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**Capital Allowance and Financial Performance of Manufacturing Firms**

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### Capital Allowance and Financial Performance of Manufacturing Firms



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#### Abstract

**Purpose:** The main objective of this study was to examine the effect of capital allowance on the financial performance of manufacturing firms in Nyeri County

**Methodology:** A descriptive research design was adopted. In this study, the population comprised all the 15 manufacturing firms in Nyeri County that are registered by the Nyeri County finance department; licensing office 2023. The study used census methods to acquire information from finance managers, tax managers, and senior managers of the targeted manufacturing firms. To gather primary data, questionnaires with Likert scales were used. The study collected secondary data from the manufacturing firms' internal sources for six years. The researcher utilized descriptive statistics, including measures like the mean, standard deviation, and frequency, to analyse the data. Additionally, the study employed Pearson correlation and regression analysis to investigate the relationship between the variables and ascertain whether the independent variables could predict the dependent variable in the study. The program Statistical Package for Social Sciences (SPSS) was used to analyze the data. Data was presented in the form of tables and graphs.

**Findings:** The study findings established that there exists a significant relationship between capital allowance and the financial performance of manufacturing firms in Nyeri County. Capital Allowance emerged as a crucial predictor of financial performance (Beta = 0.766. Participants expressed a positive perception regarding the influence of capital allowances on their respective firms' financial performance, with strong agreement on investment deductions, wear and tear allowance, capital allowance incentives, and overall satisfaction with the current level of capital allowances.

**Unique Contribution to Theory, Practice, and Policy:** The study was anchored on tax discrimination theory to show the effect of capital allowance on the financial performance of manufacturing sectors. The study recommended that there is a need to maintain and even improve capital allowance laws to meet taxpayers' demands and expectations and encourage investment.

**Keywords:** *Capital Allowance, Financial Performance, Manufacturing Firms*

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## INTRODUCTION

Governments across the globe have been in a fierce rivalry with one another to market their nations as investment centres. They have deliberately adopted strategies to support the development of industries through financial interventions. This is achieved through the formulation of taxation policies which are particularly used in the launch of domestic enterprises (UNCTAD, 2019). Governments provide the laws required for advancing industries for economic growth by offering incentives to motivate both people and body corporations (Mwangi, 2016). One of the main tactics used by governments to promote and maintain domestic companies is tax incentives (Basu & Srinivasan, 2002). According to Uwaoma (2016), tax benefits primarily serve to encourage investment in a few key economic sectors while also luring foreign capital to supplement local investment and hasten economic growth. Capital allowance, tax-free dividends, personal allowance, investment allowance, export processing zones, custom duty, and tax-free holidays are some of these incentives (Uwaoma, 2016).

While several scholars provide different justifications for tax incentives, Philip (2010) provides the most noteworthy input. According to Philip, tax breaks are defined as a means of lowering the tax burden on the taxpayer with an emphasis on advancing a certain economic sector. He emphasized that using tax incentives has many benefits, including motivating the taxpayer to increase investment from savings, encouraging investors to expand for an increase in exports, and promoting national economic development. In contrast to individual taxpayers, the advantages mentioned match corporate entities better, hence the definition is well-connected to industrial economic progress. Tax incentives, according to Mwangi (2016), are government strategies used to purposely amend the tax system to benefit the taxpaying population. Investors stand to profit and enhance their investments since Philip (2010) agrees with this description.

Special zones, tax credits, investment allowances, tax exemptions, tax holidays, accelerated depreciation, indirect tax breaks, and reductions in tax rates are only a few of the numerous tax incentives available in Kenya (IEA, 2012). The two primary types of tax incentives are those that promote exports and investments, respectively. Many nations have adopted tax incentives because they have less of an impact on fiscal collections than general tax deductions and because they specifically target firms that would offer more value to the nation (Jacques & Neda, 2004).

Tax breaks are particularly useful in terms of economic growth because they allow governments to lower the cost of capital for risky new enterprises while maintaining a high rate of taxation for overall revenue collection (IEA, 2012). Tax incentives, according to Joosung (2017), may help enhance productivity and economic development in countries with substantial informal economies by discouraging enterprises from entering these markets. Additionally, he pointed out that investment incentives are to be credited for the rapid economic expansion of nations like the Republic of Korea, Mauritius, Ireland, Taiwan, and Singapore.

Manufacturing output continues to increase by roughly 2.7% annually in advanced economies, whereas it increases by 7.4% annually in key developing economies, according to Jensen & Malesky (2010). In industrialized countries, there is a sizable manufacturing sector that makes a considerable contribution to productivity, economic growth, and innovation. Due to its significant role in driving economic growth, the industry remains an indispensable component in the process of economic development in any state (Khalifa & Shafii, 2013).

Financial performance is a measure employed in accounting to evaluate the efficiency of a company in utilizing its resources to generate revenue. It involves quantifying a company's performance (Mwangi, 2016). Businesses can assess their financial performance by connecting the outcomes presented in the income statement with the components outlined in the financial position statements. Overall, fiscal performance reflects a company's financial well-being relative to other companies in the same sector or over a specific timeframe. There are several methods to gauge a company's financial success. Total unit sales, operating cash flow, and operating revenue are examples of items of income (Njeru, 2012). Quantitative measurements, such as profitability as assessed by net margin or gross margin, may also be used to gauge a company's success. The net margin encompasses value addition, sales return, return on equity, and assets. Assessing financial achievement can also involve examining the ratio of free cash flow to sales, historical revenue growth, and projected revenue (Kiaritha, 2015).

A study conducted by Onyango (2015) aimed to assess the effect of tax incentives on the financial performance of five-star hotels in Nairobi County. The target population comprised all seven five-star hotels in Nairobi County, and a quantitative descriptive approach was employed. The findings of the regression and correlation analysis revealed a strong correlation between the deductions permitted for industrial structures and investments and the monetary success of the five-star hotels in Nairobi County. Additionally, the investigation concluded that the five-star hotels in Nairobi County experienced financial benefits from wear and tear allowances.

According to Musgrave (2005), as stated in the taxation canon of equality, tax advantages should be enjoyed by all taxpaying citizens. However, the researcher's analysis only considered seven-star hotels, which make for a very minor portion of Nairobi County's hospitality sector. Mayende (2013) conducted a study utilizing panel data estimation methods to investigate the impact of tax incentives on the value-added and gross sales of manufacturing firms in Uganda. The findings revealed that companies benefiting from capital allowances outperformed their competitors in terms of gross sales and value-added. The study emphasized the importance of the government enhancing tax incentives to foster growth in the industrial sector. It highlighted the necessity for the equitable distribution of tax incentives, irrespective of a company's ownership, and emphasized the importance of transparent accessibility criteria.

Agundu and Ohaka (2013) conducted a study to evaluate the effectiveness of capital allowance as a notable investment incentive for companies in Nigeria's manufacturing sector. The study examined three crucial financial performance indicators: profit after tax (PAT), return on total assets (ROA), and return on shareholders' equity (ROE). The research collected financial data from 58 industrial companies listed on the Nigerian Stock Exchange (NSE). The statistical analysis, including correlation and determination coefficients, supported the strong association between capital allowance and PAT, ROA, and ROE, thereby affirming the efficacy of capital allowance as a motivating factor.

The study concluded that, despite the enticement of financial economies of capital investment, investors in the manufacturing sector should exercise caution and avoid indiscriminately acquiring and developing industrial assets. Foreign Direct Investment (FDI) in companies listed on the NSE. The study specifically focused on the influence of wear and tear, Investment Deduction (IBD), and Investment Deduction (ID) in attracting FDI inflows. The sample consisted of 10 randomly selected enterprises from the population of 60 firms listed on the NSE. The findings of the correlation analysis between FDI and tax incentive variables

indicated that tax incentives had a significant effect on the FDI inflows of companies listed on the NSE, with wear and tear having a notable impact on FDI.

Kenya's manufacturing industry plays a crucial role in the growth of the economy, the reduction of poverty, and collaboration with other bigger businesses. It serves as an excellent source of local supply and service for larger firms as well as a major foreign exchange earner. They typically have a vast amount of local knowledge of resources, consumer behaviour, and supply trends (Ngure, 2018). The manufacturing industry has benefited from the implementation of governmental initiatives, including the Vision 2030 policy on manufacturing. The vision intends to achieve an annual GDP growth rate of 10% and elevate the nation to a middle-income position by 2030, acknowledging the relevance of the manufacturing sector as a key engine of economic progress. These initiatives aim to strengthen the manufacturing sector's contribution to Kenya's economic growth plan (KAM, 2018).

The Kenyan government unveiled its Big 4 Development Agenda in December 2017, which includes expanding food security, boosting the proportion of manufacturing in the economy, improving access to affordable housing, and achieving universal health care. According to the Big 4 Agenda, the manufacturing sector's contribution to GDP should have increased to 15% by 2022. There is a deficit that has to be filled given the manufacturing sector's 7.5% contribution to GDP in 2021 (KAM, 2021). However, from a peak of 9.4% in 2015 to a low of 7.5% in 2019, the manufacturing sector's contribution to GDP has steadily declined over the last five years (KAM, 2021). This shows that Kenya is deindustrializing rather than industrialising. This shows the impending danger to achieve the policy goal of 15% by 2022 put out in the Big Four Agenda is the manufacturing sector's ongoing reduction in GDP contribution (KAM, 2021).

The remainder of this paper is organised as follows: Section two (2) reviews prior research while section three (3) outlines the research design, how the sample was selected and highlights the variables. Section four (4) presents the results while section five (5) presents the summary, conclusions and recommendations..

## **Theoretical Review**

### **Tax Discrimination Theory**

Glaeser (2001) formulated the tax discriminatory theory, which suggests that governments impose different tax rates depending on investments and geographic regions. The tax rates are influenced by the objective of attracting businesses to specific locations. This theory states that enterprises located on the outskirts of an area will enjoy tax benefits. The government uses tax discrimination to promote growth in rural regions. Investors are given reduced tax rates and holidays to locate their businesses in locales that are anticipated to flourish relative to large towns. Tax discrimination causes citizens and non-residents in the same jurisdiction to be subject to various tax regimes (Mason, 2006).

Kenyan tax law mandates that manufacturing companies and other taxable entities that engage in capital expenditures get capital allowances. Depending on the location, different capital allowances are provided. Manufacturing companies in Kenya are given a capital allowance of 100%, however, investors are given a capital allowance of 150% if their capital expenditure surpasses KSh 200 million and they are operating outside of Nairobi (GOK, 2012). Glaeser (2001) claims that since these rates are provided for the same purpose in various places, there is tax discrimination taking place.

This theory applies to the research because tax incentives may be used to recruit businesses to certain locations to enhance their financial performance by awarding capital allowances at various rates. In this case, manufacturing companies operating in Nyeri County, are among the 20% of manufacturing firms operating outside Nairobi. The idea is also pertinent to the research since tax discrimination occurs when the government offers preferred tax rates as tax incentives in select industries.

### **Research Gaps**

The study aims to fill a gap in the existing literature by investigating the effect of capital allowance on the financial performance of manufacturing firms specifically in Nyeri County. Previous research studies have not explicitly explored the combined effects of capital allowance incentives, on the financial performance of manufacturing firms within the context of Nyeri County. For instance, Onyango (2015) assessed the effect of tax incentives on the financial performance of five-star hotels in Nairobi County and Mayende (2013) investigated the impact of tax incentives on the value-added and gross sales of manufacturing firms in Uganda. The researcher has identified this gap in empirical evidence and contextual understanding and the current study seeks to address and close this gap through its examination of the topic.

### **METHODOLOGY**

A descriptive research design was adopted. In this study, the population comprised all the 15 manufacturing firms in Nyeri County that are registered by the Nyeri County finance department; licensing office 2023. The study used census methods to acquire information from finance managers, tax managers, and senior managers of the targeted manufacturing firms. To gather primary data, questionnaires with Likert scales were used. The study collected secondary data from the manufacturing firms' internal sources for six years. The researcher utilized descriptive statistics, including measures like the mean, standard deviation, and frequency, to analyse the data. Additionally, the study employed Pearson correlation and regression analysis to investigate the relationship between the variables and ascertain whether the independent variables could predict the dependent variable in the study. The program Statistical Package for Social Sciences (SPSS) was used to analyze the data. Data was presented in the form of tables and graphs.

### **RESULTS**

The study assessed how capital allowance influenced the financial performance of manufacturing firms in Nyeri County. The individuals included in the sample were asked to provide their perspectives on specific components of capital allowances, including investment deductions, wear and tear allowance, capital allowance incentives, and their level of satisfaction with the existing capital allowances. Figure 1 and Table 1 in this article explore the findings in detail. As the findings of Figure 1 and Table 1 portray the level of agreement of all aspects of capital allowances when ranked are as follows : investment deductions with 70% of the respondents indicating agreement (31.7% agree & 38.3% strongly agree), wear and tear allowance with 71.7% respondents indicating agreement (28.3% agree & 43.4% strongly agree), capital allowance incentives with 78.4% of the respondents indicating agreement (51.7% agree & 26.7% strongly agree) and satisfaction with present level of capital allowance with 85% of respondents indicating agreement (33.3% agree & 51.7% strongly agree).

Overall, there is agreement with all elements of capital allowances by all the respondents as indicated by an average value of agreement of 76.28%. These findings mirror Onyango's (2015) conclusions, which highlighted the positive correlation between deductions permitted for industrial structures and investments and the monetary success of firms. The high level of agreement expressed by the respondents in this study, with an average value of agreement of 76.28%, further strengthens the evidence supporting the efficacy of capital allowances as a motivating factor for firms' financial performance.

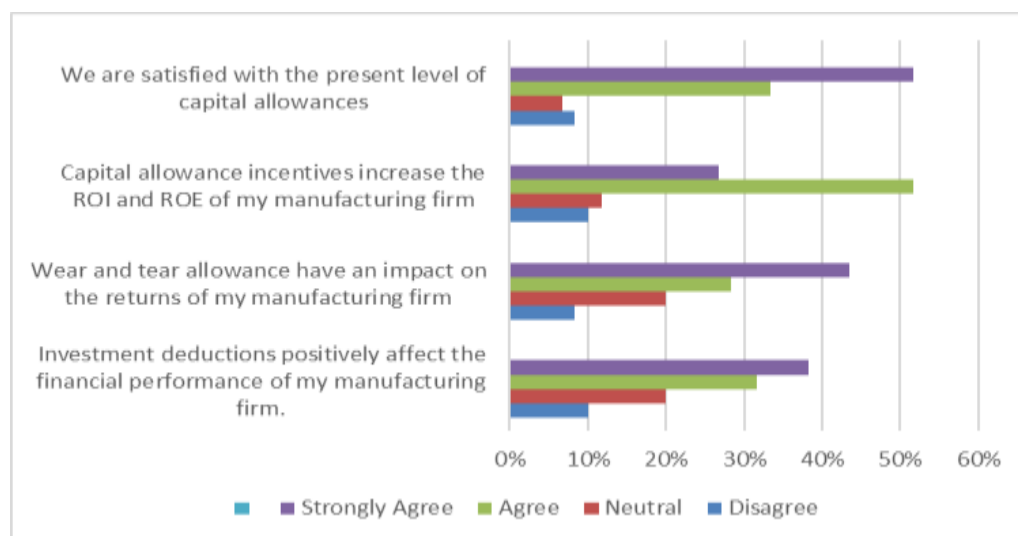


Figure 1: Descriptive Statistics on Elements of Capital Allowance

Table 1: Descriptive Statistics on Elements of Capital Allowance

Factors	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Investment deductions positively affect the financial performance of my manufacturing firm.	0%	10%	20%	31.7%	38.3%
Wear and tear allowance have an effect on the returns of my manufacturing firm	0.0%	8.3%	20%	28.3%	43.4%
Capital allowance incentives increase the ROI and ROE of my manufacturing firm	0.0%	10%	11.7%	51.7%	26.7%
We are satisfied with the present level of capital allowances	0.0%	8.3%	6.7%	33.3%	51.7%
<b>Average</b>	<b>0.0%</b>	<b>9.15%</b>	<b>14.6%</b>	<b>36.25%</b>	<b>40.03%</b>

The respondents were then asked to rate how much they agreed with various capital allowance statements. The results, which are presented in Table 2, demonstrate that respondents' attitudes on all aspects of capital allowance were neutral, as shown by the values of the means and standard deviations.

**Table 2: Capital Allowances**

Measurement Aspect	Mean	Std.Dev
Investment deductions positively affect the financial performance of my manufacturing firm.	3.98	1
Wear and tear allowance have an effect on the returns of my manufacturing firm	4.07	0.989
Capital allowance incentives increase the ROI and ROE of my manufacturing firm	3.95	0.891
We are satisfied with the present level of capital allowances	4.28	0.922

**Capital Allowance and Financial Performance**

The study undertook the regression analysis for capital allowance incentives and the financial performance of manufacturing firms in Nyeri County. The model summary, analysis of variance and model coefficients obtained are as shown in Table 3, Table 4 and Table 5.

**Table 3: Capital Allowance Model Summary**

Model Summary <sup>b</sup>				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.433 <sup>a</sup>	.187	.182	.29806

a. Predictors: (Constant), Capital Allowance

b. Dependent Variable: Financial Performance

As shown in Table 3, the value of R was 0.433 implying that there exists a correlation between capital allowance incentives and the financial performance of manufacturing firms in Nyeri County. The R squared ( $R^2$ ) value of 0.187 indicates that 18.7% of the financial performance is affected by capital allowance when all the other factors were held constant. The remaining 71.3% can be explained by other factors.

**Table 4: Capital Allowance Analysis of Variance**

ANOVA <sup>a</sup>						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	3.298	1	3.298	37.120	.000 <sup>b</sup>
	Residual	14.303	56	.089		
	<b>Total</b>	<b>17.601</b>	<b>57</b>			

a. Dependent Variable: Financial Performance

b. Predictors: (Constant), Capital Allowance

From the analysis of variance indicated in Table 4, the results showed the existence of fit between the hypothesized capital allowance incentive model and financial performance with  $F= 37.12$  and  $P < 0.05$ . This indicated a significant relationship between capital allowance and the financial performance of manufacturing firms in Nyeri County.



**Table 5: Capital Allowance Coefficients**

Model		Coefficients <sup>a</sup>		Standardized Coefficients	t	Sig.
		Unstandardized Coefficients	Std. Error			
		B		Beta		
1	(Constant)	5.114	.090		56.643	.000
	Capital Allowance	0.453	.074	0.433	6.093	.000

a. Dependent Variable: Financial Performance

**SUMMARY AND RECOMMENDATIONS****Summary**

The study examined the effect of capital allowance on the financial performance of manufacturing firms in Nyeri County. To accomplish this objective, participants were requested to express their agreement level regarding specific aspects of capital allowance. These aspects included investment deductions, wear and tear allowance, and satisfaction with the provided amounts of capital allowance. The study initially hypothesised that there existed no statistically significant correlation between capital allowance and the financial performance of manufacturing companies in Nyeri County. However, the results showed the existence of a statistically significant correlation between capital allowance and manufacturers' financial success. Consequently, the null hypothesis (H01) which proposed the non-existence of a statistically significant association between capital allowance and the financial performance of manufacturing firms in Nyeri County, was disproven in favour of the alternative. Notably, capital allowance exhibited a beta value of 0.594, a t-value of 18.395, and a p-value of 0.000 based on the standardized coefficient. Given that the p-value is not equal to or more than 0.05, we reject H01 at a significance threshold of 0.05.

The study revealed a statistically significant effect of capital allowance on the financial performance of industrial enterprises in Nyeri County. Furthermore, the majority of participants in the research expressed a positive perception regarding the influence of capital allowances on the financial performance of their respective manufacturing firms. Participants agreed strongly on investment deductions, wear and tear allowance, capital allowance incentives, and satisfaction with the current level of capital allowances. These findings emphasize the need to maintain and even improve capital allowance laws to meet taxpayers' demands and expectations and encourage investment.

The results of this investigation are consistent with the study conducted by Agundu and Ohaka (2013), which examined how capital allowance functioned as an attractive stimulus for investors involved in Nigeria's manufacturing industry. The statistical results of both studies confirmed the effectiveness of capital allowance, as it exhibited significant correlations with profitability indicators such as (Return on Equity), (Return on Assets) and (Profit after Tax). However, it is important to note that while capital investment may offer financial benefits, the report advised caution among investors in the manufacturing sector to avoid indiscriminate acquisition of industrial assets and expansion.

The research outcomes indicate that capital allowance exerts a statistically significant effect on the financial performance of manufacturing companies in Nyeri County. A substantial proportion of the respondents in the study conveyed a positive perspective regarding the influence of capital allowances on the financial performance of their manufacturing firms.

Parameters such as investment deductions, wear and tear allowance, capital allowance incentives, and satisfaction with the current level of capital allowances received significant agreement levels from the participants. These results underscore the importance of maintaining and potentially enhancing capital allowance policies to meet the expectations of taxpayers, encourage investment, and align with the needs of the manufacturing sector.

These findings align with the outcomes of Agundu and Ohaka's (2013) research, which examined the extent to which the provision of capital allowance served as an attractive investment incentive for individuals involved in the manufacturing industry in Nigeria. The statistical findings from their analysis provided support for the efficacy of capital allowance, demonstrating a robust correlation between capital allowance and key financial metrics such as profit after tax (PAT), return on assets (ROA), and return on equity (ROE). Despite the financial advantages of capital allowance, the study recommended caution against the indiscriminate acquisition and extension of industrial assets for manufacturing sector investors.

### **Recommendations**

The effect of capital allowances on the financial performance of manufacturing firms can be analyzed from theoretical, practical, and policy perspectives. Here are recommendations based on each of these aspects. The theory suggests that higher capital allowances might incentivize firms to invest in new equipment and technology, leading to increased production efficiency and profitability. Develop models to quantify the relationship between capital allowance rates, investment levels, and subsequent profitability. The study also recommends that shareholders should investigate specific manufacturing firms that have significantly benefited from capital allowances. Understand how these firms strategically utilized capital allowances to enhance their financial performance. Consider factors such as the timing of investments, equipment upgrades, and expansion plans. The study also recommends that the government should enact policies and incentives provided by governments to encourage capital investments in the manufacturing sector. Evaluate the effectiveness of these incentives in terms of attracting investments, improving productivity, and enhancing the overall financial health of manufacturing firms.

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