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EFFECT OF EFFECTIVE TAX RATE ON FIRM VALUE OF COMMERCIAL BANKS IN NAIROBI SECURITY EXCHANGE'S LISTED BANKS IN KENYA

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Abstract: **Taxes are fundamental to the progress of a nation. Therefore, it is essential for organizations to strategize their tax obligations to effectively manage their current profits while avoiding penalties associated with tax evasion. Therefore, this study sought to investigate the effect of effective tax rate on firm value of commercial banks in Nairobi Security Exchange's listed banks in Kenya. The research employed a mixed methodology that incorporated both explanatory and correlational research approaches. The target population for this investigation comprised 11 banks that are listed on the NSE. As a census study, it encompassed all 11 banks listed on the NSE. The analysis utilized panel regression, which integrated both time series and cross-sectional data. The information for all variables under study was sourced from the financial statements and annual reports of the commercial banks listed, covering the period from 2014 to 2022 on the NSE. The data were organized and presented in tables and figures. Throughout the data analysis, various diagnostic tests were conducted, including pre- and post-estimation tests. These tests encompassed stationarity tests, normality tests, multicollinearity tests, and heteroskedasticity tests for both fixed and random effect models. 1. The regression analysis indicates that the effective tax rate (ETR) has a statistically significant positive impact on firm value (Coefficient = 850.593, $p < 0.05$). The results of this study offer significant insights into the determinants of firm value within the banking industry, highlighting important considerations for tax planning and financial management strategies. The findings indicate that banks ought to prioritize the optimization of their tax planning approaches and capital structure to improve their overall firm value.**

Keywords: **Tax Rate, Firm Value.**

1. INTRODUCTION

The value of a firm serves as an essential metric for assessing managerial performance in numerous corporate organizations (Omesi & Appah, 2021). Acting as representatives of the shareholders, managers are tasked with the responsibility of enhancing and maximizing this value. Izevbekhai and Odion (2018) assert that the firm's value, as indicated by its owned assets, is also a reflection of the wealth of its shareholders. Furthermore, Kirkpatrick and Radicic (2020) contend that tax planning plays a significant role in influencing firm value.

The topic of firm value is frequently discussed in relation to tax behavior and tax avoidance on a global scale. Research conducted in the United Kingdom challenges the traditional notion that there is a direct link between tax planning and business value. Desai and Dharmaphala (2019) argued that tax planning exhibits an unbiased relationship with market value, while also recognizing its positive correlation with accounting performance. In the context of the United States, evidence regarding the origins of foreign tax structures, which are inherently challenging to observe without access to subsidiary tax information, suggests that these structures can enhance firm value (De Simone & Olbert, 2022). Additionally, studies in Spain and Portugal have shown that tax planning has positively influenced firm value (Feldman et al., 2021; & Gilje & Whitten, 2022). Tax planning strategies, including leveraging, tax savings, and effective tax rates, have been instrumental in boosting share prices and, consequently, market value (Bernstein, 2019).

In addition, many companies in China have enhanced their firm value by employing various tax planning strategies. Leverage has emerged as a significant factor contributing to the increase in firm value through corporate taxation (Edwards & Hutchens, 2020). Other factors influencing firm value in China include industry-specific tax savings (Chyz et al., 2022), the effective tax rate (Edwards, Hutchens & Rego, 2019), and compensation planning (Dambra, Gustafson & Quinn, 2020). Ftouhi, Ayed, and Zemzem (2019) suggested that corporate tax planning significantly enhances enterprise value, particularly for those listed in the Euronext 100 index during the period from 2008 to 2012. Conversely, Chen Chen and Shelving (2019) contended that tax planning has a significant and adverse relationship with enterprise value. These findings align with investors' apprehensions regarding the moral hazard risks associated with taxation. Through tax planning initiatives, corporations may realize sustained tax savings and an increase in firm value.

In Africa, a significant number of companies engage in tax planning practices and behaviors that are influenced by their understanding of tax-related knowledge. Research conducted by Kawor and Kportorgbi (2019) indicates that, within the African context, tax planning has a notable impact on the performance of non-financial corporations listed in Ghana. This finding is predicated on the assumption that shareholders should acknowledge the tax savings generated from tax planning initiatives. However, since these tax savings alone do not sufficiently reduce the agency costs between shareholders and management, the evidence supports the notion that tax planning incurs agency costs. Oyeyemi and Babatunde (2016) contend that for companies in Nigeria to capitalize on existing legal loopholes and enhance their value, they must engage in aggressive tax planning strategies. Nevertheless, the challenges confronting the tax systems in many developing nations, including Nigeria, have led to the implementation of various approaches aimed at alleviating tax burdens (Akinyomi & Okpala, 2019; Omesi & Appah, 2021). Taxation significantly affects a firm's investment, financing, and overall value. A high tax burden can hinder a firm's investment capabilities and productive potential by limiting the availability of financial resources (Fagbemi, Olaniyi & Ogundipe, 2019). When financing investment opportunities through debt, companies benefit from tax deductions on interest payments, whereas financing through equity results in taxes being levied on dividends, thereby creating a scarcity of financial resources for the organization (Gabriel & Gimenez, 2018; Nekasa, Namusonge & Makokha, 2019).

In Kenya, Wachira (2019) suggested that companies enhance their value through various strategies, including improvements in core business operations, cost reduction, and management of legal tax obligations. Kamau, Mutiso, and Ngui (2022) contended that tax avoidance and planning significantly affect the practices of creative accounting within the Kenyan context. Conversely, Karioki (2017) noted a weak correlation between firm value and tax planning, indicating that tax planning strategies for savings may be ineffective. The performance of the banking sector in Kenya is affected by several factors, including high operational costs and excessive taxation, such as double taxation (Kenya Association of Manufacturers, 2021). In response to these challenges, the Kenyan government has proposed various tax incentives for the sector. Nevertheless, the effects of these taxation measures on the firm value within banking studies remain inadequately explored.

The relationship between tax planning and firm value can be examined from two perspectives. The first perspective indicates that effective tax planning enhances after-tax profits, which is a matter of concern for shareholders (Wahab & Holland, 2019). The second perspective posits that tax planning is intricate and may create opportunities for managerial misconduct. Such behavior could result in a decline in firm value if managers engage in underreporting accounting profits and are incentivized to reduce corporate income tax liabilities by misrepresenting taxable income. Tax planning is essential in guiding corporations' strategic decisions and actions that aim to create value (Mgammal, 2020). The tax expenses incurred by a business can be considerable, thereby placing a significant strain on the financial performance and overall valuation of organizations.

Enterprises have the opportunity to strategically reorganize their operations and activities to enhance their tax benefits (Feng, Habib, & Tian, 2019). The main aim of tax planning is to reduce the overall tax liability. Furthermore, as noted by Christina and Alexander (2019), effective tax planning is essential for ensuring that funds generated from taxable activities are utilized in productive investments, thereby promoting business growth. Through tax planning, companies can lower their tax liabilities by judiciously applying allowable deductions as per tax regulations. It is imperative, however, that these strategies are executed in accordance with legal standards to mitigate the risk of tax-related disputes (Kiesewetter & Manthey, 2017). Christina (2019) asserts that tax planning options are accessible to businesses of all sizes and in various jurisdictions. The financial documentation of a company serves as an indicator of its tax planning efforts. The relationship between tax, accounting, and finance underscores the necessity for strategic corporate tax planning to achieve positive financial results as reflected in the organization’s financial statements.

Taxes serve as a fundamental instrument of fiscal policy in the oversight and regulation of any economy (Nwaobia, Kwarbai, & Ogundajo, 2016). Zhu, Mbroh, Monney, and Bonsu (2019) assert that taxes are employed to foster economic growth and to promote investment activities. Omesi and Appah (2020) emphasized that taxes represent a primary source of revenue for governments globally. They contended that taxes are mandatory contributions from individuals within a society to the state, governed by the jurisdiction of the government, aimed at generating revenue to support economic growth, stabilize the economy, redistribute income, promote fairness and equity, ensure fiscal responsibility and accountability, and provide national goods and services (Omesi & Appah, 2020).

Mais and Patmininingih (2017) assert that taxpayers play a crucial role in fostering the growth and development of any economy. Nevertheless, taxpayers often perceive tax payments as a burden, leading them to exploit various tax provisions to reduce their corporate income tax obligations. This reduction in tax liability can be accomplished through strategic tax planning. Mappadang (2019) notes that the primary aim of tax planning is to lower taxable income. Corporate tax planning encompasses the strategies employed by company managers to minimize the corporate tax owed (Appah, 2019). Uchendu, Ironkwe, and Nwaiwu (2016) describe tax planning as involving strategies aimed at decreasing a company's corporate tax liability and optimizing the timing of tax payments to avoid penalties. Nwaobia, Kwarbai, and Ogundajo (2016) suggest that effective corporate tax planning can reduce the effective tax rate to below the statutory rate. They further contend that such tax planning practices positively influence the cash flow of companies, thereby enhancing their after-tax rate of returns.

Adegbie, Akintoye, and Isiaka (2019) indicated that the value of a firm can be assessed through accounting-based metrics, including return on assets, return on equity, price-to-earnings ratio, and price-to-book ratio. In contrast, market-based indicators typically utilize Tobin’s Q, which is calculated as the sum of total assets and the market value of ordinary shares, minus the book value of ordinary shares and deferred tax, all divided by total assets. Tobin's Q serves as a measure of firm value, reflecting management's effectiveness in asset management. The resulting value illustrates the investment opportunities available to the firm and its potential for growth (Adegbie, Akintoye & Isiaka, 2019; Hidayat et al., 2019).

The annual report from the Central Bank of Kenya (CBK) for 2022 indicates that there are currently 42 commercial banks operating in Kenya. Among these, 28 are domestically owned, while 14 are owned by foreign entities. Notably, of the 28 Kenyan-owned banks, only 11 are publicly traded and listed on the Nairobi Securities Exchange (NSE). To ensure the longevity and sustainability of these commercial banks, maintaining a positive net income is essential. The commercial banking sector represents the largest segment of the financial industry in the country, necessitating close scrutiny to ensure compliance with established laws and regulations. Recently, a series of significant financial and regulatory reforms have been implemented to enhance the operations of commercial banks in Kenya. These reforms have led to substantial improvements, thereby optimizing the functioning of these institutions (CBK, 2021).

2. STATEMENT OF THE PROBLEM

Kenyan commercial banks have faced a multitude of significant challenges in recent years, including a liquidity and credit crisis, the failure of certain banks, interbank bail-out schemes, and the need for recapitalization, alongside serious management issues exemplified by the cases of Chase and Imperial banks (CBK, 2022). Trend analyses reveal a general decline in the values of Torbin’s Q from 2019 to 2022, averaging a decrease of 5%. The exposure to credit risks has resulted in a reduction in credit lending, with the Central Bank of Kenya (CBK, 2020) reporting a decline in average lending from 12.47% in 2019 to 11.89% in 2020, while deposit rates also fell from 7.19% in 2019 to 6.86% in 2020. According to the CBK Report (2022), banks began with stable Torbin’s Q values in 2020, which decreased by over 5% throughout 2021 and 2022. Tax planning has emerged as a significant factor in enhancing the firm value of banks; however, the specific impact of tax planning practices on the firm value of commercial banks in Kenya remains largely unexplored.

3. LITERATURE REVIEW

Theoretical Literature Review

Hoffman’s Tax Planning Theory

Geert Hofstede introduced the Tax Planning Theory in 1980. According to Hofstede's (1980) Tax Planning Theory, effective tax planning can greatly influence a company's financial performance and overall value. The theory posits that engaging in tax planning can enable a firm to lower its tax obligations, enhance its after-tax earnings, and boost its financial performance and value. A fundamental premise of Hofstede's Tax Planning Theory is that companies undertake tax planning initiatives to minimize their tax liabilities and optimize their after-tax profits.

Hoffman (1961) posits that the primary objective of tax planning is to redirect funds that would ordinarily be allocated to tax authorities towards business enterprises. Engaging in activities that minimize taxable income to the greatest extent possible, without compromising accounting income, is beneficial in the context of tax planning. This concept is founded on the principle that a company's tax liabilities are calculated based on the lowest taxable income achievable, without jeopardizing its accounting revenue. The assertion is rooted in the understanding that it is taxable income, rather than accounting income, that dictates the tax obligations of a business. Consequently, the aim is to enhance strategies that reduce taxable income while leaving accounting profits unaffected.

The concept acknowledges a positive relationship between a company's tax planning activities and its overall performance. Hoffman (1961) further identified the significance of tax costs in tax planning efforts. Consequently, this concept posits that there exists a beneficial correlation between corporate performance and tax planning, based on the premise that the advantages of tax planning outweigh the associated tax costs. The validity of Hoffman's tax planning hypothesis does not negate the influence of dynamic tax planning on market performance. As the capital market evolves and the separation of ownership and corporate governance becomes more pronounced, the need for a comprehensive understanding of tax planning becomes crucial. An empirical approach emphasizes the necessity of practical application over theoretical considerations (Inger, 2012). This framework will guide the overarching objective of the study concerning tax planning and its impact on firm value.

Hofstede's Tax Planning Theory posits that effective tax planning can enhance a firm's financial performance and overall value. By minimizing tax obligations and maximizing after-tax earnings, tax planning contributes to improved financial outcomes, thereby making the firm more appealing to investors and elevating its market value. Furthermore, by lowering tax liabilities, tax planning can release capital that can be reinvested into the business, further bolstering its financial health and value.

This research on tax planning and its impact on firm value is based on the Hoffman tax planning theory, which was introduced by Hoffman in 1961, as referenced by Akintoye, Adegbie, and Iheme-Onyeka (2020). According to Fagbemi, Olaniyi, and Ogundipe (2019), this theory is particularly significant in contexts where there is a necessity to minimize corporate income tax without negatively influencing accounting income. Ogundajo and Onakoya (2016), along with Akintoye, Adegbie, and Iheme-Onyeka (2020), highlighted that Hoffman identified various complexities and gaps within tax legislation, attributing these to concealed intentions. They concluded that effective tax strategies, executed with accurate legal interpretations and adherence to tax laws by corporations, can yield tax savings. Abdul-Wahab and Holland (2012), Abdul-Wahab (2016), and Akintoye, Adegbie, and Iheme-Onyeka (2020) noted that Hoffman articulated four principles of tax planning: the complexity of tax planning, the multiple benefits it offers, the improper utilization of tax planning, and the general unawareness of its advantages among individuals. Furthermore, Hoffman (1961) asserted that tax planning can only be effectively maintained for a limited time if the practices employed are not adaptable to evolving tax management strategies (Akintoye, Adegbie, & Iheme-Onyeka, 2020; Abdul-Wahab, 2016). Consequently, this theory advocates for the implementation of tax planning strategies by organizations, provided that such actions comply with applicable tax regulations. This theory is pertinent to the current study as it suggests that corporate entities that exploit the gaps in tax legislation while maintaining optimal leverage, thereby benefiting from tax shields on deductible interest, are likely to decrease their tax liabilities and enhance their post-tax income.

Empirical Literature Review

Mwaluku (2022) investigated the impact of tax planning on the value of manufacturing firms listed on the Nairobi Securities Exchange over a decade, from 2010 to 2019. The research specifically aimed to assess the effect of asset tangibility on the firm value of these manufacturing entities, analyze the role of leverage in influencing firm value, and determine the impact of the effective tax rate on the firm value of manufacturing firms listed on the Nairobi Securities Exchange. The study was grounded in three theoretical frameworks: the pecking order theory, agency theory, and political power theory. A longitudinal research survey was utilized, employing panel least squares analysis for data evaluation. The study's population comprised all 13 manufacturing companies within the manufacturing, construction, and allied sectors of the Nairobi Securities Exchange as of December 2020. Given the limited number of firms, a census approach was implemented, eliminating the need for sampling. The findings revealed that physical assets had a positive, albeit statistically insignificant, effect on firm value, while the effective tax rate demonstrated a positive and statistically significant influence on firm value.

Kirkpatrick and Radicic (2020) investigated the impact of tax planning strategies on the value of publicly listed companies in the United Kingdom. The research utilized the market value of equity per share as the dependent variable, while the independent variables included the effective tax rate, calculated as tax expense divided by pre-tax profit, long-term debt per share, and tax per share, which was derived from annual income tax divided by the number of ordinary shares. The study analyzed a sample of 70 large firms from the UK FTSE 100 over a five-year period from 2000 to 2010. The static panel data analysis conducted in the study indicated a positive and statistically significant correlation between tax per share and firm value. Conversely, the effective tax rate exhibited a positive relationship with firm value, although it was statistically insignificant. It is important to note that the research was specific to the United Kingdom, and its findings may not be applicable to the Kenyan context. Additionally, as the study was conducted over a decade ago, there is an opportunity to extend the research to include more recent data.

Vu and Le (2021) utilized the effective tax rate as an indicator of tax planning to investigate its impact on the value of publicly listed companies in Vietnam from 2015 to 2019. Additionally, the research explored the moderating role of state control in the relationship between tax planning and firm value. The effective tax rate, serving as the independent variable, was calculated as the ratio of total tax to earnings before tax. Conversely, state control, acting as the moderator, was assessed based on the proportion of state equity holdings relative to total equity shares. Firm value, the dependent variable, was measured using the Tobin’s Q ratio, which was derived from the formula: total assets minus book value of equity plus market value of equity, divided by total assets (Vu & Le, 2021). The study was grounded in two theoretical frameworks: agency theory and political power theory. Employing a longitudinal research design, the researchers applied pooled ordinary least squares to evaluate the proposed relationships. A purposive sampling method was used to select 513 non-financial firms listed on the Vietnam Securities Exchange over the five-year period. Secondary panel data was sourced from the stock market regulatory authority in Vietnam. The findings indicated that tax planning negatively affected firm value, with this relationship being exacerbated by state ownership.

Timothy, Izilin, and Ndifereke (2020) conducted a study on corporate tax planning, board compensation, and firm value in Nigeria, covering the years 2008 to 2015. The research utilized an ex post facto design. The population for the study included non-financial firms, excluding those in the oil and gas sector, that are listed on the Nigerian Stock Exchange (NSE). A sample of 71 firms was selected from this population for the analysis period. Data was sourced from the published financial statements of the sampled firms. The dependent variable identified was return on assets, while the independent variable was the effective tax rate, with firm size and leverage serving as control variables. The secondary data was analyzed using both descriptive and inferential statistical methods, including correlational and regression analyses. The findings indicate a positive and significant relationship between tax planning practices and the value of listed non-financial firms in Nigeria.

Chukwudi, Okonkwo, and Asika (2020) conducted a study on the relationship between tax planning and the value of firms listed in the consumer goods sector on the Nigerian Stock Exchange, covering the years 2009 to 2018. The research utilized an ex post facto design, focusing on the entire consumer goods sector, with a sample consisting of twenty-one companies. Data for this analysis were sourced from secondary information derived from the published financial statements of the selected firms. The collected data were examined through both descriptive and inferential statistical methods, with the inferential analysis being based on a panel multiple regression model. The findings indicated that tax planning, as measured by the effective tax rate, has a negative and significant impact on firm value, whereas the book tax difference exhibited a positive and significant effect on firm value.

Izevbekhai and Odion (2018) conducted a study to explore the relationship between tax planning and firm value, utilizing a sample of 87 companies listed on the Nigerian stock exchange from 2010 to 2016. The research relied on secondary panel data derived from the financial statements of these firms, resulting in a balanced panel comprising 609 firm-year observations. Tax planning was operationalized through the effective tax rate, while firm value was represented by the Tobin’s Q ratio. Additionally, capital intensity, defined as the ratio of tangible non-current assets to total assets, was included as a control variable. A fixed effects model was employed to estimate the coefficients. The study's findings indicated that the effective tax rate, as a measure of tax planning, exhibited a negative but statistically insignificant relationship with firm value. Furthermore, the moderating effect of capital intensity was also determined to be insignificant.

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4. RESEARCH METHODOLOGY

The research employed a mixed methodology that incorporated both explanatory and correlational research approaches. The target population for this investigation comprised 11 banks that are listed on the NSE. As a census study, it encompassed all 11 banks listed on the NSE. The analysis utilized panel regression, which integrated both time series and cross-sectional data. The information for all variables under study was sourced from the financial statements and annual reports of the commercial banks listed, covering the period from 2014 to 2022 on the NSE. The data were organized and presented in tables and figures. Throughout the data analysis, various diagnostic tests were conducted, including pre- and post-estimation tests. These tests encompassed stationarity tests, normality tests, multicollinearity tests, and heteroskedasticity tests for both fixed and random effect models.

5. FINDINGS

Table 1 presents descriptive statistics concerning essential variables associated with tax planning and the value of firms among commercial banks listed on the Nairobi Securities Exchange. The dataset, derived from 99 observations covering the period from 2014 to 2022, includes information on firm value. Each variable is detailed with respect to its minimum, maximum, mean, and standard deviation.

Table 1: Effective Tax Rate

	Obs	Minimum	Maximum	Mean	Std. Deviation
Effective Tax Rate	99	.0045	.6515	.4934	4.2363
	99				

The effective tax rate exhibits a considerable range, spanning from a low of 0.0045 to a high of 0.6515, with an average of 0.4934. The standard deviation of 4.2363 reflects a significant level of variability in effective tax rates among the banks. This pronounced variability may stem from variations in tax planning approaches, levels of profitability, or distinct tax regulations that apply to different banking institutions. The average effective tax rate indicates that, generally, banks endure a considerable tax burden; however, the extensive range and elevated standard deviation underscore notable differences in the tax implications for various banks. The considerable variability in effective tax rates aligns with the observations made by Vu and Le (2021), who noted that tax planning could adversely affect firm value, especially when influenced by state ownership. In contrast, research by Timothy et al. (2020) and Chukwudi et al. (2020) identified a positive and significant correlation between tax planning and firm value, although the significance of this relationship was context-dependent. This indicates that while effective tax rates can impact firm value, the nature and extent of this impact can differ significantly based on the context, including the regulatory framework and specific tax strategies adopted by the banks.

Random Effect Regression Analysis Results

The main aim of this research was to examine the influence of effective tax rate on the value of firms within the commercial banking sector listed on the Nairobi Securities Exchange. To fulfill this aim, and considering that the assumptions of classical linear regression were upheld, along with the Hausman specification test confirming the suitability of the Random Effects Model (REM), the study employed the REM linear regression model. For the analysis, Stata statistical software was used to evaluate pooled panel data consisting of 99 observations, which represented 11 commercial banks over an 11-year timeframe. The findings are detailed in Table 4.7, where firm value, indicated by Tobin's Q ratio, was regressed against leverage, effective tax rate, and asset tangibility.

Table 2: Random Effects Regression Model

Tobins Q	Coef.	Std. Err.	Z	P>|z|	[95% Conf.	Interval]
Effective tax rate	850.593	373.965	2.27	0.000	106.520	1594.666
_cons	-2.601	5.985	-0.43	0.665	-14.168	9.315
R squared	0.729					
Adjusted R-Square	0.569					
Prob > chi2	0.001					

The Model adopted was; Tobins Q = -2.601+ **850.593**$\mathbf{X_1}$ **+ ε**

The hypothesis was evaluated through a Random-effects Regression Model, which indicated that the Effective Tax Rate (ETR) possesses a coefficient of 850.593, accompanied by a standard error of 373.965, a z-statistic of 2.27, and a p-value of 0.000. Given that the p-value is below the significance threshold of 0.05, it implies that the Effective Tax Rate exerts a statistically significant positive influence on firm value. As a result, the study rejected the null hypothesis (HO1), confirming that there is a notable effect of the Effective Tax Rate on the firm value of commercial banks listed on the NSE.

6. CONCLUSIONS

The study concludes that favorable tax rates allow commercial banks to retain more profits, leading to higher dividends and reinvestment opportunities, which can boost market valuation. Investors favor profitable banks, potentially increasing stock prices. Banks with lower taxes gain a competitive edge, enabling them to offer better interest rates on loans and deposits, thus expanding their market share and improving customer acquisition and retention. Additionally, efficient tax rates enhance banks' risk management capabilities, as they can invest in advanced systems to mitigate losses, making them more attractive to investors and increasing their valuation.

7. RECOMMENDATIONS

The study recommends that banks can review their corporate structures to ensure they are taking advantage of available tax incentives, deductions, and credits. This includes assessing the benefits of holding companies, subsidiaries, and joint ventures. Banks should actively seek out and apply for any available tax holidays or exemptions offered by the Kenyan government, particularly for investments in specific sectors or regions. Banks can explore issuing bonds or other financial instruments that offer tax advantages to investors, thereby attracting more capital while optimizing their tax positions.

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