

**APPLICABILITY OF TAX PREFERENCE THEORY FOR COMPANIES LISTED IN
THE NAIROBI SECURITIES EXCHANGE.**

BY

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DECLARATION

I, declare that this project is my original work and has not been submitted for the award of a degree in any other university.

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DEDICATION

I dedicate this project to my parents, Mr. & Mrs. Mburu, for the patience and support they have accorded to me during this period. It has been one long journey, which you have made bearable.

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ABSTRACT

The aim of this study was to determine applicability of tax preference theory for companies listed in the Nairobi securities exchange (NSE). The study was anchored on the following study objectives; to establish the effect of taxes on the supply of dividends in the listed companies, to establish the effect of taxes on capital gains in the listed companies, to establish how taxes affect firm value among the listed companies , and also to establish how tax advantages of capital gains over dividends predispose investors among the listed companies. The research used both descriptive and quantitative research design. The target population constituted all companies quoted at the NSE for the period of five years from 2008 to 2012. The study used both primary and secondary data collection methods. An inferential statistical technique was also used to analyze the data. The data from the field was analyzed by use of statistical packages for social sciences (SPSS). The study concluded that tax is an important determinant in the financial performance of companies listed in the Nairobi Securities Exchange. The financial performance of the companies is linked to taxation through dividend tax rate, capital gains tax rate, and corporate tax rate. Dividend tax rate influences the dividends that the firms pay to the shareholders. Capital gains tax rate and corporate tax rate affects the value of the firm and they also affect final dividend paid to the shareholders. Implementation of policies that increases dividend tax rate, capital gains tax rate, and corporate tax rate lead to decreased financial performance of companies listed in the Nairobi Securities Exchange. Higher taxes on capital hinder the growth of investment and capital stock. The decrease in capital reduces economic growth which, in turn, lead to higher unemployment and reduced personal income.

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CHAPTER ONE

INTRODUCTION

1.1 Background to the study

The M&M assumption of a perfect capital market excludes any possible tax effect. It has been assumed by Modigliani and Miller that there is no difference in tax treatment between dividends and capital gains. However, in the real world taxes exist and may have significant influence on dividend policy and the value of the firm. In general, there is often a differential in tax treatment between dividends and capital gains, and, because most investors are interested in after-tax return, the influence of taxes might affect their demand for dividends (Taliercio, 2004).

1.1.1 The concept of dividends

Collins et al (2005) define dividend as the portion of net income paid out to shareholders. It is paid in cash and/or stock for making investment and bearing risk. Dividend decision of the firm is yet another crucial area of financial management as it affects shareholders wealth and value of the firm. The percentage of earning paid out in the form of cash dividend is known as dividend payout ratio Shiller (2005). A company may retain some portion of its earnings to finance new investment. The percentage of retained in the firm is called retention ratio. Dividend policy is an integral part of the firm's financing decision as it provides internal financing. Dividend policy is concerned with determining the proportion of firm's earnings to be distributed in the form of cash dividend and the portion of earnings to be retained (Goetzmann, 2005).

A firm has three alternatives regarding the payment of cash dividends: it can distribute all of its earnings in the form of cash dividends; it can retain all of its earnings for reinvestment and it can distribute a part of earnings as dividend and retain the rest for reinvestment purpose (Omran &

Pointon, 2004). When dividends are paid to the stockholders the firm's cash is reduced. A firm may decrease its dividend payout and use the retained funds to expand its capacity, to pay off some of its debt or to increase investment (Moyi, 2003). In this way, the firm's dividend policy is closely related with the firm's investment and financing decisions. Determining the part of earnings to be distributed as dividends is a key decision that affects the value of firm's common stock in the market place (Poterba, 2004). Similarly, the retained earnings are considered to be the most convenient internal source available for financing corporate growth. Thus, every corporate firm should establish and implement an effective dividend policy that leads the firm to stockholders wealth maximization (Lippert et al 2003).

Under most corporate tax laws, corporate income is taxed twice: first when corporations earn it and then again when it is distributed to shareholders. In general, dividend distributions are more heavily taxed than capital gains. Capital gains face lower statutory taxes, are taxed at the time of realization rather than when they accrue, and enjoy the tax-free step-up on the basis of bequeathed assets (Fama and French, 2002). Conditional on investment opportunities firms should, therefore, either retain profits and allow shares to appreciate, or distribute earnings to investors in the form of share repurchases. Corporations should never pay dividends. Nonetheless, firms have traditionally paid a large share of their profits out as dividends (Black, 2005).

1.1.2 The concept of capital gains

The investopedia defines capital gains as the profits that an investor realizes when he or she sells the capital asset for a price that is higher than the purchase price (Investopedia). Most nations have top capital gains tax rates that are much lower than their top rates on ordinary income.

Some policymakers globally think that a reduced rate for capital gains is an unjustified tax preference (Rees, 2005). Taxing of capital gains upon realization creates numerous problems. One problem is “bunching,” which means that realizations often come in a transitory spike, such as the one-time sale of a family business. The spike may push a taxpayer into a higher tax bracket than usual, which is unfair because the gain may represent years of modest accrued gains. This is one reason that some countries use a low, single rate to tax gains, rather than the normal graduated tax rate structure (Taliencio, 2004).

Another problem is “lock-in,” which occurs when taxpayers delay selling investments that have large unrealized gains in order to avoid the immediate tax hit. Lock-in induces people to hold assets longer than optimal, and they may forgo diversification opportunities because they are stuck in current investments (ibid).

Capital gains lock-in reduces market efficiency. It interferes with the crucial economic activity of people shifting their funds from lower- to higher-yielding investments. Economic growth is synonymous with economic change, and thus growth is dependent on capital being moved from older to newer uses. Capital gains taxes create a barrier to that beneficial movement. In a study of capital gains tax policy, the OECD found that ameliorating lock-in was a main concern of tax policy officials in its member countries (OECD, 2006). Most countries have responded to the lock-in problem by implementing a reduced effective tax rate on individual capital gains.

1.1.3 Concept and development of the tax preference (M&M) theory

Modigliani and Miller in 1961 rattled the world of corporate finance with the publication of their paper: Dividend Policy, Growth, and the Valuation of Shares in the Journal of Business. They proposed an entirely new view to the essence of dividends in determining the future value of the

firm. As such, they argued that subject to several assumptions, investors should be indifferent on whether firms pay dividends or not. The 1961 paper was a sequel to the 1958 paper in which they argued that the capital structure of a firm is irrelevant as a determinant factor its future prospects (Zhou & Ruland, 2006).

The M&M theorem holds that capital gains and dividends are equivalent as returns in the eyes of the investor. The value of the firm is therefore dependent on the firm's earnings which result from its investment policy and the lucrativeness of its industry. When a firm's investment policy is known (its industry is public information), investors will need only this information to make an investment decision (Stulz, 2000).

The theory further explains that investors can indeed create their own cash inflows from their stocks according to their cash needs regardless of whether the stocks they own pay dividends or not. If an investor in a dividend paying stock doesn't have a current use of the money availed by a particular stock's dividend, he will simply reinvest it in the stock. Likewise, if an investor in a non-dividend paying stock needs more money than availed by the dividend, he will simply sell part of his stock to meet his present cash need (Zhou & Ruland, 2006).

1.1.4 History of the Nairobi Securities Exchange (NSE)

The Nairobi Securities Exchange, formally Nairobi Stock Exchange, was founded in 1954 and operates in Kenya Shillings. It has a total of 60 listed companies to date but only begun with the listing of 20 companies (www.nse.co.ke). It was constituted as a voluntary association of stock brokers under the Society's Act. In the period February 1994, the NSE was rated by the International Finance Corporation (IFC) as the best performing market in the world with a return of 179 per cent in dollar terms (Wikipedia). This is no mean achievement. Capital Markets

Authority (CMA) is the body mandated with the regulation of stock exchange market in Kenya and was established on 15th December 1989 under an Act of Parliament (Cap 485 A) of the laws of Kenya under the Ministry of Finance. The CMA is a regulatory body charged with the prime responsibility of supervising, licensing and monitoring the activities of market intermediaries which includes the stock exchange market. The most crucial role played by this regulatory authority is to facilitate the allocation and mobilization of capital resources in order to fund long-term investments. All the regulatory and supervisory powers of the CMA emanate from the Capital Markets Act. It is therefore an important player in the stock exchange market since it provides the guidelines upon which players in this market operate.

The stock exchange market performs a number of roles. It is the channel through which investors or members of the public can be able to save their money. The economy generates a lot of money which would otherwise be in banks or other financial institutions and therefore it is through the stock market that this money can be made productive. The investment function is one of the chief roles played by the stock market. A number of various shares are available here and it is up to persons to identify those that interest them and so invest in them. Portfolio diversification is a common practice in this market where investors invest their monetary resources in a myriad of investments. Other functions of the stock market include: Allocation of capital, Mobility of capital, Accessibility to finance, Accounting, resource management and the transparency in business management, Facilitation of corporate governance, Wealth redistribution & a unit of measure of the economy

1.2 Research Problem

Target dividend payouts have traditionally been explained as a function of the growth and earnings prospects of each particular firm and its associated industry, taking investors' preferences as given. This is puzzling because even if dividend policy were irrelevant to firm value (Pérez-González, 2003), the tax treatment of dividends relative to capital gains for most investors and the common charter restrictions faced by institutions would generate tax clienteles: institutions and individuals holding high and low payout stocks, respectively.

Despite the numerous studies based on different dividend theories (Arnott & Asness 2003; Farsio et al 2004 and Nissim & Ziv 2001) that have been done, dividend policy remains an unresolved issue in corporate finance. Several theories have been proposed to explain dividend policy, but there has not been a universal agreement (Stulz, 2000; Pandey, 2003; DeAngelo et al., 2006). Researchers Amidu (2007), Lie (2005), Zhou & Ruland (2006), Howatt et al. (2009), continue to come up with different findings about the relationship between dividend payout and firm performance. A study by Amidu (2007) revealed that dividend policy affects firm performance as measured by its profitability. The results showed a positive and significant relationship between return on assets, return on equity, growth in sales and dividend policy. Howatt et al. (2009) also concluded that positive changes in dividends are associated with positive future changes in earnings per share. In contrast, Lie (2005) argues that there is limited evidence that dividend paying firms experience subsequent performance improvements.

A number of studies (Arnott & Asness 2003; Farsio et al 2004 and Nissim & Ziv 2001) have been done with regard to dividend policy and firm performance, especially in developed economies. Can the findings of those studies (Aivazian et al., 2001 and Al-Haddad, et al., 2011)

be replicated in emerging economies or infant capital markets? In Kenya, few empirical studies have been done to establish the relationship between dividend payout and firm performance. Particularly, a study is yet to be done on the applicability of the tax preference theory on firms, either listed on the NSE or not. This study therefore comes in to fill the void by establishing whether the M&M tax preference theory is applicable among the firms listed in the NSE, and to what extent at that.

1.3 Objectives of the Study

To investigate the applicability of tax preference theory for companies listed in the Nairobi Securities Exchange. Which primarily includes?

1. To establish the effect of taxes on the supply of dividends in the listed companies
2. To establish the effect of taxes on capital gains in the listed companies
3. To establish how taxes affect firm value among the listed companies
4. To establish how tax advantages of capital gains over dividends predispose investors among the listed companies

1.4 Value of the Study

The knowledge from this study will be of great importance to the following groups:

To the listed companies

The study findings will benefit management and staff of the listed companies under study, by gaining insight into how their companies can effectively harness their dividends and capital gains to enhance their financial performance. Management can gain the best policies for applications.

To Academicians

The research will provide valuable information regarding the NSE listed companies in Kenya. Being upcoming entrepreneurs the academicians will be furnished with relevant information regarding dividends and capital management and the tax preference theory. It will contribute to the general body of knowledge and form a basis for further research in other sectors.

To Regulatory Bodies

Regulatory bodies can use this study to improve on the framework for regulation of companies in Kenya. The results of this study will also assist policy makers and regulators to implement new set of policies and regulations regarding dividend and working capital taxation in the companies.

To Investors

This study will be of use to security analysts, financial analysts, stock brokers and other parties whose knowledge of the relationship between taxation and dividend and capital gains is important input into investment analysis and portfolio construction.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter focuses on theoretical framework, previous studies done by various authors as well as a conceptual framework in relation to the applicability of the Tax Preference Theory among the manufacturing companies listed in the Nairobi Securities Exchange.

2.2 Theoretical framework

There are various dividend theories that have been put across by academicians (Stulz, 2000; Pandey, 2003; DeAngelo et al., 2006). The theories view dividends as either relevant or irrelevant in making financial decisions. This section reviews the tax preference theory as developed by Modigliani and Miller in 1961.

2.2.1 The tax preference theory

The tax preference theory developed by Modigliani & Miller (1961) provides that in an ideal world, the total market value of all the assets issued by a firm is determined by the risk and return of the firm's real assets, not by the mix of issued securities (the capital structure). Modigliani & Miller proved that, in a theoretical world, neither the capital structure nor the dividend policy affected the value of the firm. That is, they showed that the choice of one particular capital structure or dividend policy over another is irrelevant for the shareholders of the firm. Basically, the management of the firm should focus on other more important problems such as where and in what the firm's funds should be invested. In an ideal M&M world there are no taxes, no transaction costs and no information asymmetry (DeAngelo et al., 2006).

The ideology behind the theorem is that the investor, i.e. the stockholder, can simulate any capital structure on her own and the firm therefore has no reason to dwell on this. If the investor is highly indebted, herself, the risk and return of the firm's stock (to the investor) will simply be the same as if the firm, itself, was highly leveraged (indebted). This finding, together with the observation that a more leveraged firm (a firm with relatively more debt) not only returns a higher expected return to the investor, but also a higher risk is the center piece of the Modigliani & Miller theorem (Al-Kuwari, 2009).

The M&M assumption of a perfect capital market excludes any possible tax effect. It has been assumed by Modigliani and Miller that there is no difference in tax treatment between dividends and capital gains. However, in the real world taxes exist and may have significant influence on dividend policy and the value of the firm. In general, there is often a differential in tax treatment between dividends and capital gains, and, because most investors are interested in after-tax return, the influence of taxes might affect their demand for dividends (Amidu, 2007).

The tax-preference hypothesis suggests that low dividend payout ratios lower the cost of capital and increase the stock price. By extension, low dividend payout ratios contribute to maximizing the firm's value. This argument is based on the assumption that dividends are taxed at higher rates than capital gains. In addition, dividends are taxed immediately, while taxes on capital gains are deferred until the stock is actually sold. These tax advantages of capital gains over dividends tend to predispose investors, who have favorable tax treatment on capital gains, to prefer companies that retain most of their earnings rather than pay them out as dividends, and are willing to pay a premium for low-payout companies (Farsio et al., 2004).

Another important tax consideration is that in an estate situation; where an heir is entitled to shares after the death of a benefactor, no capital gains taxes will be due from the heir in such a situation.

The tax preference theory (Stulz, 2000) argues that in a capital market where there are no imperfections such as taxes, transaction costs, asymmetric information and agency costs, the dividend policy of a company is irrelevant for the market value of its shares. It therefore implies that financial managers cannot alter the value of their firms by changing their dividend policy. They showed that firm value is enhanced by investing in productive assets and not by the way in which income is distributed to shareholders (Stulz, 2000). According to their theory, dividend policy is therefore irrelevant and a rational investor does not have a preference between dividends and capital gains. Several researchers have come up to oppose the theory developed by Miller and Modigliani stating that it does not apply in the real world where there are a lot of imperfections (Dhanani, 2005)

This argument is based on two assumptions. The first is that there is no tax disadvantage to an investor to receiving dividends, and the second is that firms can raise funds in capital markets for new investments without bearing significant issuance costs. The proponents of the second school feel that dividends are bad for the average stockholder because of the tax disadvantage they create, which results in lower value (Omran, 2004). Finally, there are those in a third group who argue that dividends are clearly good because stockholders (at least some of them) like them and react accordingly when dividends are increased. Although dividends have traditionally been considered the primary approach for publicly traded firms to return cash or assets to their stockholders, they comprise only one of many ways available to the firm to accomplish this objective. In particular, firms can return cash to stockholders through equity repurchases, where

the cash is used to buy back outstanding stock in the firm and reduce the number of shares outstanding. In addition, firms can return some of their assets to their stockholders in the form of spinoffs and split-offs (Juma'h, 2008).

The underlying intuition for the theory's proposition is simple. Firms that pay more dividends offer less price appreciation but must provide the same total return to stockholders, given their risk characteristics and the cash flows from their investment decisions. Thus, if there are no taxes, or if dividends and capital gains are taxed at the same rate, investors should be indifferent to receiving their returns in dividends or price appreciation (DeAngelo et al., 2006).

For this argument to work, in addition to assuming that there is no tax advantage or disadvantage associated with dividends, various researcher argue that the following also have to be assumed: There are no transaction costs associated with converting price appreciation into cash, by selling stock (Jiraporn, 2011). If this were not true, investors who need cash urgently might prefer to receive dividends; firms that pay too much in dividends can issue stock, again with no issuance or transaction costs, and use the proceeds to invest in good projects. Managers of firms that pay too little in dividends do not waste the cash pursuing their own interests (i.e., managers with large surplus cash flows do not use them to invest in bad projects). Consequently, the investment decisions of the firm are unaffected by its dividend decisions, and the firm's operating cash flows are the same no matter which dividend policy is adopted (Franklin, 2000).

One of the most commonly used models is the so-called dividend model of share prices, based on earnings that the shareholder gains on his share (Morisset, 2001). That model is based on discounted (dividend) earnings based on shareholding when the shareholder's rate of return is changing. It is presumed that private investors buy future dividends when they buy a share and

then a share is worth only what an investor can get out of it. The market establishes share prices by discounting an anticipated stream of future dividends. Models based on that assumption are, for instance, Walter's (1956) model and Gordon's (1959, 1962, 1966) model.

Researchers have different views about whether dividend payout materially affects the long term share prices. Dhanani, (2005) who used a survey approach to capture managerial views and attitudes of corporate managers regarding dividend policy found that dividend policy serves to enhance corporate market value. However, Farsio et al., (2004) argues that empirical studies that conclude a causal relationship exists between earnings and dividends are based on short periods of time and are therefore misleading to potential investors. Therefore, dividends have no explanatory power to predict future earnings. This research therefore tries to establish whether a relationship exists between dividend payout and firm performance.

A popular view suggests that in the presence of asymmetric information, dividends are valuable signals of firms' prospects (Omran, 2004). Dividends may also limit insiders' dissipation (Juma'h, 2008). Alternatively, they may be preferred because they may have lower transaction costs relative to capital gains or because investors view income from dividends differently than income from capital gains. A more recent theory by Allen, Bernardo and Welch (2000) shows that when institutional investors are relatively less taxed on dividends than individuals, and are better able to monitor firms than dispersed owners, firms can use dividends to attract institutional investors: their presence serves as either a signal of firm quality (in an asymmetric information case) or as a commitment that firms will be adequately managed (in an agency case). Yet, all these theories, suggest that firms should weigh the non-tax benefits of dividends against the increased tax burden for investors (DeAngelo et al., 2006).

Despite the double taxation at the investor level, alternative models suggest that personal taxes should not affect firms' dividend decisions. The "tax irrelevance view" (Jiraporn, 2011) posits that all taxes can be effectively laundered, and therefore, they should not influence dividend decisions. Alternatively, the "new view" of dividend taxation assumes that dividends are paid as a residual or profits minus investments, and that investments are entirely financed by retained earnings, which in turn are not subject to personal taxation (Frankfurter, 2000). Therefore, the residual is not directly affected. Dividends are only indirectly affected by personal taxes when they change the marginal incentive to invest. For example, higher personal income tax rates reduce the returns on interest income and make investment more attractive, reducing dividend payouts. Empirically, the predictions of the "traditional view" or the double taxation view and the "new view" are hard to separate (Franklin, 2000).

2.3 Empirical review

Although Poterba and Summers (2004) identify tax effects on dividend decisions, their analysis has several shortcomings. First, tax analysis on aggregate dividend payments is subject to time trends, such as economy-wide shocks that may be correlated with the enactment of tax reforms. Second aggregate analysis may hide large responses to taxes at the micro level; for example, tax induced dividend increases that are overshadowed by non-tax driven dividend reductions. Third, these results may be special to the U.K., where share repurchases were explicitly prohibited, but less relevant in other settings; and finally, their analysis does not investigate whether agency considerations are important for firms' decision-making.

Pettit (2003), Collins et al (2005) and Shiller (2005) used survey data to find evidence supporting the tax clientele story that dividend yields are negatively correlated with marginal income taxes.

However Lippert (2003) found very little evidence of this hypothesis. Alternatively, Garrett & Priestley (2000) attempted to identify tax clienteles indirectly using the variation in the price of stocks around ex-dividend dates.

Ohlson (2003) reviewed and synthesized the theory of security valuation for multiple date settings with uncertainty. The theory results in a formula that determines security value as a function of expected dividends adjusted for their risk and discounted by the term structure of risk-free rates. Models such as CAPM is only seen in special cases. Earnings are seen as an information variable that suffices to determine a security's payoff, price plus dividends¹⁰. Ohlson postulates that only (anticipated) dividends can serve as a generally valid capitalization (present value) attribute of a security.

Goetzmann–Jorion (2005) re-examined the ability of dividend yields to predict long-horizon stock returns. He used two series beginning in 1871 (up to 1993), a monthly series for the United States, and an annual series for the United Kingdom. As a result, dividend yields only display marginal ability to predict stock market returns in either country.

Dempsey (2007) advanced a discounted dividend model of share prices in the context of personal taxation. In terms of the model, consistent costs of capital expressions are advanced relating investor and firm perspectives. Rees (2005) analysed a sample of 8,287 firms/years drawn from UK industrial and commercial sectors during the years 1997–2004. The evidence strongly suggests that earnings distributed as dividends have a bigger impact on value than do earnings retained within the firm.

In Finland Torkko (2004) tested the application of Gordon's model. The sample was 23 firms from the years 1996–2003 but the results were not very encouraging. Suvas (2004) tested, in his

dissertation, Gordon's new model, as well as the models of Malkiel–Cragg (1970) and Bower–Bower (1970). Martikainen (2002) studied 28 Finnish companies listed on the Helsinki Stock Exchange during 1994–2001 and found significant positive correlation between the dividend growth rate and stock market returns.

According Korhonen (2007) the Helsinki Stock Exchange seems to be in the category of informational weak-form efficiency by nature. Berglund (2000) and Virtanen–Yli-Olli (2005), tested Korhonen's results. Korhonen (2007) and Berglund–Liljeblom–Wahlroos (2007) have studied semi strong-form efficiency in Finland. In testing strong-form efficiency, Korhonen also tested how the market reacted to various dividend informations such as stock dividends, dividends and new issues of stock.

Berglund–Liljeblom–Wahlroos (2007) extended the results obtained by Korhonen by using daily data. They found significant positive excess returns on the announcement day for stock dividends and mixed announcements of stock dividends and new issues. For new issues, the announcement day return was insignificant, although a slightly positive preannouncement price development was detected.

According Charitou–Vareas (2003) the relationship between cash flows and dividend changes substantially depends on the magnitude of total accruals and on growth opportunities as proxies by the firm's market-to-book ratio. Assuming stock markets to be informationally efficient, they should rather lead than lag accounting earnings. Fama (2005) discovered that real stock market returns lead economic variables and are not led by them.

The results from these studies show that the efficiency of the Finnish stock market is not especially high compared with other stock markets in the world. According to Martikainen (1989), there exists evidence on anomalies from market evidence even in the weak-form sense.

Pérez-González (2003) investigated whether firms' dividends are determined by the preferences of their large shareholders. The results show that dividends respond to the tax preferences of large shareholders. More specifically, he investigated the impact of U.S. personal income taxes on dividend policy by comparing the dividend payments of firms whose large shareholders were affected by personal income tax reforms (individuals) to a control group whose large shareholders were unaffected. Results show that dividend payouts increased as the tax disadvantage of dividends relative to capital gains fell after the 1986 tax reform, and decreased as dividends became relatively less attractive, but only for firms whose large shareholders were affected by these tax reforms. The inclusion of firm fixed effects, year and industry controls, as well as controls for observable firm characteristics, does not affect the estimated results.

A study by Zhou & Ruland (2006) revealed that high dividend payout firms tend to experience strong future earnings but relatively low past earnings growth despite market observers having a contradicting view. The findings of another study done by Arnott & Asness (2003) also revealed that future earnings growth is associated with high rather than low dividend payout. They concluded that historical evidence strongly suggests that expected future earnings growth is fastest when current payout ratios are high and slowest when payout ratios are low. Their evidence contradicted the view that substantial reinvestment of retained earnings would fuel faster future earnings growth. Their study was done to investigate whether dividend policy of the U.S. equity market portfolio, forecasts future earnings growth. The study comprised companies in the S&P 500 which tend to be large and well established firms in advanced economies (Zhou

& Ruland, 2006). Empirical studies need to be done in developing capital markets or for newly listed companies which tend to be, less profitable and more growth oriented.

Arnott & Asness (2003) suggested that the positive relationship between current dividend payout and future earnings growth is based on the free cash flow theory. Low dividend resulting in low growth may be as a result of suboptimal investment and less than ideal projects by managers with excess free cash flows at their disposal. This is prominent for firms with limited growth opportunities or a tendency towards over-investment. Paying substantial dividends which in turn would require managers to raise funds from issuance of shares, may subject management to more scrutiny, reduce conflicts of interest and thus curtail suboptimal investment (Arnott & Asness, 2003). This is based on the assumption that suboptimal investments lays the foundation for poor earnings growth in the future whereas discipline and a minimization of conflicts will enhance growth of future earnings through carefully chosen projects. Therefore, paying dividends to reduce the free cash flows enhances the performance of a company since managers will have less cashflows thus avoiding suboptimal investments. This is also consistent with the agency cost theory.

Another explanation by Arnott & Asness (2003) for the positive relationship between dividend payout and growth in future earnings is that managers are reluctant to cut dividends. A high payout ratio indicates management's confidence in the stability and growth of future earnings and a low payout ratio suggests that management is not confident of the stability of earnings or sustainability of earnings growth (Arnott & Asness, 2003). Managers therefore pay low dividends to avoid dividend cuts when earnings drop. The positive relationship is also driven by sticky dividends combined with mean reversion in more volatile earnings (Arnott & Asness, 2003). The temporary increases and decreases in earnings subsequently reversed cause the

payout ratio to be positively correlated with future earnings growth. Their robustness check for the mean reversion of earnings suggested that earnings seem to revert to the mean but may revert most strongly in terms of their ratio to dividends.

A study by Dhanani (2005) revealed that dividend policy is important in maximizing shareholder value. A firm's dividend policy can influence one or more of imperfections in the real world such as information asymmetry between managers and shareholders; agency problems between managers and shareholders; taxes and transaction costs and in turn, enhance the firm's value to shareholders (Dhanani, 2005). In an imperfect market setting, dividend can influence shareholders' wealth by providing information to investors or through wealth redistribution among shareholders (Travlos et al., 2001; Adesola & Okwong, 2009).

Malcolm and Wurgler (2004) demonstrate that firms design dividend policy in response to shareholders' preference for dividends. Certain shareholders may have a preference for cash dividends, others for dividend stability and others would prefer capital gains earned through reinvestment of dividends and thus no cash dividends. This may be explained by the bird in hand fallacy as investors may deem dividends a more current and certain return than capital gains (Amidu, 2007 & Howatt et al., 2009).

Individual investors' tax preferences may also influence their dividend preferences. Investors afraid of higher taxes are likely to prefer low or no dividend payouts in an attempt to reduce their taxable income thus preferring capital gains (Howatt et al., 2009). In Kenya dividends are taxed at 5% as a final tax for individuals while capital gains tax are tax exempt (Income Tax Act, 2010). Firms that meet the needs of individual investors are more likely to be able to command a higher share price premium and thus an enhanced firm value. However, Amidu (2007) argues

that, if investors migrate to firms that pay the dividends that most closely match their needs, no firm's value should be affected by its dividend policy.

A 2006 study by the Kenya Institute of economic studies reviewed tax revenue performance as well as tax design and administration changes during the period 1996 - 2005 in order to identify priorities for further tax reform. Empirical analysis revealed the adverse effect of inflation on tax revenues. The tax structure is less buoyant and possibly inelastic although indirect taxes, and not direct taxes, hold the capacity to improve the flexibility of the tax system. The challenges that confront tax design include taxation of agriculture and the informal sector, repeal of tax holidays, high effective protection, high dispersion of tariff rates, detailed and rigid custom rules, poor response of VAT to reforms, weak capacity to process large volumes of returns and refunds for zero-rated transactions. They add that Kenya's tax system is burdensome in terms of time taken to prepare and submit tax returns.

The study concludes that further tax reforms should give priority to the following areas: first, taxation of the informal sector by designing simplified registration processes and giving the sector treatment other than that provided by the current methods and tax code. Second, there should be a policy shift towards internationally acceptable investment incentives such as accelerated depreciation for qualifying manufacturing assets. Third, tax productivity should be improved through simplifying the tax structure and reducing the tax rates, reviewing cumbersome custom procedures and enhancing the tax monitoring function.

Murekefu & Ouma (2012) sought to establish the relationship between dividend payout and firm performance among listed firms in the Nairobi Securities Exchange. Regression analysis was carried out to establish the relationship between dividend payout and firm performance. The

findings indicated that dividend payout was a major factor affecting firm performance. Their relationship was also strong and positive. This therefore showed that dividend policy was relevant. They conclude that dividend policy is relevant and that managers should devote adequate time in designing a dividend policy that will enhance firm performance and therefore shareholder value.

2.4 Conclusion for Literature Review

In summary, there are no detailed studies investigating the applicability of tax preference theory on firms. Previous empirical analysis on dividend taxation has concentrated on aggregate dividend payments and not in relation to the theory, and this literature has generally ignored tax preference considerations, in particular, the effect of taxes on the supply of dividends; the effect of taxes on capital gains; how taxes affect firm value as well as how tax advantages of capital gains over dividends predispose investors. The purpose of this study is to fill in this gap.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the research methods that the researcher will adapt to facilitate execution of the study to satisfy study objectives. These steps include; research design, population of interest, sample and sampling techniques, data collection instruments, procedures and data analysis.

3.2 Research Design

Research design is the plan and structure of investigation so conceived as to obtain answers to research questions. The plan is the overall scheme or program of the research (Robson, 2002). The main purpose of this research is to investigate the applicability of tax preference theory for companies listed in the Nairobi Securities Exchange. Therefore a descriptive research design is used to study the applicability of tax preference theory for companies listed in the Nairobi Securities Exchange.

The research will use both descriptive and quantitative research design. The major purpose of descriptive research is to provide information on characteristics of a population or phenomenon. Descriptive research will be used as a pre-cursor to quantitative research designs as it provides the general overview giving some valuable pointers as to what variables are worth testing quantitatively.

3.3 Population

A population is an entire group of individuals, events or objects having common characteristics that conform to a given specification (Mugenda & Mugenda, 2003). The population of interest in

this study constitutes all companies quoted at the NSE for the period of five years from 2007 to 2011. The study is limited to listed companies due to lack of readily available data from private companies not listed in NSE. Currently we have a total of eighteen (18) manufacturing firms listed in NSE.

3.4 Sample Design

The study is based on the firms listed on the Nairobi securities Exchange. Observations of firms with anomalies such as negative values in their total assets and current assets will be eliminated. In addition, only firms that have continuously traded over the period 2007 to 2011 will be considered in the study. Further observations of items from the statement of financial position and statement of comprehensive income showing signs contrary to reasonable expectations will be removed.

It's intended that the study will be a census survey in which all manufacturing firms listed at the NSE will be studied due to the manageable numbers involved. The firms that have merged and those that have been de-listed from the Nairobi Securities Exchange, due to any reason/restriction imposed by the regulators during the period under review will be ineligible for inclusion in the study. New incumbents in the market that have been newly listed at NSE will also not be included in the sample due to non-availability of past historical data.

3.5 Data Collection

Data collection is gathering empirical evidence in order to gain insights about a situation and answer questions that prompt undertaking of the research (Flick, 1998). Primary and secondary data are the types of data collection. Primary data is defined as firsthand information received

from a respondent while data that has been already collected and passed through the statistical process is secondary data (Chandran, 2004).

The study will use both primary and secondary data collection methods which will be obtained by use of structured questionnaires to be administered by the researcher as well as annual reports and other financial reports. Questions on the questionnaires will be framed towards addressing the study objectives and answering the research questions. The secondary data will be obtained from the reports and financial statements where the variables of interest will be obtained, in this case, going by the tax preference theory, capital gains, dividends and firm value.

3.6 Data analysis

The whole process which starts immediately after data collection and ends at the point of interpretation and processing data is data analysis (Cooper and Schindler, 2003). Chadran (2004) defines statistics as a discipline that provides the tools of analysis in research and one which refers to facts, information or data and to a system of data collection and analysis. After the fieldwork and before analysis all questionnaires will be adequately checked for reliability and verification. Quantitative analysis will be used. In quantitative analysis, descriptive statistics will be employed. This includes measures of central tendency, measure of variations and percentages. The data is presented using tables and figures. The textual data from the field will subjected to quantitative analysis by use of excel software.

Inferential statistical techniques will also be used to analyze the data. Multivariate regression Model based on Cross sectional pooled data from the annual reports and other financial statements to assess the applicability of tax preference theory for companies listed in the Nairobi Securities Exchange. As per the theory, variables of interest will include: Capital gain, dividends

and firm value as the independent variables against firms' financial performance as measured by their profitability, determined by the firms' Return on Equity as the dependent variable. The following regression model was adopted for the study:

$$y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + e$$

Where:

y = Financial Performance

β_0 = Constant Term

β_1 = Beta coefficients

X_1 = dividend tax rate

X_2 = capital gains tax rate

X_3 = corporate tax rate

e = the standard error

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATION

4.1 Introduction

This chapter presents the data presentation and analysis. The main objective of the study was to investigate the applicability of tax preference theory for companies listed in the Nairobi Securities Exchange. Specifically the study established the effect of taxes on the supply of dividends in the listed companies, the effect of taxes on capital gains in the listed companies, how taxes affect firm value among the listed companies and how tax advantages of capital gains over dividends predispose investors among the listed companies.

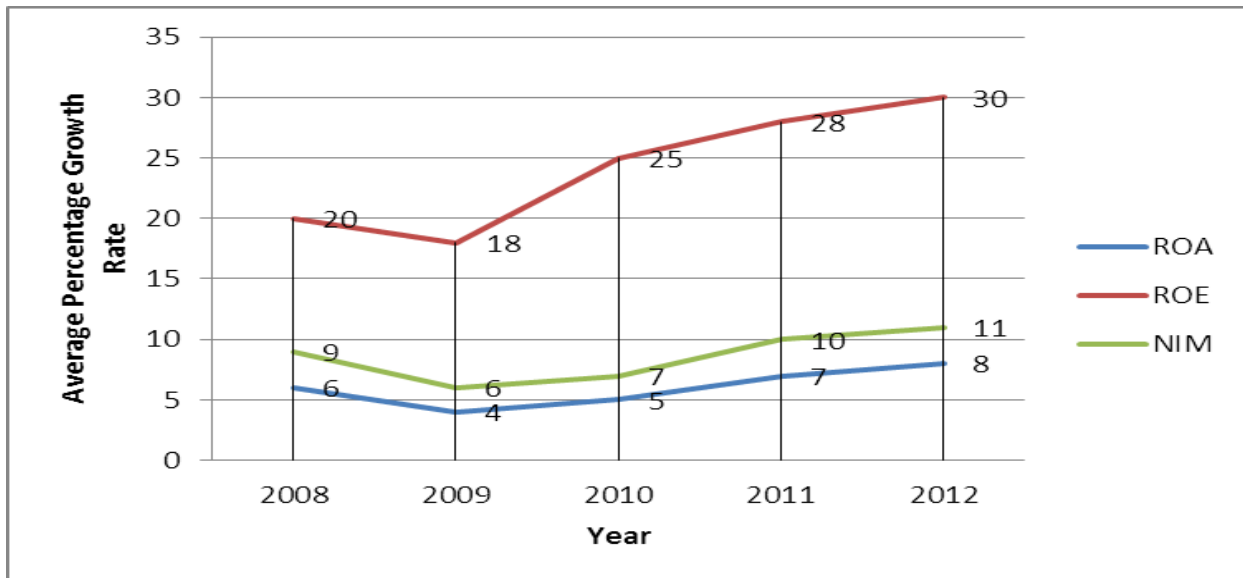
4.1.1 Reliability of the Data

The reliability of the data collected for the study was determined through ascertaining the reliability of the questionnaires used in data collection. Reliability was computed by determining the degree of consistency in responses elicited in the questionnaires. The Spearman rank order correlation (r), whose acceptable range of reliability lies between 0.600 and 0.900, was used to compute the reliability of the questionnaires in the study. The Spearman rank order correlation (r) was 0.826 indicating that questionnaires used were reliable and the data collected can be generalized to the entire target population.

4.2 Trend Analysis of Financial Performance of companies listed in the Nairobi Securities Exchange

This section presents the trend of the financial performance of companies listed in the Nairobi Securities Exchange in Kenya from 2008 to 2012. Figure 1 shows the trend of financial performance of companies listed in the Nairobi Securities Exchange in Kenya from 2008 to 2012 as expressed by Return on Asset (ROA), Return on Equity (ROE) and Net Interest Margin (NIM).

Figure 1: Trend in Financial Performance of companies listed in the Nairobi Securities Exchange



As can be seen from the above figure the trend of companies listed in the Nairobi Securities Exchange in Kenya has shown an erratic trend. In 2008 the average bank performance was 6, 20 and 9 as expressed by ROA, ROE and NIM respectively. In 2009 the above figures declined to 4, 18 and 6 respectively. Performance declined in 2009 may be because of the effect of global economic crisis and its effect on the domestic one. Again performance improved in

2010 after the recovery. Nevertheless, on average the performance of companies listed in the Nairobi Securities Exchange in Kenya has been increasing.

4.2.1 Description of financial of performance of companies listed in the Nairobi Securities Exchange

Table 1 below presents the average financial performance of companies listed in the Nairobi Securities Exchange as expressed by ROA, ROE and NIM for the year 2008 to 2012.

Table 1: Five years average Financial Performance of companies listed in the Nairobi Securities Exchange

	ROA	ROE	NIM
MEAN SCORE	6.0	24.2	8.6

As can be observed from the Table 1, the average ROA, ROE, NIM for the companies listed in the Nairobi Securities Exchange was 6.0, 24.2 and 8.6 respectively. The performances as expressed by the above ratios are average.

4.3 The effect of taxes on the supply of dividends in the listed companies

In order to establish any relationship between tax and dividend, the Pearson correlation coefficient was used in correlating the variables. Table 2 is the correlation table and shows that tax and dividend have a significant positive correlation (Pearson correlation coefficient 0.927).

Table 2: Correlation between tax and dividends

		Tax	Dividend
Tax	Pearson Correlation	1	0.912
	Sig. (2-tailed)		0.000
	N	18	18
Dividend	Pearson Correlation	0.912	1
	Sig. (2-tailed)	0.000	
	N	18	18

Foremost among the determinants of the dividends structure are the liquidity position of the company. This is a function of the profitability of the company. Organizations that have investment projects will rely on their after tax profit. Thus, the availability of more capital invested in alternate investment opportunity shapes what the dividend will eventually be paid.

The study established that the introduction of tax reforms in Kenya will lead to increase in the long-term capital gains tax rate. This will make retained earnings (capital gains) a less popular investment choice than distributed earnings (dividends). Companies responded to the change in the dividend tax rates by reducing dividend payments, and some would not disburse dividend payments. Investors now have fewer choices when making investment decisions between companies that pay dividends or rely on capital appreciation to reward investors.

The study found out that raising taxes on dividends also increases the double taxation of corporate income, as this dividend income was already taxed at the corporate level. This makes the tax code less fair and also discourages economic growth by raising the tax on capital.

Tax rate on capital gains and dividends makes an enormous difference in the way investors and firms handle income from capital. High tax rates on dividends also have a distorting effect. Firms retain earnings instead of paying them to stockholders. This reduces the influence of stockholders as firms seek funding from resources independent of the marketplace of investors. In short, high taxes on these two forms of income from capital have the same effect they exercise on other capital incomes: The marketplace for capital operates less efficiently and with less capital, the pace of economic growth slows, and the quality of investments diminishes.

4.4 To establish the effect of taxes on capital gains in the listed companies

Pearson correlation coefficient was used to establish the relationship between tax and capital gain. The study findings in Table 3 indicate that tax and capital gain have a significant positive correlation (Pearson correlation coefficient 0.931).

Table 3: Correlation between tax and capital gain

		Tax	Dividend
Tax	Pearson Correlation	1	0.931
	Sig. (2-tailed)		0.000
	N	18	18
Dividend	Pearson Correlation	0.931	1
	Sig. (2-tailed)	0.000	
	N	18	18

The study established that the termination of low tax rates on capital discourage investment and slow economic growth. The current long-term rate does not appear to discourage investors significantly from selling assets. However, high capital gains taxes in the new tax policy will

create what is called a "lock-in effect," where investors avoid onerous taxation by not selling assets. The respondents stated that a strong link exist between higher capital gains tax rates and the lock-in effect. Investors are willing to hold onto investments for a longer period of time in order to pay the lower taxes on long-term capital gains.

If high taxes make investors unwilling to sell taxable assets, the lock-in effect can reduce economic growth by preventing the reallocation of capital in low-performing investments to more profitable ventures. Economic growth slows as new businesses find it difficult to acquire start-up or expansion capital.

Though reducing the tax on capital gains is beneficial to the economy, a better tax policy would reduce the tax rate on all capital investment. A broad reduction in the taxation of capital will lead to more investment and more capital stock. The reductions in capital taxation increase the return on investment and therefore the formation of capital. The resulting increase in the capital stock yields greater output and higher incomes throughout much of the economy.

4.5 To establish how taxes affect firm value among the listed companies

Pearson correlation coefficient was used to establish the relationship between tax and firm value. The study findings in Table 4 indicate that tax and firm value have a significant positive correlation (Pearson correlation coefficient 0.906).

Table 4: Correlation between tax and firm value

		Tax	Dividend
Tax	Pearson Correlation	1	0.906
	Sig. (2-tailed)		0.000
	N	18	18
Dividend	Pearson Correlation	0.906	1
	Sig. (2-tailed)	0.000	
	N	18	18

The study established that as the corporate tax rate rises, the market value of a firm declines. On the one hand, the firm may want to raise more debt as the tax shields increase; on the other, the firm is financially constrained as a result of its declining market value. Consequently, corporate leverage may first increase and then decrease as the corporate tax rate rises.

The corporate tax rate changes can enhance stock prices most of the time, while there are cases in which the effects are neutral or even detrimental. The study findings revealed that these different results are caused by the current provisions that allow firms to carry their tax losses forward for seven years as well as the net balance on firms' tax deferred accounts. The study found out that firms' past and future profitability are crucial in identifying the exact threshold points to experience value changes or not.

The respondents were asked to indicate the extent to which tax affect Supply of dividends, Capital gains and firm value of the companies listed in the Nairobi Securities Exchange. The responses were rated on a five point scale whereby 1 represented No extent at all, 2 little extent, 3 moderate extent, 4 great extent, and 5 great extent. Mean and standard deviations were calculated as shown in Table 5.

Table 5: The extent to which tax affect supply of dividends, capital gains and firm value

Statement	Mean (x)	Standard Deviation
Supply of dividends	4.062	0.2472
Capital gains	4.167	0.2215
firm value	4.056	0.2114

The response with a mean close to 1 denotes No extent at all, 2 little extent, 3 moderate extent, 4 great extent, and 5 great extent. Standard deviation less than 1.000 denotes little dispersion of the responses in the given continuum (1 to 5). From the study findings in Table 5, majority of the respondents said that tax affect supply of dividends, capital gains and firm value to great extent as dented by $x=4.062$, $S.D=0.2472$; $x=4.167$, $S.D=0.2215$; and $x=4.056$, $S.D=0.2114$ respectively.

4.6 Regression Analysis

The researcher performed a regression analysis to establish the association between the independent variables with the dependent variables of the study. The following regression model was adopted for the study:

$$y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + e$$

Where:

y = Financial Performance

β_0 = Constant Term

β_1 = Beta coefficients

X_1 = dividend tax rate

X_2 = capital gains tax rate

X_3 = corporate tax rate

e = the standard error

4.6.1 Strength of the model

Analysis in table 6 shows that the coefficient of determination (the percentage variation in the dependent variable being explained by the changes in the independent variables) R^2 equals 0.843, that is, dividend tax rate, capital gains tax rate, corporate tax rate explains 84.3% of observed change in financial performance. The P- value of 0.000 (Less than 0.05) implies that the regression model is significant at the 95% significance level.

Table 6: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.918(a)	.843	.805	.51038	.843	1.242	4	96	.000

Predictors: (Constant), dividend tax rate, capital gains tax rate, corporate tax rate

Dependent Variable: financial performance

Source: Researcher 2013

Table 7: ANOVA

	Sum of Squares	df	Mean Square	F	Sig.
Regression	.852	4	.213	1.242	.000
Residual	20.35	119	.171		
Total	22.64	123			

Predictors: (Constant), dividend tax rate, capital gains tax rate, corporate tax rate

Dependent Variable: financial performance

Source: Researcher 2013

ANOVA findings (P- value of 0.00) in table 8 shows that there is correlation between the predictors variables (dividend tax rate, capital gains tax rate, corporate tax rate) and response variable (financial performance)

Table 8: Coefficients of Regression Equation

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)					
Dividend tax rate	-.016	.028	.018	1.021	.031
Capital gains tax rate	-.035	.021	.013	1.115	.015
Corporate tax rate	-.034	.023	.105	1.157	.016

a. Dependent Variable: Financial Performance of companies listed in the Nairobi Securities Exchange

The established multiple linear regression equation becomes:

$$Y = 0.903 - 0.016X_1 - 0.035X_2 - 0.034X_3 + 0.028$$

Constant = 0.903, shows that if all the independent variables (dividend tax rate, capital gains tax rate, corporate tax rate) are rated as zero, financial performance of companies listed in the Nairobi Securities Exchange would be 0.903.

The level of confidence for the analysis was set at 95%. Therefore, the P- value less than 0.05 imply that the independent variable is significant. The regression results show that financial

performance of companies listed in the Nairobi Securities Exchange is influenced by dividend tax rate ($p=0.031$), capital gains tax rate ($p=0.015$), and corporate tax rate ($p=0.016$).

The independent variables in the regression model with negative coefficient have an inverse relationship with the dependent variable. Therefore, financial performance of companies listed in the Nairobi Securities Exchange increases with decrease in dividend tax rate, capital gains tax rate, and corporate tax rate.

4.7 Summary of the Study Findings

The study established that companies listed in the Nairobi Securities Exchange in Kenya have shown an erratic trend in financial performance over the five year period (2008-2012). In 2008 the average bank performance was 6, 20 and 9 as expressed by ROA, ROE and NIM respectively. In 2009 the above figures declined to 4, 18 and 6 respectively. Performance declined in 2009 may be because of the effect of global economic crisis and its effect on the domestic one. Again performance improved in 2010 after the recovery. Nevertheless, on average the performance of companies listed in the Nairobi Securities Exchange in Kenya has been increasing. The average ROA, ROE, NIM for the companies listed in the Nairobi Securities Exchange was 6.0, 24.2 and 8.6 respectively. The performances as expressed by the above ratios are average.

The study found out that tax and dividend have a significant positive correlation (Pearson correlation coefficient 0.927). Liquidity position of the company is a determinant of the dividends structure. Liquidity is a function of the profitability of the company. Organizations that have investment projects will rely on their after tax profit. Thus, the availability of more capital invested in alternate investment opportunity shapes what the dividend will eventually be paid.

The study established that the introduction of tax reforms in Kenya would lead to increase in the long-term capital gains tax rate. This would make retained earnings (capital gains) a less popular investment choice than distributed earnings (dividends). Companies responded to the change in the dividend tax rates by reducing dividend payments, and some would not disburse dividend payments. Investors now have fewer choices when making investment decisions between companies that pay dividends or rely on capital appreciation to reward investors.

Raising taxes on dividends also increases the double taxation of corporate income, as this dividend income was already taxed at the corporate level. This makes the tax code less fair and also discourages economic growth by raising the tax on capital. Moreover, tax rate on capital gains and dividends makes an enormous difference in the way investors and firms handle income from capital. High tax rates on dividends also have a distorting effect. Firms retain earnings instead of paying them to stockholders. This reduces the influence of stockholders as firms seek funding from resources independent of the marketplace of investors. In short, high taxes on these two forms of income from capital have the same effect they exercise on other capital incomes: The marketplace for capital operates less efficiently and with less capital, the pace of economic growth slows, and the quality of investments diminishes

The study established that tax and capital gain have a significant positive correlation (Pearson correlation coefficient 0.931). The termination of low tax rates on capital discourages investment and slow economic growth. The current long-term rate does not appear to discourage investors significantly from selling assets. However, high capital gains taxes in the new tax policy will create what is called a "lock-in effect," where investors avoid onerous taxation by not selling assets. The respondents stated that a strong link exist between higher capital gains tax rates and

the lock-in effect. Investors are willing to hold onto investments for a longer period of time in order to pay the lower taxes on long-term capital gains.

If high taxes make investors unwilling to sell taxable assets, the lock-in effect can reduce economic growth by preventing the reallocation of capital in low-performing investments to more profitable ventures. Economic growth slows as new businesses find it difficult to acquire start-up or expansion capital.

Though reducing the tax on capital gains is beneficial to the economy, a better tax policy would reduce the tax rate on all capital investment. A broad reduction in the taxation of capital will lead to more investment and more capital stock. The reductions in capital taxation increase the return on investment and therefore the formation of capital. The resulting increase in the capital stock yields greater output and higher incomes throughout much of the economy.

The study findings indicated that tax and firm value have a significant positive correlation (Pearson correlation coefficient 0.906). The study established that as the corporate tax rate rises, the market value of a firm declines. On the one hand, the firm may want to raise more debt as the tax shields increase; on the other, the firm is financially constrained as a result of its declining market value. Consequently, corporate leverage may first increase and then decrease as the corporate tax rate rises. The corporate tax rate changes can enhance stock prices most of the time, while there are cases in which the effects are neutral or even detrimental. The study findings revealed that these different results are caused by the current provisions that allow firms to carry their tax losses forward for seven years as well as the net balance on firms' tax deferred accounts. The study found out that firms' past and future profitability are crucial in identifying the exact threshold points to experience value changes or not

The regression results show that financial performance of companies listed in the Nairobi Securities Exchange is influenced by dividend tax rate ($p=0.031$), capital gains tax rate ($p=0.015$), and corporate tax rate ($p=0.016$). The financial performance of companies listed in the Nairobi Securities Exchange increases with decrease in dividend tax rate, capital gains tax rate, and corporate tax rate.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

5.1 Summary

This chapter presents conclusion and recommendations. The main objective of the study was to investigate the applicability of tax preference theory for companies listed in the Nairobi Securities Exchange. Specifically the study established the effect of taxes on the supply of dividends in the listed companies, the effect of taxes on capital gains in the listed companies, how taxes affect firm value among the listed companies and how tax advantages of capital gains over dividends predispose investors among the listed companies.

The study found out that tax and dividend have a significant positive correlation (Pearson correlation coefficient 0.927). Liquidity position of the company is a determinant of the dividends structure. Liquidity is a function of the profitability of the company. Organizations that have investment projects will rely on their after tax profit. Thus, the availability of more capital invested in alternate investment opportunity shapes what the dividend will eventually be paid.

The study established that the introduction of tax reforms in Kenya would lead to increase in the long-term capital gains tax rate. This would make retained earnings (capital gains) a less popular investment choice than distributed earnings (dividends). Companies responded to the change in the dividend tax rates by reducing dividend payments, and some would not disburse dividend payments. Investors now have fewer choices when making investment decisions between companies that pay dividends or rely on capital appreciation to reward investors.

Raising taxes on dividends also increases the double taxation of corporate income, as this dividend income was already taxed at the corporate level. This makes the tax code less fair and

also discourages economic growth by raising the tax on capital. Moreover, tax rate on capital gains and dividends makes an enormous difference in the way investors and firms handle income from capital. High tax rates on dividends also have a distorting effect. Firms retain earnings instead of paying them to stockholders. This reduces the influence of stockholders as firms seek funding from resources independent of the marketplace of investors. In short, high taxes on these two forms of income from capital have the same effect they exercise on other capital incomes: The marketplace for capital operates less efficiently and with less capital, the pace of economic growth slows, and the quality of investments diminishes

The study established that tax and capital gain have a significant positive correlation (Pearson correlation coefficient 0.931). The termination of low tax rates on capital discourages investment and slow economic growth. The current long-term rate does not appear to discourage investors significantly from selling assets. However, high capital gains taxes in the new tax policy will create what is called a "lock-in effect," where investors avoid onerous taxation by not selling assets. The respondents stated that a strong link exist between higher capital gains tax rates and the lock-in effect. Investors are willing to hold onto investments for a longer period of time in order to pay the lower taxes on long-term capital gains.

If high taxes make investors unwilling to sell taxable assets, the lock-in effect can reduce economic growth by preventing the reallocation of capital in low-performing investments to more profitable ventures. Economic growth slows as new businesses find it difficult to acquire start-up or expansion capital.

5.2 Conclusion.

The study concluded that tax is an important determinant in the financial performance of companies listed in the Nairobi Securities Exchange. The financial performance of the companies is linked to taxation through dividend tax rate, capital gains tax rate, and corporate tax rate. Dividend tax rate influences the dividends that the firms pay to the shareholders. Capital gains tax rate and corporate tax rate affects the value of the firm and they also affect final dividend paid to the shareholders. Implementation of policies that increases dividend tax rate, capital gains tax rate, and corporate tax rate lead to decreased financial performance of companies listed in the Nairobi Securities Exchange. Higher taxes on capital hinder the growth of investment and capital stock. The decrease in capital reduces economic growth which, in turn, lead to higher unemployment and reduced personal income. The study established that the introduction of tax reforms in Kenya would lead to increase in the long-term capital gains tax rate. This would make retained earnings (capital gains) a less popular investment choice than distributed earnings (dividends). Companies responded to the change in the dividend tax rates by reducing dividend payments, and some would not disburse dividend payments. Investors now have fewer choices when making investment decisions between companies that pay dividends or rely on capital appreciation to reward investors.

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funding from resources independent of the marketplace of investors. In short, high taxes on these two forms of income from capital have the same effect they exercise on other capital incomes: The marketplace for capital operates less efficiently and with less capital, the pace of economic growth slows, and the quality of investments diminishes

5.3 Policy Recommendation.

The study recommends that tax rates should be maintained at the possible minima levels. Investment is a forward-looking enterprise, and companies make decisions about their future. Making permanent the lower tax rates on capital gains and dividends will make future investment more attractive to businesses and investors. This will ensure more capital stock and economic growth.

Tax law is said to be barely connected with the universe and with universal law as we understand it. However, tax law is founded not only on principles but also on practicality. There is no element of perpetuity about tax law, only the constant clash of the immediate and semi-permanent. A State cannot run a democracy well without taxation and a taxation system cannot be run well without democracy. As Oliver Wendell Holmes has said on one occasion, "Taxes are what we pay for civilized society."

The importance of tax law must be and is tempered as a result with the capabilities of a state and its constitutional and legislative provisions. First, tax law is of immense importance to society, but considering its lack of consistent principles, the tax lawyer must remember that the ultimate and perfect answers in taxation can never be found. Instead it is a constant system of trial and error which works in a dynamic society.

Secondly, there has been much discussion internationally about simplifying and elaborating upon the tax law. There is a gradual but steady increase in case law with the five classes of the users of tax law; taxpayers; people such as employers on whom the law places obligations; professional advisers and enforcers.

Thirdly, tax reform today has been moving towards considering new legislation, such as whole new taxes or reliefs, rather than patching of existing taxes by either increasing or decreasing the amount of taxation. This breaks down into the fact that there are ongoing considerations of widening the tax base. Kenya is no exception to this and there are ongoing considerations into taxing the informal or 'jua kali' sector including the taxation of the 'mitumba', the second hand clothing industry as well as the taxation of all informal tax payers of small amounts.

Fourthly, tax like any other legal issue finds its initial source and authority from the Constitution of the country in which it applies. However unlike other laws that are based on fixed principles, the tax law and its policy objectives for specific countries changes based on the goals or aims of the government of the day based on what it wishes to achieve

5.4 Limitations of the Study.

There were various limitations to this study. Like for example Capital gain tax in Kenya was increased this year from 0% to 10%. This alone indicates how taxes can vary depending on the government of the day. Taxes are more so determined by the political class and thus make calculating future prospects very difficult. It's very difficult to know what the tax rate will be next year for dividends and capital gains in a developing country like Kenya that strives to make ends meet.

The tax clientele in a 3rd World country would more so ignore the taxes levied on dividends due to their desire for immediate cash. This in a nut shell means investors in Kenya would desire dividends more as opposed to capital gains irrespective of the tax preference theory.

The procedure of selecting the companies studied was subjective and judgmental. It is not easy to judge between actively and none actively traded firms. It is therefore difficult to generalize the results of this analysis as a representative on the reliability of the applicability of tax preference theory model in the entire market.

The study only covered those firms listed at the NSE and whose data for the period of the study was available. Thus, the applicability of the findings to other firms may be limited by this scope and more so to public quoted firms and not to privately owned companies.

Further, it was difficult getting some of the data from both the CMA and the NSE on the listed firms to be surveyed as some of the data was not, kept nor updated by the two authorities. Thus, some of the information had to be requested from the companies studied.

This study was also limited by other factors in that some respondents may have been biased or dishonest in their answers. More respondents would have been essential to increase the representation of the NSE team in this study and allowed for better check of consistency of the information given. However, the researcher did look for contradictions in the information given and no inconsistency were found.

5.5 Suggestions for further Research.

This topic provides a large pool of opportunities for researchers. For future studies and to get a clear understanding of this relationship, researchers can undertake studies on specifically how taxes on dividends affect investors more so in a developing economy.

Also researchers could check the literacy levels of the investors in regard to the tax system and investigate if it enables them invest in dividends as opposed to capital gains or vice versa. They could also make it more interesting by establishing which investors. Whether institutional or individual investors. This could add to the body of knowledge.

Researchers could also investigate on what impacts the share price or the value of the firm more, is it taxation on dividends or taxation of capital gains and how they can leverage that to their advantage and maximize shareholders value.

A further study may also be conducted using a different model of equilibrium rather than the market model .More dynamic models like Arbitrage Pricing Model may produce a result with better significance.

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APPENDICES

Appendix I: Cover Letter

KELVIN NDUATI MBURU,

University of Nairobi,

P.O BOX, 30197

Nairobi.

SEPTEMBER, 2013

Dear Sir/Madam,

RE: DATA COLLECTION

I am a diploma student at University of Nairobi undertaking a
..... One of my academic outputs before graduating is a project and for this I
have chosen the research topic “applicability of tax preference theory for companies listed
in the Nairobi securities exchange.”

You have been selected to form part of the study. This is to kindly request you to assist me
collect the data by responding to the Questions. The information you provide will be used
strictly for academic purposes and will be treated with utmost confidence. A copy of the
final report will be available to you upon request. Your assistance will be highly
appreciated.

Yours sincerely,

KELVIN NDUATI MBURU

Appendix II: Questionnaire

Kindly answer the following questions.

1. Indicate the trend in the financial performance of your company in the period 2008 to 2012 with regard to Return on Asset (ROA), Return on Equity (ROE) and Net Interest Margin (NIM).

Parameters of financial performance	Year				
	2008	2009	2010	2011	2012
Return on Asset (ROA)					
Return on Equity (ROE)					
Net Interest Margin (NIM)					

2. To what extent has tax affect supply of dividends, capital gains and firm value of the companies listed in the Nairobi Securities Exchange?

	No extent at all	Little extent	Moderate extent	Great extent	Very great extent
Supply of dividends					
Capital gains					
Firm value					

3. To what extent do the following tax rates affect financial performance of companies listed in the Nairobi Securities Exchange?

	No extent at all	Little extent	Moderate extent	Great extent	Very great extent
Dividend tax rate					
Capital gains tax rate					
Corporate tax rate					

4. What measures can be taken to ensure that taxation enhances the value of companies listed in the Nairobi Securities Exchange?

- i.
- ii.
- iii.
- iv.
- v.
- vi.

Appendix III: NSE Equities

A).Agriculture.

1. Uniliver Tea
2. Kakuzi
3. Rea Vipingo
4. Sasini Ltd.
5. Eaagads
6. Williamson Tea
7. Kapchuora
8. Limuru Tea

B).Commercial and Allied

9. Access Kenya Group Ltd.
10. Car & General
11. CMC
12. Hutchings Biemer
13. Kenya Airways Ltd.
14. Marshalls
15. Nation Media Group
16. Safaricom Ltd.
17. Scangroup Ltd.
18. Standard Group Ltd.
19. TPS Eastern Africa (Serena) Ltd.
20. Uchumi Supermarkets
21. Express *

C).Finance & Investment

22. Barclays Bank
23. CFC Stanbic Ltd.
24. Diamond Trust
25. Equity Bank Ltd.
26. Housing Finance

27. Centum Investments Ltd.
28. Jubilee Holdings Ltd.
29. K.C.B.
30. Kenya Re-Insurance Co.
31. National Bank
32. National Industrial Credit
33. Pan African Insurance Ltd.
34. Standard Chartered Bank
35. City Trust

*

D).Industrial & Allied

36. Athi River Mining Ltd.
37. BOC (K)
38. Bamburi
39. British American Tobacco
40. Carbacid
41. Crown Berger
42. E.A.Cables
43. E.A.Portland
44. E.A.Breweries
45. Everready East Africa Ltd.
46. Kenya Oil
47. K.Pow.&L.
48. KenGen
49. Mumias
50. Olympia Capital Holdings
51. Sameer Africa Ltd.
52. Total
53. Unga
54. A.Baumann
55. K.Orchads

Source:NSE/DN,tue,july,2008.