from tax. The results also revealed that the higher debt tax shield the higher tax advantage from debt interest to the firm. In addition, the results revealed that with high tax rate, the firm uses more debt and has more income to shield from tax. These findings agree with that of Mbulawa (2014) who found that a firm with high tax rate should use more debt rate therefore should have more income to shield from tax. The regression results revealed that tax shield has a positive and significant effect. These findings agree with that of Mbulawa (2014) who found that a firm with high tax rate should use more debt rate therefore should have more income to shield from tax.

V. Conclusion And Recommendation Of The Study

The study concluded that high tax shields cause increase in debt. In addition the study concluded that high debt tax shield cause increase in debt. The results also revealed that the higher debt tax shield the higher tax advantage from debt interest to the firm. In addition, the results revealed that with high tax rate, the firm uses more debt and has more income to shield from tax. . The study recommended that firms should increase debt when tax shields are high

VI. Areas Of Further Research

Related studies should be conducted for members of the Kenya Association of Manufacturers who are engaged in consultancy and support services but no manufacturing; a similar study can be carried out on country wide non manufacturing firms. Since this study concentrated on firms within Nairobi and its environs where we have 80% of KAM members as per the members' directory a similar study be conducted on the remaining 20% of those members outside Nairobi and its environs. Further a separate study can be conducted on each segment as provided for in the members' directory of 2015. The study also recommends that a study seeking to establish

influence of other variables on capital structure of private manufacturing firms. These other variables may encompass free cash flows, ownership structure

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