

## **Influence of Tax Saving Mitigation Strategies on Financial Performance of Flower Firms in Naivasha, Kenya**

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**Abstract:** *Tax expense is a significant cost to organizations. Organizations all over the world adopt tax planning strategies targeted at minimizing their tax liability without adversely affecting the overall financial liquidity of the firm. Thus, this study empirically examined the influence of tax mitigation strategies on financial performance of flower firms in Naivasha. The study specifically sought to establish the influence of tax incentives on financial performance of flower firms. The study was based on Agency Theory of Tax Incentive. The researcher used descriptive research method. The target populations of this study were 37 finance officers from the 37 firms operating in Naivasha. Census survey was employed. Data collections were done through use of questionnaires and were tested for validity and reliability. The collected data was analyzed using statistical package for social sciences (SPSS). Data was analyzed using descriptive statistics and inferential statistics and was presented in tables and figures. Findings indicated that tax incentives had a significant influence on financial performance. From the findings the researcher concluded that tax incentive utilization has significantly influences the financial performance of flower firms. The study recommended that flower firms' management should adopt measures that help them utilize tax incentives given by the government.*

**Keywords**– *Tax, tax incentives, tax mitigation, financial performance, flower firms*

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### **I. INTRODUCTION**

In an economic environment dominated by globalization and turbulences, governments and economic entities have opposite objectives. Governments are interested in attracting resources to the state budget and investors, while companies are oriented toward financial performance and, implicitly, reduced taxes and duties. Thus, the tax system is the interface between governments and economic entities in their approach to create and improve performance; both at macroeconomic and microeconomic level (Ileana, Aurelia, Adriana & Arina, 2016). Companies, in essence, prefer paying lower taxes or get some tax savings on tax payable given that the main purpose of the company is to maximize it's after tax profit by minimizing its overall effective tax rate of the company. Indeed, many tax planning approaches have been used by companies to achieve this objective (Seyram & Holy, 2013).

Faced with high costs of production, Dess, Lumpkin and Taylor (2008) argued that there is need for major and minor changes in a business firm's strategic direction. Kaplan and Norton (2006) on their part observe that most organizations have their management strategies focused on the financial themes of increasing revenues, minimizing cost and increasing productivity, enhancing asset utilization and reducing risk as a way of attaining and sustaining competitive advantages in the market. Davis (2009) points out that the dual challenge facing many companies today is to improve the quality of goods and services while cutting corporate overhead costs.

The major challenge of corporate entities, and in particular manufacturing firms, come in a midst of high corporate tax rates and multiples of other taxes that lead to high effective tax rates far above the statutory company income tax rate. Many of these taxes from the different levels of government overlap and are forcefully extracted from corporate organizations. The effect of these extractions of course is high cost structure for firms (Nwaobia, 2014). One will not fail to agree with Nnadi and Akpomi (2008) that a tax policy defines the cost structure of firms as it is factored into pricing. In addition, tax costs and eventual payout deplete the disposable income of individuals as well as the distributable profits of corporate organizations. These taxes in fact, do translate to a substantial cost to organizations and if not properly planned and managed can have adverse impact on the bottom line, cash flow and capacity to invest.

To mitigate the effect of taxes on liquidity and profitability of corporate bodies and by extension firm value, tax mitigation measures become imperative. But unfortunately, many companies are ignorant of the strategies they can adopt to legally mitigate their tax burdens. Over the years, experience has shown that the tax authorities can dip the largest possible shovel into the resources of an organization if left vulnerable. Fortunately, the law supports a tax payer if he arranges his affairs in such a way that the tax chargeable is minimized or even avoided. Therefore, a company is not a bad corporate citizen if it can organize its business or trade in a legal manner to minimize its tax liability.

This is the concept and essence of tax planning. Tax planning is thus one of the vital decisions that confront any proactive company management. Tax planning therefore is a conscious effort made by a tax payer, within the ambit of the law, to minimize the tax payable by the individual or entity. Tax planning has been variously described as managing taxable income downward (Ayers, Jiang & Laplante 2006); legitimate methods of increasing an entity's or individual's tax efficiency (Morien 2008); all activities designed to produce a tax benefit (Abdul-Wahab & Holland 2010) or legal activities designed by tax payers to lower the effective tax rate, described as the actual measure of the company's tax burden (Sabli, & Md Noor, 2012).

Critically, there are also reputational and political costs from being associated with tax avoidance, both for the firm (Gallermore, Maydew & Thornock 2013) and the individual managers (Chyz, 2013). Reputational damage can affect a company's sales, and produce a negative effect on a firm's share price, leading to an increased cost of equity capital (Hanlon & Slemrod, 2009). Loss creation is particularly useful for large infrastructure investments, such as resources and energy companies as they are characterised by large initial investments with long time lags between the commencement of the investment, the start of production and the receipt of sales revenues. During these time lags, the operation is incurring expenses, such as interest payments and administrative costs, but is not receiving any revenues, therefore reporting a loss. Losses can accumulate over extended periods and it can take years to offset these losses with profits before any tax is paid. Loss creation provides an opportunity for firms to maximise losses in order to reduce future tax liabilities.

## **II. FLOWER FIRMS**

Agriculture accounts for about 24% of Kenya's GDP with an estimated 75% of the population depending on the sector either directly or indirectly (Ministry of Agriculture, 2012). The horticulture sub-sector of agriculture has grown significantly to become a major employer and foreign exchange earner only second to tourism. Currently, horticulture which comprises of fruits, vegetables and flowers, is the fastest growing sub-sector of the economy with Kenya having a long history of growing horticultural crops for both domestic and export markets. Kenya is the largest supplier of cut flowers to the European Union.

In an effort to encourage the industry growth, Kenya has diversified its market to Japan, Korea, Middle East and south East Asia (Hortfresh journal, 2013). In Africa, it is one of the most prominent fresh flower exporting countries. Floriculture is the most developed sector and accounts for about 40 per cent of all horticultural exports. Flowers form a major part and account for about half of Kenya's fresh horticultural exports, with the foreign exchange of the year 2012 standing at ksh. 43 billion, according to Kenya flower Council. The cut flower industry provides direct employment to about 50,000 Kenyans with a further 70,000 employed in related industries (Kenya Flower Council, 2012).

Kenya is the largest supplier of cut flowers to the European Union. Floriculture industry is the most developed sector and accounts for about 40 per cent of all horticultural exports (Kenya Flower Council, 2012). Majority of the flower firms are located in Naivasha, accounting for more than half of the flower firms in the country. This is due to availability of vast land that allows large scale flower farming through the green-house technology. This is coupled with availability of water from Lake Naivasha and cheap labor, which are the critical resources in this industry.

The total number of firms operating in Naivasha is 37, majority of them multinationals, with a few local (Kenya Flower Council, 2012). Naivasha is a strategic location for these organizations due to the readily available water sourced from Lake Naivasha, land for expansion and cheap labor which are critical resources in the floriculture industry. Majority of flower firms are therefore concentrated in this region as opposed to the other parts of the country. Most of the flower firms are subsidiaries of multinational companies.

## **III. STATEMENT OF THE PROBLEM**

One among a couple of big issues that way heavy on the competitiveness of the Kenyan flower industry not only in Kenya but also abroad, are the ever rising costs (Kenya flower council, 2012). The price levels remain under pressure and are not expected to rise albeit the rising costs of operations. As such there is a clear need for efficiency improvement. In this endeavour firms strive to mitigate most of their expenditures with the aim of profit maximization. Among the key mitigation strategies adopted by firms are tax mitigation strategies. According to Kenya flower industry global competitive report (2012), the decentralized system of taxation often results in double taxation of the firms. Further the report observes that the VAT rebate system is very inefficient

and a burden to the industry. The report further observes that growers generally feel that flowers are more heavily taxed. With the enactment into law of a new Value Added tax (VAT) bill 2012, exemptions and zero rating of items are removed, resulting in taxpayers spending less time computing taxes. This adds to the tax burden noting that VAT on some basic agricultural inputs and basic food commodities will be charged at 16% up from 0%. Several studies have focused on this area including a study by Ogundajo and Onakoya (2016) on tax planning and financial performance of manufacturing firms in Nigeria. Further Hedia and Amira (2012) did a study on taxation and corporate finance in Tunisian firms. Nwaobia et.al, (2016) examined the influence of tax planning on firm value of consumer goods industrial sector in Nigeria. The above studies have not addressed the influence of tax mitigation strategies on financial performance. Further no study focused on flower firms in Kenya. This study seeks to fill this gap by assessing how firms can utilize relevant tax provision to plan their tax mitigation strategies and the effect this have got on the financial performance of flower firms in Naivasha.

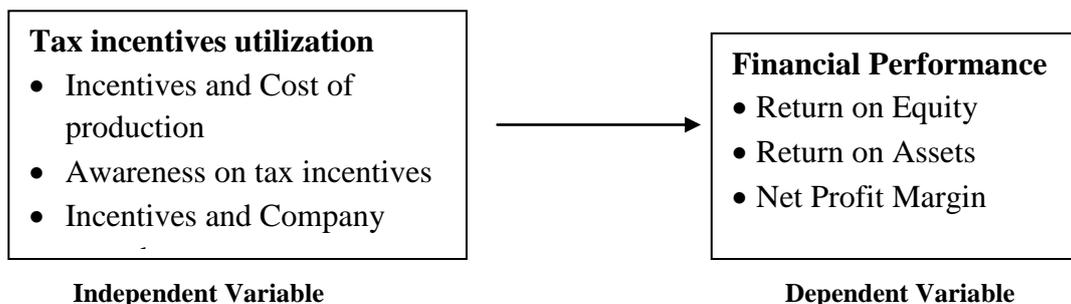
**OBJECTIVE OF THE STUDY**

The study sought to examine the influence of tax mitigation strategies on financial performance of flower firms in Naivasha, Kenya.

**HYPOTHESIS OF THE STUDY**

There is no significant influence of tax incentive utilization on financial performance of flower firms in Naivasha, Kenya.

**CONCEPTUAL FRAMEWORK**



**IV. AGENCY THEORY OF TAX INCENTIVE**

Despite the lack of evidence to support the efficacy or efficiency of fiscal incentives, governments continue to offer them. Wells, L, Allen.N, Morisset, J. and Pirnia, N (2001) argue that tax incentives offer an easy way to compensate for other government-created obstacles in the business environment. In other words, fiscal incentives respond to government failure as much as market failure. It is far harder, and takes far longer, to tackle the investment impediments themselves low skills base, regulatory and compliance cost than to put in place a grant or tax regime to help counterbalance these impediments. Although it is a second-best solution to provide a subsidy to counteract an existing distortion, this is what often happens in practice.

Agency problems also exist between government agencies responsible for attracting investment and those responsible for the more generic business environment. Whilst investment-promotion agencies can play an important role in coordinating government activities to attract investment, they also often argue for incentives without taking account of the costs borne by the economy as a whole (Zee, Stotsky & Ley, 2002). According to Wells et.al, (2001) governments may legitimately feel that strict horizontal equity with government taxation and expenditure does not adequately address policy objectives and inherent market failures in certain sectors. The policy objectives might include; increasing investment to a specific region, which does not receive as much investment as it should, given the economic fundamentals because of information asymmetries.

The accountant as the agent of the principal (Stakeholders, Shareholders and Users of the Financial Information) is expected to discharge his work according to the specification of accounting principles, rules and regulations as to avoid misrepresentation of financial fraud or mal-falsification of figures. The application of creative accounting by Osisioma and Enahoro (2006) show that stakeholders, shareholders and other users of accounting information rely heavily on the yearly financial statements of a company as they can use this information to make an informed decision about investment. They rely on the opinion of the accountants who prepared the statements, as well as the auditors that verified it, to present a true and fair view of the company.

The agency theory shareholders expect the agents to act and make decisions to the best of the principal's interest. On the contrary, the agent may not necessarily make decisions in the best interest of the principals (Padilla, 2000). Such a problem was first highlighted by Adam Smith in the 18th century and

subsequently explored by Ross (1973) and the first detailed description of agency theory was presented by Jensen and Meckling (1976). Indeed, the notion of problems arising from the separation of ownership and control in agency theory has been confirmed by Davis, Schoorman and Donaldson (1997).

### **V. Tax Incentive Utilization And Financial Performance**

Tax incentives are meant to encourage and stimulate the economic activities of enterprises and investments. They are fiscal policies designed by the government to revive, rehabilitate and stabilize individuals and corporate bodies. The tax incentives are also used by the government to channel some specific economic activities towards the vital sectors of the economy where they are not felt or non-existent (Kaplan, 2001). Tax incentives are widely used by governments around the world to attract private investment in preferred industries, including tourism. Incentives are often granted to offset actual or perceived differences in the cost of doing business in different political jurisdictions whether the cost differences arise from tax differences or from differences in transportation, labour, or other costs. This acts as a catalyst for improved performance (Philips, 2010).

Incentives raise the return to capital thereby making investment in a location more attractive and in turn increase profitability of the firm. There are various types of fiscal incentives. These include government provision of below market interest loans, tax relief through the use of credits, deductions, or abatements, direct grants of land and facilities, and taxpayer financed work force training for targeted firms and industries (Bronson & Mc Donald, 2008). Barbour (2005) points out that there are other purported benefits of tax incentives, such as symbolic signalling effects and the need to compensate for inadequacies in the investment regime elsewhere. Provision of investment incentives is in the form of either tax relief or cash grants. International experience shows that such incentives play only a minor role in investment decisions. Firms make investment decisions based on many factors including projections of future demand, certainty about future government policy, prevailing interest rates and moves by competitors. In general, they see incentives as 'nice to have' but not deal breaking. Yet incentives remain a popular policy for both developed and developing countries.

Chukwumerije and Akinyomi (2011) examined the impact of the tax incentives on the overall performance of registered small scale industries in Rivers State, Nigeria. Eleven, out of the twenty two registered small scale food and beverages manufacturing industries in Rivers State were selected randomly for the study. Questionnaires were administered to 260 respondents in the selected. Frequency distribution and chi-square were used in the analysis of data and hypotheses testing 24 respectively. The findings revealed that there are various tax incentives available to small scale industries and the operators in these industries are very familiar with them. It was also discovered that tax incentives do significantly affect the profitability, staff strength and the growth and development of small scale industries positively.

Musyoka (2012) studied the relationship between tax incentives and foreign direct investment in Kenya. To achieve this objective, the entire set of data for investment incentives, trade related incentives, import duty exemptions and foreign direct investments inflows for ten most recent years was collected. Basic analysis begun with the determination of various measures of central tendency; namely mean, minimum and maximum. The study found that there was no significant improvement in foreign direct investment as a result of implementing tax incentives in Kenya.

### **VI. Financial Performance**

Financial performance is a subjective measure of how well a firm can use its current assets from its primary mode of business and operations and generate revenues for the business (Baxter, 2007). Financial performance is an indication of the financial health over a given period of time for a firm, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation to enable a business make decision on how it can improve on the prevailing situation or sustain a desirable position (Berger, Oliver & Pua, 2007). There are many different ways to measure financial performance, but all measures should be taken in aggregation. Line items such as revenue from operations, operating income or cash flow from operations can be used, as well as total unit sales. Furthermore, the analyst or investor may wish to look deeper into financial statements and seek out margin growth rates or any declining debt (Brush, Bromiley & Hendrickx, 2000).

Heavy tax burdens on company profits have been observed to reduce the amount available to companies to meet their working capital needs. As noted by Ikpakan and Owolabi (2014) working capital management is very fundamental to the liquidity and profitability of any organization. Khan and Safiuddin (2016) opined that an efficient management of the liquidity levels of a company is of extreme relevance for the firm's profitability and well-being. Thus, the management of the working capital and current ratio directly affects the results of a company's business (Garanina & Petrova, 2015).

Correlative-description design using cross sectional method of analysis was conducted by Desai and Hines (2002), Chen, Chen, Chen and Shevlin (2010). They established that intensive tax planning is associated

with higher firm performance. On the other hand, the study reported that tightening of the tax system is positively associated with higher market performance of firms. The same positive association was reported between tax planning savings and performance for well-governed firms by Desai and Dharmapala (2009). They concluded that corporate governance mediates the tax planning-firm performance relationship.

Strulik (2003) through a comparison of policies of firms in different economics shows that a decrease of 10% of tax would increase the firm's gain of 5%. The author emphasizes that the standard models (not taking into consideration the overall economy) overestimate the effect of tax reform on investment and profitability since they neglect the financial adjustments of the company. Similarly, Teraoui et al. (2011) confirm the positive impact of taxation on the financial results of the company through the estimation by the method of least squares (GLS). They showed that a change in tax rate by 1% would decrease by 0.31% the output of the company and an increase of the CT by 1% resulting in less 0.07% of net income. They also showed, through a survey by questionnaire on a sample of 60 exporting companies, that taxation affects the economic and financial performance of companies. In the same line of ideas, Simmons (2003) confirms the positive effect of taxation on investment

### VII. Research Methodology

In this study, descriptive research design was adopted. Ghauri and Gronhaug (2005) asserts that in descriptive design the problem is structured and well understood, a fact that Mugenda and Mugenda (2003) agrees that descriptive design is most preferred because it gives a report on things as they actually are. Descriptive studies were also conducted to demonstrate associations or relationships between things in the world around you. In addition, a descriptive survey enabled the researcher to obtain quantitative data which he analyzed using descriptive and inferential statistics (Saunders & Clark 2002). The targeted population constituted of 37 finance officers from the 37 firms operating in Naivasha (Kenya Flower Council, 2012). The total number of participants in this study was 37 in number where the researcher adopted a census where all the financial officers in all the flower firms in Naivasha were taken as respondents to the study. Primary methods and secondary methods of data collection were used in the study. The study employed the use of questionnaires as the main tools for collecting data. Questionnaire helped the researcher to collect large amount of data in areas within a short time thus saving time for the study. Orodho, (2003), Mugenda, (2003) also recognizes that questionnaire provides the researcher with avenue to ask probing questions, to be fast, cheap and self-administered. The questionnaire was composed of short structured closed ended statement constructed on a 5 point Likert scale. Data was processed and analyzed by use of descriptive statistics and inferential statistics. The raw data was edited to detect elements of errors and omissions. Inferential statistics was done to establish the relationships between variables and the strength of prediction. This was done using correlation, simple linear regression analysis and multiple regression analysis. Analysis was done using statistical package for social sciences (SPSS).

### VIII. Findings And Analysis

#### Tax Incentives Utilization

Respondents' views regarding tax incentives utilization were sought. The findings from the analysis were shown in table 4.4.

**Table 4. 1: Descriptive Statistics on Tax Incentives Utilization**

	SA (%)	A (%)	U (%)	D (%)	SD (%)	Mean	Std. Dev
The company enjoys the tax incentives provided by government on flower processing companies	43.3	53.3	0	3.3	0	4.37	.669
Tax incentives on flower processing firms have attracted more investment by the flower companies	36.7	43.3	13.3	6.7	0	4.10	.885
The tax incentives enjoyed by the company has enabled it gain high return on capital	30.0	50	13.3	0	6.7	4.03	.850
The government offers incentives on all export products from the country as such encouraging the growth of flower business	20.0	63.3	13.3	3.3	0	4.00	.695
Through utilization of government incentives on flower firms, the cost of production have been reduced	16.7	56.7	13.3	6.7	6.7	3.70	1.055
The company keeps updated on the available tax incentives for its business	30.0	60.0	10.0	0	0	4.20	.610
Valid N (listwise)	30						

From the table, findings indicate that respondents agreed that the company enjoys tax incentives provided by the government. 43.3% of the respondents strongly agreed while 53.3% agreed with the assertion returning a mean of 4.37 and a standard deviation of .669. Further the findings also demonstrated that the respondents agreed

(M=4.10, StD=.885) that tax incentives on flower firms attract investment by the firms. 36.7% of the respondents strongly agreed while 43.3% of them agreed with the statement. 50% of the respondents agreed that tax incentives have enabled the company to gain high return on capital while 30% strongly agreed returning a mean of 4.03 and a standard deviation of .850. In addition, the respondents agreed that government offers incentives on all export products to encourage growth of flower firms having 63.3% of them agreeing and 20% strongly agreed. Further the analysis indicated that 56.7% and 16.7% of the respondents agreed and strongly agreed respectively that utilization of incentives on flower firms has led to a reduction in production cost. These findings had a mean of 3.70 and a standard deviation of 1.055. Finally, the respondents agreed that the company updates itself with the available tax. 30% of the respondents strongly agree while 60% of the respondents agree registering a mean of 4.20 and a standard deviation of .610.

**Financial Performance**

The study went further to establish the views of the respondents in regard to financial performance of flower firms. The percentages, means and standard deviations of the responses were established to aid in making inferences. The findings from the analysis were as presented in Table 4.7

**Table 4. 2: Descriptive Statistics of Financial Performance**

	SA (%)	A (%)	U (%)	D (%)	SD (%)	Mean	Std. Dev
The company has continually registered an increase in the amount of cash flows	30.0	40.0	23.3	3.3	3.3	3.90	.995
Heavy tax burden in the company reduces the amount of the working capital	3.3	70.0	16.7	6.7	3.3	3.63	.809
Intensive tax planning in the company have led to increased financial performance	30.0	50.0	16.7	3.3	0	4.07	.785
Tax savings through tax incentives increase firm's profitability	40.0	40.0	13.3	6.7	0	4.13	.900
The company maintains the right liquidity levels to maintain the company's operations	30.0	33.3	16.7	16.7	3.3	3.70	1.179
The company has registered a decline in debt financing and adopted equity financing	13.3	26.7	30.0	20.0	10.0	3.13	1.196
Valid N (listwise)	30						

From the findings majority of the respondents agreed that the company has been registering an increase in the amount of cash flows with 40% and 30% of the respondents having agreed and strongly agreed respectively. The findings had a mean of 3.90 and a standard deviation of .995. Further, 70% of the respondents agreed while 3.3% strongly agreed that heavy tax burden reduces the amount of the working capital with a mean of 3.63 and a standard deviation of 0.809. 50% and 30% of the respondents agreed and strongly agreed respectively that intensive tax planning have led to increase in financial performance with a mean of 4.07 and a standard deviation .785. Also majority of the respondents (80%) agreed that tax savings through tax incentives increase firm’s profitability registering a mean of 4.13 and standard deviation of .900. In addition, majority of the respondents agreed that the company maintains the right liquidity levels to maintain the company's operations. 33.3% of the respondents agreed while 30% strongly agreed with the assertion returning a mean of 3.70 and a standard deviation of 1.179. The research also observed that respondents agreed that the company has registered a decline in debt financing and adopted equity financing. 13.3% Of the respondents strongly agreed while 26.7% of them agreed. This finding registered a mean of 3.13 and a standard deviation of 1.196.

**Influence of Tax Incentives on Financial Performance**

The study employed the use of simple linear regression analysis to establish the influence of tax incentives on financial performance

**Table 4. 3: Model Summary on Tax Incentives and Financial Performance**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1		.438 <sup>a</sup>	.192	.163

a. Predictors: (Constant), Tax Incentives

The model summary gave a coefficient of determination (R<sup>2</sup>) value of 0.192 for the tax incentives and financial performance. This indicated that tax incentives can account for up to 19.2% of the total variation in the financial performance of flower firms in Naivasha. This demonstrates that tax incentives have a significant contribution on the financial performance of the flower firms. The analysis of variance gave the results shown in table 4.10

**Table 4. 4: ANOVA<sup>a</sup> on Tax Incentives and Financial Performance**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	2.553	1	2.553	6.641	.016 <sup>b</sup>
	Residual	10.763	28	.384		
	Total	13.316	29			

a. Dependent Variable: Financial performance

b. Predictors: (Constant), Tax Incentives

The analysis yielded an F-value of 6.641 with a p-value of 0.016 which was significant at  $p < .05$  level of significance. Therefore the study observed that tax incentives are significant in influencing the financial performance of flower firms in Naivasha. Consequently, the null hypothesis  $H_{01}$  that there is no significant influence of tax incentive utilization strategy on financial performance of flower firms in Naivasha, Kenya was rejected. Therefore the study concluded that tax incentives significantly influence the financial performance of flower firms in Naivasha.

### IX. Conclusions

Findings from correlation indicated that tax incentives have a direct relationship with financial performance of flower firms in Naivasha. The findings also demonstrated that tax incentives have a significant contribution on the financial performance of flower firms. From the findings the study concluded that tax incentives utilization have a direct relationship with financial performance of flower firms. This demonstrates that tax incentives have a strong significant contribution towards financial performance of flower firms. Therefore the study concluded that tax incentives have a role in improving the financial performance of flower firms. It was recommended that the management of the flower firms should adopt measures that help them be able to take advantage of the tax incentives by the government. The findings demonstrated that tax incentives influence the financial performance of the flower firms. As such, making use of the tax incentives will help the flower firms improve their financial performance.

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