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**TAX INCENTIVES AS AN ANTECEDENT OF FINANCIAL
PERFORMANCE OF RIVATEX EAST AFRICA LIMITED, KENYA**

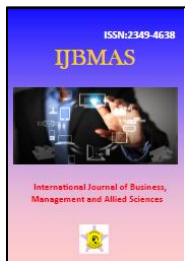
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ABSTRACT

The overall objective of this research article was to; determine the effect of tax incentives on firms' financial performance. The specific objectives were to; find out the effect of Investment Deduction on a firms' financial performance; determine the effect of Wear and Tear Allowance on a firms' financial performance. Investment Deduction, Wear and Tear Allowance were the indicators for the independent variable while Return on Assets was the proxy for the dependent variable. A positivism research philosophy and a longitudinal research design were used to guide the study. The results were; Investment Deduction had ($\beta = 1.126$, $\alpha = 0.000$, $p < .01$) implying that Investment Deduction had a significant effect on firms' financial performance and Wear and Tear Allowance had ($\beta = .128$, $\alpha = .363$, $p > 0.01$). This implies that wear and tear allowance had no significant effect on firms' financial performance. The study concluded that Investment Deduction positively affects firms' financial performance. Wear and Tear allowance does not significantly affect firms' financial performance. The study recommended that Rivatex East Africa limited should prepare at all times the statement of taxation using the most appropriate tax rates.

Keywords: Tax Incentives, Return on Assets, Wear and Tear Allowance, Investment Deduction

1.0 Introduction

Tax burden is a nightmare to majority of firms in any given economy. The main object of tax incentives is to reduce the tax burden of firms in order to induce them to invest in particular portfolios. Tax incentives in any tax regime may include, reduced tax rates on profits, tax holidays, accounting rules that allow accelerated depreciation and loss carry forwards for tax purposes, and reduced tariffs on components, raw materials and imported equipment or increased tariffs to protect the domestic market. Empirically countries that are offering tax incentives have benefited through transfer of technology, non-economic gains from industrialization, creation of jobs and an increase in tax revenues [5].

Scholarly works of Gruber [6] postulates that investment decisions are fairly sensitive to tax incentives and tax policy is a powerful proponent in determining investments flow. According to Mbuthia [14], for Burundi, at least 81 billion Burundian Francs has been lost to companies or officials, who have been given tax exemptions to import goods, build infrastructure and instead sold on the materials. In Tanzania, revenue losses from tax incentives given in 2014/15 were likely to be around US\$790 million. In Kenya, the amount of revenue lost through tax incentives is likely to be near the KShs100 billion. In Ugandan, the amount is likely to be around US\$370 million. In Rwanda, estimates suggest that Rwanda is losing between Rwandan frank 87 billion and Rwf123 billion a year. Kenya, Tanzania, Uganda and Rwanda could still be losing around \$1.5 billion and possibly up to \$2 billion a year through the granting of corporate tax incentives to foreign companies.

Kenya around US\$1.1 billion, Rwanda up to US\$176 million and Uganda loses around US\$370 million. This amounts to, total revenue losses that would amount to up to \$2 billion a year [10]. Attempt to address impediments to market growth has necessitated the Government of Kenya to implement not less than twenty fiscal and tax incentive measures. Relevant institutional and market infrastructure reforms have been put in place to enable capital markets to play a significant role in economic growth [4]. Despite all this, KRA report of 2009 opined that about Kshs 220.8 billion was lost between the years 2003-2009 as a result of granting of investment incentives whose results remains intangible. Past studies on tax incentives have not been holistically conducted to separate doubts from the commonly known truths. It matters that whenever the government is giving tax incentives and those incentives are not improving performance of firms in the textile industry, then the government is wasting public resources.

1.1 Statement of the Problem

Kiarie [9] posits that Kenya loses more than Sh100 billion annually on tax incentives to multinationals. Concessions extended are aimed at attracting more foreign direct investment. The report points out that in 2008/9, the Government gave away Sh10.3 billion in generalized investment promotion incentives, about Sh10 billion in incentives for exporters and about Sh5.7 billion through special economic zones. Halakhe Waqo, Ethics and Anti-Corruption Commission chief executive posits that Kenyans ought to whistle blow on corruption activities and demand accountable and transparent services. A firm might have utilized all the tax incentives in reducing its tax burden but the savings not transformed into corporate financial benefit. There are a few studies that have been done on effect of tax incentives in Kenya more specifically on financial performance of Textile Firms.

Tembur [17] researched on the effect of tax incentives on financial performance of firms operating in Export processing zones. He recommended that studies needed to be carried out on the effect of tax incentives on financial performance of firms that are listed at the Nairobi Stock Exchange. This study addresses the recommendations made by Tembur [17] by focusing on Rivatex East Africa Limited. The main intent of this research article was to analyze the effect of tax incentives on financial performance of Rivatex East Africa limited. The study was further guided by the following specific objectives; to find out the effect of Investment Deduction on a firms' financial performance and to determine the effect of Wear and Tear Allowance on a firms' financial performance. The remainder of this article paper is organized as follows. Section 2 covers review of past studies and define the main hypotheses. Section 3 covers materials and methods; section 4, results and discussion; section 5, conclusion; section 6, recommendations; section 7, acknowledgements; references followed by the tables.

2.0 Review of Past Studies

2.1 Concept of Financial Performance

Liargovas and Skandalis [11] defines financial performance as the level of performance of a business over a specified period of time, expressed in terms of overall profits and losses during that

time. Decision makers can judge the results of business strategies and activities in objective monetary terms if they evaluate the financial performance of a business. Financial performance is a subjective measure of how well a firm generates revenues and can use assets from its primary mode of business. Abor [1] argued that there are many different ways to measure financial performance, but all measures should be taken in aggregation. Return on equity, liquidity ratios, asset management ratios, profitability ratios, leverage ratios and market value ratios are some of the indicators of financial performance.

The popular ratios that measure organizational performance can be summarized as profitability and growth: return on asset, return on investment, return on equity, return on sale, revenue growth, market shares, stock price, sales growth, liquidity and operational efficiency [2]. This study conclusively assessed whether tax incentives has increased or reduced cash inflows of Rivatex East Africa Limited. Return on Assets was used because it provides a measure for assessing the overall efficiency with which the assets are used to produce net income from operations. It also indicates management's effectiveness in deploying capital, because it is certainly possible to be efficient and yet poorly positioned in terms of how capital is being utilized. Return on Assets, is calculated by dividing profit after tax and interest by total assets. Which can be interpreted as a ratio of income to its total assets. The single best overall measure of operating performance is probable the Return on Assets. It ties together the results of operations with the resources used to produce those results. It is also relatively easy to interpret.

2.2 Rivatex East Africa Limited

One of the leading textile manufacturing industries in Kenya is Rivatex East Africa Limited. It which was developed to process the cotton wool available in Kenya to various cotton products. This manufacturing industry is located on Kip Karen road in Eldoret and it is a Research, Product Development, Extension and Production facility of Moi University whose purpose is to enhance the capacity of training more students on industrial techniques, and to facilitate industrial research for staff and students. As a manufacturing industry, they manufacture textile products made from fiber through the weaving process. This manufacturing industry aims at upholding honesty, integrity, maintaining the efficiency in production and services delivery at all times, and courtesy in all actions as well as comply with all relevant legislation, legal requirements and set procedures. As a manufacturing industry, they ensure that they attach great importance to the contribution by all, build sustainable relationships and share the success of the company with all who contribute to it involving the farmers who provides the raw materials.

They also observe human rights and equality for all while respecting the dignity of individuals, attach great importance to team work and consultative approach management as they remain committed to fulfilling the company's goals and objectives and the same shall take precedence over individual interests. Khanga, Kitenge for both men and women, Bed sheets, Flannel, Poplin, Drill, Dress materials, School Checks and uniforms which are sewed into different designs, Furnishings and Curtains, Suiting Materials as well as Shirting materials are the most popular products that Rivatex East Africa Limited. Rivatex East Africa Limited also manufactures African Print Materials with African cultural designs and colors such as designs of Maasai dresses and much more cultural materials, Twill and Camouflage-like materials such as those for Military.

All the products that they manufacture are processed through the weaving procedure and technique. This industry also hosts an institute of higher learning which ensure that they train the students on the various techniques which they use in the manufacturing of the different products. This institute known as the Rivatex Institute of Science and Technology ensure that it equips the interested students with the necessary skills on the manufacture and processing of the products. The institution is equipped with all the tools and equipment used by the manufacturing industry in the

manufacturing processes and procedures for better learning and experimental purposes for the students of the Rivatex Institute of Science and Technology. Thorough analysis of the financial statements reveals that Rivatex East Africa Limited has been recording low profits and has also been recording losses.

2.3 Tax Incentives and Financial Performance

Uwaume and Ordu [15] researched on the impact of tax incentives on economic development in Nigeria between 2004 and 2014. The results were tax incentives enhanced economic development and recommended that the government should waive certain taxes on corporate bodies to help them mature especially at their early stage. Kohleer, Lareda and Rammer [9] did a study on the effect of fiscal incentives on research and development. The results were that tax incentives have a positive effect on business research & development expenditure. A study by Wachira [16] on effectiveness of tax incentives as an avoidance scheme by Kenya Airways found tax incentives to be effective and recommended that tax holidays and investments allowances and tax credits to be provided to employees as a motivational initiative. Lall [10] argues that in a survey of Taiwanese firms, only 8% of firms rated tax incentives as the single most government policy for promoting technological development, educating more research & development personnel (18.8%), coordinating firms to conduct joint research (18.6%) and introducing new technology from abroad (17.2%).

International Bank for Reconstruction and Development [7] did a survey on the effect of tax incentives on the performance of the economy. The study found that tax incentives devices that needed to be addressed included: development of the domestic market, balanced regional development, and reduction in unemployment, better utilization of existing capital, diversification of output, balance of payment consideration, and redirection of investment pattern. This in turn boosts performance of the economy. OECD [12] researched on tax incentives for investments in MENA and Non - MENA countries, the study established that generous tax incentives cannot compensate for poor business environment. Where there is a lack of good infrastructure such as transport, unreliable and expensive electricity supply and poor education, economic growth is bound to be very slow and most tax incentives offered will mainly erode the tax base, resulting in low tax revenues rather than increase the flow of investments to a country.

Mauritius, Costa Rica, Ireland and Malaysia are examples of countries which were able to attract investments without giving tax breaks and instead focused on ensuring stable economic and political conditions a well educated labor force, good infrastructure, open trade for exporters, dependable rule of law, and effective investment promotion systems to attract investors. Barbour [3] assessed South Africa's investment incentive regime on performance with a focus on the manufacturing sector. The results observed that there was a significant relationship between tax incentives and performance. Musyoka [13] studied the relationship between tax incentives and foreign direct investment in Kenya. The study found that there was no significance improvement in foreign direct investment as a result of implementing tax incentives in Kenya. This study was guided by the following research hypotheses;

H₀₁: Investment deduction has no significant effect on a firms' financial performance

H₀₂: Wear and tear allowance has no significant effect in a firms' financial performance

3.0 Materials and Methods

Research philosophy can simply be defined as a belief about the way in which data about a phenomenon should be gathered, analyzed and used. For this study, a positivism research philosophy was adopted. The choice for the positivism research philosophy is supported by the principle underlying this philosophy. According to the principles of positivism, the philosophy depends on quantifiable observations that lead themselves to statistical analysis. It is noted that

positivism is in accordance with the empiricist view that knowledge stems from human experience. This principle conforms to the nature of the study in that it deals with the quantifiable observations. With regard to the progression of this study, it was guided by the hypotheses in attempt to show the association between independent variable and dependent variable.

All these attributes of the study apply for the positivism research philosophy hence its choice as the ideal research philosophy. This study employed longitudinal research design. Secondary data was the main source of data. A time frame of eight years was considered (2009-2016). Investment Deduction was operationalized as (investment deduction / total capital deductions) and wear and tear allowance (wear and tear allowance / total capital deductions). A Statistical Package for Social Science (SPSS 24.0) was used for analysis. Data was analyzed using inferential statistics. Regression analysis was performed on the data to test any effect of tax incentives (independent variable) on a firm's financial performance (Dependent variable). Multiple linear regression equation was as elucidated below;

$$ROA = \beta_0 + \beta_1x_1 + \beta_2x_2 + e$$

Where; Return on Assets (net income / average total assets).

X_1 = Investment Deduction (investment deduction / total capital deductions).

X_2 = Wear and Tear Allowance (wear and tear allowance / total capital deductions).

4.0 Results & Discussions

4.1 Tax Incentives and Financial Performance

Karl Pearson product moment correlation was used to assess for association between dependent variable (ROA) and the independent variables (Wear and Tear allowance, Investment Deduction) before conducting regression analysis and the results were as follows; both wear and tear allowance and investment deduction had a significant relationship with Return on Assets with a p value of 0.000, 0.003 respectively at 1% level of significance. The results are as tabulated in Table 4.1 as shown in section 9.0 of this research article.

4.2 Regression Analysis

Multiple regression analysis is a powerful technique used for predicting the unknown value of a variable from the known value of two or more variables. In this case, multiple linear regression analysis helped predict financial performance from Wear and Tear allowance and Investment Deduction allowance. The results of beta coefficient are .128 and 1.126 for Wear and Tear Allowance and Investment deduction respectively. Implying that a unit change in Wear and Tear allowance and Investment Deduction influenced .128 and 1.126 changes in ROA respectively as shown in Table 4.2:

4.2.1 Analysis of variance

Analysis of variance is a statistical technique which measures the differences in means, in this study it was between financial performance and its predictor variables. The results are shown in the table 4.3. The value of F- statistic was 1.801 at 2 degrees of freedom. At 99% confidence level the effect size of the regression model is significant ($p=0.000$) indicating that financial performance can be predicted from investment deduction and wear and tear allowance. From the results in Table 4.4, $R = .999$, $R \text{ square} = .999$, $\text{adjusted } R \text{ Square} = .998$, and the standard estimate error = .01789. R coefficients indicate the degree of linear relationship of performance in Rivatex East Africa limited with the predictor variables, whereas the coefficient of determinations R square shows the provision of the total variation in financial performance as explained by the independent variables, wear and tear allowance, and investment deduction in the regression equation. The adjusted R square gives us the coefficient of determination indicating that the independent variables explains 99.8% change in financial performance as shown in Table 4.4:

The study had proposed the null hypothesis H_01 : Investment deduction has no significant effect on firms' financial performance. The effect was found to be significant ($p < 0.01$). The hypothesis was therefore rejected implying that investment deduction has a significant effect on firms' financial performance. The beta coefficient of 1.126 implies that investment deduction explained 1.126 change in firms' financial performance. The one hundred percent capital allowance applied on machinery used in manufacturing translates into improved financial performance of Rivatex East Africa Limited.

The 150% capital allowance on manufacturing exceeding two hundred million set up outside Nairobi results into increased incomes for manufacturing firms. The 100% capital allowance on industrial building used for manufacturing increases a firms' financial performance. This study is an agreement with the findings of Uwaume and Ordu [15] who carried out a study to establish the impact of tax incentives on economic development in Nigeria from years 2004 to 2014. They found sufficient tax incentives enhanced industrial growth and recommended the government waive certain taxes on corporate bodies to help them mature especially at their early stage. The study had also proposed the null hypothesis H_02 : Wear and Tear allowance has no significant effect on a firms' financial performance. The relationship was found to be insignificant ($p > 0.01$). This null hypothesis was therefore accepted implying that wear and tear allowance has no significant effect on a firms' financial performance. The beta coefficient of .128 implies that wear and tear allowance explained 12.8% change in firms' financial performance. The rate of 37.5% applied on Lorries above three tones and trucks does not translate into significant profits. 30% rate applied on computers, photocopiers and scanners does not significantly improve firms' performance. Motorbikes, Lorries under three tones at 25% and telephone sets at 12.5% does not significantly improve a firms' financial performance. The results concur with those of OECD [12] who established that generous tax incentives cannot compensate for poor business environment.

5.0 Conclusion

Investment deduction tax incentive positively affects firms' financial performance. All companies that incur capital expenditure on the construction of a building and on the purchase of and installation of new machinery enjoy this tax incentive. Investment deduction is used for the following ancillary purposes such as generation, transformation and distribution of electricity; clean up and disposal of effluents and other waste products; reduction of environmental damage; water supply or disposal and for the maintenance of the machinery. Wear and Tear allowance positively affects firms' financial performance although not statistically significant. The tax rates that are applied on the various items that fall under this category do not translate into significant profits for Rivatex East Africa Limited.

6.0 Recommendations

Rivatex East Africa limited should ensure they prepare the statement of taxation using the most appropriate tax rates. The above mentioned statement of taxation will provide guideline in the implementation of all the tax incentives and hence better financial performance. From the findings of this study, wear and tear allowance and investment deduction tax incentives explained only 99.8% change in financial performance. This implies that there are other tax incentives that account for the remaining 0.2% change in financial performance. A further research should be conducted to evaluate the effect of tax incentives on financial performance of all manufacturing firms listed at the Nairobi Stock Exchange. The study should identify other tax incentives that affect financial performance of the manufacturing firms.

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Table 4.1: Correlation Statistics

		Wear and tear Allowance	Investment Deduction	Return on Assets
Wear and Tear Allowance	Pearson Correlation	1		
	Sig. (2-tailed)			
	N	8		
Investment Deduction	Pearson Correlation	-1.000**	1	
	Sig. (2-tailed)	.000		
	N	8	8	
Return on Assets	Pearson Correlation	-.894**	.894**	1
	Sig. (2-tailed)	.003	.003	
	N	8	8	8

** . Correlation is significant at the 0.01 level (2-tailed).

Table 4.2: Coefficients Analysis

Model		Coefficients			t	Sig.
		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta		
1	(Constant)	- 1.386	.324		- 4.274	.008
	wear and tear allowance	.333	.333	.128	1.000	.363
	investment deduction	2.849	.323	1.126	8.817	.000

a. Dependent Variable: Return on Assets

Table 4.3: ANOVA

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	1.153	2	.576	1.801E3	.000 ^a
	Residual	.002	5	.000		
	Total	1.154	7			

a. Predictors: (Constant), investment deduction, wear and tear allowance

b. Dependent Variable: Return on Assets

Table 4.4: Regression Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.999 ^a	.999	.998	.01789	1.250

a. Predictors: (Constant), investment deduction, wear and tear allowance

b. Dependent Variable: Return on Assets