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# Corporate Governance Practices and Tax Disclosure among Firms Listed at the Nairobi Securities Exchange, Kenya

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# Abstract

Tax disclosure has been associated with numerous benefits including putting pressure on regulators to develop the tax system and also propels organizations to oppose aggressive tax decrease strategies. The aim of this study was to establish the relationship between corporate governance practices and disclosure of corporate tax among companies listed on the Nairobi Securities Exchange (NSE), Kenya. The study employed an explanatory research design. The target population was 65 companies listed at the NSE, but only 56 firms were surveyed. Research variables data was derived from the companies' annual financial statements. Panel data was collected from 2014 to 2018 for all 56 companies making 280 observations. The results revealed that ownership structure, board size and board independence had a positive and significant relationship with corporate tax disclosure among firms listed at NSE, Kenya. The study concluded that listed firms with directors who have a higher stock holding have high level of financial disclosure. In addition, board size has an impact on corporate tax disclosure because boards that are larger in size have diverse expertise to help make better decisions, and are harder for their powerful CEOs to dominate. Larger boards enable a firm to include more diverse board members bringing different areas of technical expertise. In addition, the study concluded that the higher proportion of independent non-executive and executive directors increased board effectiveness in monitoring the management of the firms in their decision making thereby increasing voluntary disclosures of information. The study recommended that the management of firms listed in NSE should ensure that the ownership structure is well constituted so that this does not limit corporate tax disclosure. It suggested that the firms' management should ensure that there is an appropriate board size to ensure there is smooth coordination within the board. It also recommended that listed firms regulators ensure that there is board independence whereby majority of directors should be non-executive directors as this allows them to make appropriate and non-partisan decisions including matters regarding tax disclosure.

**Keywords:** *Corporate governance practices, tax disclosure, Nairobi securities exchange*

## 1.0 INTRODUCTION

The issue of state company tax disclosure was raised in 1987 by a study for New York State's Legislative Tax Study Commission. Several states have embraced regulations requiring some state-level disclosure by corporations (Mazerov, 2007). Currently, activists around the world call on governments to request disclosure of information for public users from companies about what, what amount and where on the globe firms, particularly multinational firms(Christians, 2013). Their point is to stir public thoughtfulness to the systemic under-taxation of multinational companies, to demonstrate that this is linked to the failure of development in developing countries, and to persuade law-makers that the public is curious in changing this model.

Tax disclosure is a term utilized to depict the legal requirement to provide current taxation information to the other party or disclosure of information related to transactions that may be viewed as tax sheltering (Francois, 2012). Corporate tax disclosure is a good mechanism for finding out if each corporation is handled fairly and on the other hand that corporations on their end are paying their fair portion of taxes (ITEP, 2016). Among the OECD countries; Lenter, Shackelford and Slemrod (2003), found that only Finland, Sweden, Norway, and Japan allow several forms of public access to taxation information.

The improvement of corporate governance practices is widely recognized as one of the essential elements in strengthening the foundation for the long-term economic performance of countries and corporations (Ibrahim, Rehman & Raoof, 2010). According to Sandada (2015), the connection between different attributes of the board members of companies, for example, the size of the board, its creation, its ability among others has been of great enthusiasm to certain specialists for a long time. It is evident that the failure of financial institutions in many cases arises as a result of poor governance. This has been seen in frequencies of deficient inward controls and predominance of people bringing about wasteful aspects and amplified expenses. Safari, Mirshekary and Wise (2015) stated that mitigation of residual losses is one of the aims of good corporate governance.

The Nairobi Securities Exchange (NSE) is a leading African Exchange market, based in Kenya is one of the fastest-growing economies in Sub-Saharan Africa. The NSE was founded in 1954 with a six decade heritage in listing equity and debt securities. It offers a world class trading facility for local and international investors looking to gain exposure to Kenya and Africa’s economic growth. NSE demutualized and self-listed in 2014. Its Board and management team are comprised of some of Africa’s leading capital markets professionals, who are focused on innovation, diversification and operational excellence in the Exchange (NSE, 2019). NSE is performing a critical role in the growth of Kenya's economy by encouraging savings and investment and helping local and international companies access cost-effective capital. . It operates under the jurisdiction of the Capital Markets Authority of Kenya. It is mandated to oversee listing, delisting and regulation of trading of financial securities such as shares. According to My Stock (2014), the NSE 20-Share in the chosen and agreed index for benchmarking the equities traded in Kenya. Firms at the NSE are chosen on the basis of market capitalization, the quantity of offers exchanged, the quantity of arrangements developed and the total turnover (Buigut, Soi, Koskei & Kibet, 2013).

### 1.1 Statement of the Problem

Tax disclosure has been associated with numerous benefits including putting pressure on regulators to develop the tax system and also propels organizations to oppose aggressive tax decrease strategies. Companies are expected to adopt best practices of tax disclosure in implementing their future plans (Mgammal, Bardai & Ku Ismail, 2018). The tax disclosures

is important and it increases transparency will improve taxpayer compliance. In Kenya, tax efficiency has been a subject that has attracted significant discussion among policy makers. According to Okech and Mburu (2011), a large percentage of tax revenue comes from discretionary tax policy and not from pure responsiveness of tax revenue to changes in national income. Taxation leads to higher rates of return on both equity and assets and also frees up some revenue to be reinvested in the economy of a country (Uwaumq & Ordu, 2014). Kenya is yet to achieve this characteristic of a good tax system (PwC, 2013).

Cases of tax evasion have been on the rise in Kenya. The effects arising from tax evasion impose serious consequences to the companies where they are required to pay hefty penalties. The government as well loses a significant amount of revenue as a result of tax evasion. These questionable performances have been attributed to the inability of firms to meet their tax obligations, which include tax disclosure, as well as internal friction arising from the corporate governance (Kuria, 2017). Board composition and responsibilities have recently become vital in relation to tax matters more than ever before (Tax Journal, 2019). According to Safari et al (2015) one of the targets of good corporate governance is to mitigate residual losses and in so doing, companies may craft ways of reducing their tax obligations by manipulating tax rate reconciling items in the area of tax disclosure. Therefore, the study seeks to shed more light on the subject.

Numerous studies have attempted to discuss the aspect of corporate governance. Tembur (2016) analysed the effect of Tax Incentives on Financial Performance of Export Processing Zone Firms in Kenya but rather did not focus on the concept of corporate tax. The study thus presented a conceptual gap. Omodero and Ogbonnaya (2018) did an analysis on corporate tax and profitability of deposit money banks in Nigeria. The study presented a contextual gap since it was in a Nigerian context. Kigotho (2014) likewise sought to look into the effects of corporate governance on financial performance of companies quoted at Nairobi securities exchange. However, no local study has looked at the relationship between corporate governance and tax disclosure. Thus, it is worthwhile for the study to fill the gap by establishing the relationship between corporate governance practices and corporate tax disclosure among firms listed at the NSE, Kenya.

### 1.2 Research Objectives

i. To establish the effect of ownership structure on corporate tax disclosure among firms listed at NSE, Kenya

ii. To assess the effect of board size on corporate tax disclosure among firms listed at NSE, Kenya

iii. To examine the effect of board independence on corporate tax disclosure among firms listed at NSE, Kenya

## 2.0 LITERATURE REVIEW

### 2.1 Theoretical Review

#### 2.1.1 Agency Theory

The theory was developed by Jensen and Meckling (1976) and defines an agency relationship as "a contract under which one or more persons (the principal(s) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent". The theory models the relationship between the principal and the agent. In the context of the firm, the agent (manager) acts on behalf of the principal (shareholder). Agency theory proposes that employees or managers in organizations can be

self-interested. The agency theory shareholders trust the agents to act and make decisions in the principal's interest. On the contrary, the agent may not necessarily make decisions in the best interests of the principals (Padilla, 2000). The agents are controlled by principal-made rules, with the aim of maximizing shareholders value hence, a more individualistic view is applied in this theory.

The agency theory was employed to explore the relationship between the ownership and management structure. Equally, where there is a separation, the agency model can be applied to bring into line the goals of the management with that of the owners. The model of an employee depicted in the agency theory is more of a self-interested, individualistic and are restricted rationality where rewards and punishments seem to take priority (Jensen & Meckling, 1976). Corporate governance is a mechanism through which shareholders are assured that managers will act in their best interests and it limits agency problems. Agency theory suggests that there are a number of mechanisms to reduce the agency problem in the company such as choosing appropriate board composition (in terms of size, gender, experience and competence), effective audit committee, and the threat of firing (Tandelilin et al., 2007). From agency theory view point, effective corporate governance improves corporate performance by resolving agency problems through monitoring management activities, controlling self-centred behaviours of management and inspecting the financial reporting process (Habbash, 2010).

This study was based on the agency theory and the study variables were identified with the aim of examining the relationships between corporate governance mechanisms and tax disclosures. Board structure has relied heavily on the concepts of agency theory, focusing on the controlling function of the board (Habbash, 2010). The corporate governance mechanisms considered in this research include ownership structure, board size and board independence and are anchored on this theory.

### 2.1.2 Signalling Theory

In markets with information asymmetry, signaling theory states corporations issue "signals" about who they are and "what they believe" (Spence, 1973). Spence defines market signals as altering the belief of, or conveying information to, other groups in the market place regarding some unobserved activity. Signaling information, therefore, is essential to decrease agency costs and information asymmetry between firms and the market. From another side, companies' disclosures of information, including information about tax, falls somewhere between no disclosure and full disclosure, depending on their motivations (Premuroso, 2008). These motivations differ and have different effects on the level of disclosure between companies, and from one country to another. This is based on numerous factors, such as regulations, tax law, and political cost. All companies, at least partially, disclose information about their business prospects in order to signal whether they have or do not have good investment opportunities (Bhattacharya & Ritter, 1980).

Another possibility of using signaling theory is that managers may desire to decrease information asymmetry existing in the market regarding the company's performance. For instance, disclosures may serve as "signals" if they reflect information about unobservable attributes of a company's decision (Morris, 1989). In such a scenario, managers of higher quality firms with private information can distinguish themselves from lower quality companies via disclosures. In this context, managers can use tax disclosure to send signals to related parties that need information about tax in order to help them in their decisions. At the same time, managers of an underperforming firm may signal that the firm is taking steps to improve performance by disclosing a decision related to outsourcing.

The finance literature tests company information disclosures using signaling theory in numerous ways. Ross (1977) contended that when managers possess inside information, the financial structure of the corporation (the amount of debt) signals information to the market. In another study, cash dividends functioned as a positive signal by the manager of expected cash flows when investors had imperfect information about companies' profitability (Bhattacharya & Ritter, 1980). Recent research also applied signaling theory to undervalued companies announcing stock repurchases to separate themselves from overvalued corporations (Utpal & Dittmar, 2003). In such scenarios, it is clear to see how companies can send signals under signaling theory to the users of information or financial statements.

In the same context, tax information can be sent as signals to IRS or users through tax disclosure. In the case of asymmetric information, Akerlof (1970) who referred to the theory suggested that firms with superior performance (good firms) utilize financial information (including tax information) to send signals to the market, users, and IRS. Therefore, managers can be motivated to provide or disclose specific information on a voluntary basis. This is because they are expected to supply (and to be interpreted as) a good indication of the performance of their companies in the market, and how to decrease the asymmetry of information. The signaling theory is therefore relevant to this study since it captures tax disclosure as one of the signals organizations send to relevant stakeholders. Communicating tax information can serve as an indication of good performance and compliance with the tax requirements. Tax disclosure was anchored on this theory.

### 2.2 Empirical Review

Al-Najjar and Kilincarslan (2016) studied the impact of ownership structure on dividend policy of listed firms in Turkey. The research used a large panel dataset of 264 Istanbul Stock Exchange-listed firms (non-financial and non-utility) over a 10-year period 2003-2012. The empirical results show that foreign and state ownership are associated with a less likelihood of paying dividends, while other ownership variables (family involvement, domestic financial institutions and minority shareholders) are insignificant in affecting the probability of paying dividends. However, all the ownership variables have a significantly negative impact on dividend payout ratio and dividend yield. Hence, the paper presents consistent evidence that increasing ownership of foreign investors and the state in general reduces the need for paying dividends in the Turkish market.

There is an increasing expectation that investors are aware that tax aggressiveness has a detrimental impact on their investment returns. Corporations try to demonstrate to investors their compliance with tax regulations. Zemzem and Khaoula (2013) examined the effects of board of directors' characteristics on tax aggressiveness. The study is based on the analysis of a sample of 73 French companies on the SBF 120 index for the period 2006-2010. A regression analysis was used to determine which variables that can reduce tax aggressiveness. Results showed that the board size and the percentage of women in the board affect the activity of tax aggressiveness.

Bansal, Lopez-Perez and Rodriguez-Ariza (2018) evaluated the impact of board independence on corporate social responsibility (CSR) disclosure and analyses the moderating effect of the presence of family ownership. Using an international sample from 29 countries from 2006 to 2014, our panel Tobit estimation shows that board independence is negatively associated with CSR disclosure practices and they present opposition to CSR disclosure practices. However, family ownership moderates the relationship and enforces the positive orientation of independent directors towards CSR disclosure. This shows that the presence of family ownership reduces independent director concern of reputation risks associated with receiving misleading information and family firms decrease the asymmetries

of information between the independent director and management. The study also finds that independent directors encourage CSR disclosure in family firms more in civil law countries where investor protection is low compared to common law countries where investor protection is high.

## 3.0 RESEARCH METHODOLOGY

The study adopted an explanatory research design. The target population was the firms on Kenya's NSE. There are 65 companies listed at the NSE and in this study, only 56 firms were surveyed. The data was derived from the company's annual financial statements. Data was collected in a period of five years between 2014 and 2018 for all 56 companies making 280 observations. Panel regression model was estimated.

## 4.0 RESULTS AND DISCUSSION

### 4.1 Descriptive Statistics

The descriptive statistics of tax disclosure, ownership structure, board size and board independence is presented in Table 1

**Table 1: Descriptive Results**

| | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| Tax Disclosure | 280 | 0.0003 | 11.431 | 0.459 | 1.018 |
| Ownership Structure | 280 | 0.0001 | 34.546 | 1.050 | 4.178 |
| Board size | 280 | 2 | 13 | 5 | 2.6 |
| Board Independence | 280 | 2 | 8 | 5 | 2.536 |

The results in Table 1 indicate that the mean of tax disclosure of firms listed in NSE from 2014 to 2018 is 0.459. In addition, the minimum is 0.0003 while the maximum is 11.431. In addition, the standard deviation is 1.018. This implies that tax disclosure is widely spread from the mean.The results further indicate that the mean of ownership structure of firms listed in NSE from 2014 to 2018 is 1.050. The minimum is 0.0001 while the maximum is 34.546. In addition, the standard deviation is 4.178. This implies that ownership structure is widely spread from the mean.

The results further indicate that the mean of board size of firms listed in NSE from 2014 to 2018 was 5. In addition, the minimum was 2 while the maximum was 13. In addition, the standard deviation was 3. This implies that board size is widely spread from the mean. The results further indicate that the mean of board independence of firms listed in NSE from 2014 to 2018 was 5. In addition, the minimum was 2 while the maximum was 8. Further, the standard deviation was 2.536. This implies that board independence was widely spread from the mean.

### 4.2 Stationarity Test

Table 2 shows Levin-Lin Chu unit root test results.

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**Table 2: Levin-Lin Chu unit-root test**

| Levin-Lin Chu unit-root test | | | |
|---|---|---|---|
| **Variable** | **Hypothesis** | **p value** | **Verdict** |
| Tax Disclosure | Ho: Panels contain unit roots<br>Ha: Panels are stationary | 0.0000 | Reject Ho |
| Ownership Structure | Ho: Panels contain unit roots<br>Ha: Panels are stationary | 0.0000 | Reject Ho |
| Board size | Ho: Panels contain unit roots<br>Ha: Panels are stationary | 0.0000 | Reject Ho |
| Board independence | Ho: Panels contain unit roots<br>Ha: Panels are stationary | 0.0001 | Reject Ho |

Based on the findings in Table 2, the null hypotheses that: Panels contain unit roots were rejected for all the variables, because the p values were less than 0.05. This implied that the panel data for all the variables were stationary.

### 4.3 Correlation Results

Table 3 presents results on the correlation between the study variables.

**Table 3: Correlation Matrix**

| | Tax disclosure | Ownership structure | Board size | Board independence |
|---|---|---|---|---|
| Tax disclosure | 1.000 | | | |
| Ownership structure | 0.070** | 1.000 | | |
| Board size | 0.320** | -0.148 | 1.000 | |
| Board independence | 0.303** | -0.070 | 0.464 | 1.000 |

* <.1; **<.05; ***<0.01

The results in Table 3 reveal that ownership structure and tax disclosure are positively and significantly correlated (r=0.070**) at 5 % significance level. This implies that both ownership structure and tax disclosure change in the same direction. These findings agree with those of Majeed, Aziz and Saleem (2015) who found positive and significant association between ownership structure and corporate social responsibility reporting.

In addition, the results show that board size and tax disclosure are positively and significantly correlated (r=0.320**) at 5 % significance level. This implies that both board size and tax disclosure change in the same direction. These findings agree with those of Zemzem and Khaoula (2013) who indicated that board size correlates with the activity of tax aggressiveness.

Further, results show that board independence and tax disclosure are positively and significantly correlated (r=0.303**) at 5 % significance level. This implies that both board

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independence and tax disclosure change in the same direction. These findings disagree with those of Bansal, Lopez-Perez and Rodriguez-Ariza (2018) who found that board independence was negatively associated with corporate social responsibility (CSR) disclosure.

### 4.4 Hausman Test

The results presented in Table 4 indicate the Hausman Test.

**Table 4: Hausman Test**

| | (b) | (B) | (b-B) | sqrt(diag(V_b-V_B)) |
|---|---|---|---|---|
| | **fixed** | **random** | **Difference** | **S.E.** |
| Ownership structure | 0.05936 | 0.03198 | 0.02738 | 0.01991 |
| Board size | 0.08358 | 0.09513 | -0.0116 | 0.01184 |
| Board independence | 0.09042 | 0.08157 | 0.00885 | 0.01466 |
| B | | | Ha; obtained from xtreg | |
| B | inconsistent | | Obtained from xtreg | |
| Test: | Ho: | difference | in | Coefficients |
| chi2(3)= | | (b-B)'[(V_b-V_B)^(-1)](b-B)=2.44 | | |
| Prob>chi2=**0.4869** | | | | |

A resultant p value of 0.4869 is higher than the conventional p value of 0.05 leading to the acceptance of the null hypothesis, that is. E (μi / xit) = 0, and thus the random effects model was more appropriate.

### 5.5 Regression Results

Regression results were presented in Table 5.

**Table 5: Regression Results**

| Tax disclosure | Coef. | std. err | z | P>\|z\| | [95% conf.interval] | |
|---|---|---|---|---|---|---|
| Ownership structure | 0.032 | 0.015 | 2.18 | 0.029 | 0.003 | 0.061 |
| Board size | 0.095 | 0.025 | 3.81 | 0.000 | 0.046 | 0.144 |
| Board independence | 0.082 | 0.025 | 3.21 | 0.001 | 0.032 | 0.131 |
| _cons | -0.277 | 0.126 | -2.2 | 0.028 | -0.523 | -0.030 |
| R squared =0.1468 | | | | | | |
| Wald chi2(3)=47.31 | | | | | | |
| Prob>chi2=0.000 | | | | | | |

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The model was: Tax Disclosure= -0.277+ 0.032 Ownership Structure+ 0.095 Board Size+ 0.082 Board Independence

Results in Table 5 indicate that ownership structure was positively and significantly related with tax disclosure of firms listed at NSE (β=0.032, p=0.029). These findings agree with those of Majeed, Aziz and Saleem (2015) who found positive and significant impact from board size and corporate social responsibility reporting. However, these findings were inconsistent with those of Mgammal, Bardai and Ku Ismail (2018) who found that ownership structure do not significantly influence tax disclosure.

In addition, results reveal that board size was positively and significantly related with tax disclosure of firms listed at NSE (β=0.095, p=0.000). These findings agree with those of Zemzem and Khaoula (2013) who indicated that board size affects the activity of tax aggressiveness.

The results further show that board independence was positively and significantly related with tax disclosure of firms listed at NSE (β=0.082, p=0.001). These findings agree with those of Ortas, Álvarez and Zubeltzu (2017) who found a positive connection between board independence and corporate social performance. These findings were however inconsistent with those of Raithatha and Bapat (2014) who studied the impact of corporate governance on financial disclosures made by the Indian firms but did not find any influence of board independence on the disclosures.

The R squared was 0.1468. This implies that ownership structure, board size and board independence contributed 14.68% to variations in tax disclosure. The R squared obtained in this study was relatively small compared to what other studies found. This is an indication that there are other factors influencing tax disclosure apart from the ones included in the study model. The results further indicated that the overall model was significant (p=0.000). This was supported by an F statistic of 47.31.

## 5.0 CONCLUSION

The study aimed to find out the relationship between corporate governance practices and corporate tax disclosure. The findings indicated that ownership structure had a positive and significant effect on corporate tax disclosure. This implied that listed firms with better ownership structure have high level of financial disclosure. The study results further indicated that board size had a positive and significant effect on corporate tax disclosure which meant that large board size is beneficial in corporate tax disclosure because they have diverse expertise to help make better decisions and are harder for their powerful CEOs to dominate. Larger board enables a firm to include more diverse board members brining different areas of technical expertise. In addition, the study results showed that board independence had a positive and significant effect on corporate tax disclosure. This indicated that the higher proportion of independent non-executive and executive directors increased board effectiveness in monitoring managerial opportunism and preventing self-interest thereby consequently, increased voluntary disclosures.

## 6.0 RECOMMENDATIONS

Based on the findings of the study, it was revealed that ownership structure had a positive and significant effect on corporate tax disclosure. Therefore, the study recommended that the management of firms listed in NSE should ensure that there is proper ownership structure. Further, board size was found to have a significant and positive impact on corporate tax disclosure. The study therefore recommended that stakeholders of the firms should constantly monitor the board size to ensure there is smooth coordination within the board,

that there is no free riding by individual directors, its efficiency in decision making remains optimal. Lastly, the board independence was found to have a significant effect on corporate tax disclosure. The study therefore recommended Nairobi stock exchange should make it mandatory to all listed firms to have board independence. In addition, effective board should be comprised of a majority of non-executive directors, who are believed to provide superior performance due to their independence from firm management.

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