

## Effect of Company Income Tax on Financing Decisions

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### ABSTRACT

*The study examined the effect of company income tax on financing decisions. A study of Guinness, Nigeria. The specific objectives were: to ascertain the extent to which company income tax influence equity financing decision of Guinness, Nigeria, determine the extent to which company income tax influence debt financing decision of Guinness, Nigeria, and to investigate the extent to which company income tax influence retained earnings financing decision of Guinness, Nigeria. Ex-post facto design was adopted in the study. Data for this study were gathered from secondary sources of data using annual report of the company of various years. Simple regression statistical tool was employed in the study. The major findings of this study include: company income tax significantly influence equity financing decision of Guinness, company income tax significantly influence debt financing decision of Guinness, and company income tax significantly influence retained earnings financing decision of Guinness, Nigeria. The study recommended that government should make it possible for companies to evade tax and penalize any registered company that evades tax. Finally, government should harness the potentials of taxation and promote tax system in order to increase the prosperity of the Nigerian economy.*

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**KEYWORDS:** *Company income tax, equity financing decision, debt financing decision, retained earnings financing decision*

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### INTRODUCTION

The financing decision is one of the three core decision areas in financial management which involves the identification of the appropriate sources of funds that would be used to finance projects. To do this, considerations are usually given to the cost associated with each source, the characteristics of each source as well as the availability of each source. According to Pandey (2011), capital structure decision should be examined from the point of its impact on the value of the firm. He noted that under favorable economic conditions, the earning per share increase with financial leverage. But that leverage also increases the financial risk of shareholders. As a result, it cannot be stated definitely whether or not the firm's value will increase with leverage. In the financing decision, the manager is concerned with determining the best financing mix or capital structure for his firm.

Capital structure decision is the mix of equity and debt that a company uses to finance its business. The concept has been a major issue in financial economics with the emergence of Modigliani and Miller who in 1958 showed that given a perfect market condition, homogeneous expectations, etc, capital structure decision of the firm is irrelevant. By relaxing

the assumptions and analyzing their effects, the theory seek to determine whether an optimal capital structure exists or not, and if so what could possibly be its determinants (Shyam-Sunder,2021).

The relationship between capital structure decisions and firm value has been extensively investigated in the past few decades. Capital structure could have two effects; firms of the same risk class could possibly have higher cost of capital with higher leverage. Second, capital structure may affect the valuation of the firm, with more leveraged firms being riskier and consequently valued lower than the less leveraged firms. If the manager of a firm has the shareholders' wealth maximization as his objective, then capital structure decision is an important decision; for it could lead to an optimal financing mix which maximizes the market price per share of the firm. If capital structure is not irrelevant, then there is also another thing to consider; the interaction between financing and investment (Ola,2019). In order to try to distinguish the effects of various determinants on capital structure, it is assumed that the investment decision is held constant.

The determining factors affecting the choice of capital structure of firms can be broken down into four categories; according to their purpose toward improving the conflicts between the various stakeholders with claims upon the firm's resources, machine and managers (the agency approach), Conveying private information to the capital market or mitigating the effects of adverse selection (the asymmetric information approach), influencing the nature of products or competition in the product/input market and influencing the results of disputes over corporate control (Aryeetey,2014). The main objective of the study was to examine the effect of company income tax on financing decisions of Guinness, Nigeria.. The specific objectives were:

- i. To ascertain the extent to which company income tax influence equity financing decision of Guinness, Nigeria.
- ii. To determine the extent to which company income tax influence debt financing decision of Guinness, Nigeria.
- iii. To investigate the extent to which company income tax influence retained earnings financing decision of Guinness, Nigeria.

## LITERATURE REVIEW

Taxes are used in modern times to generate revenue, in addition, they are applied to fund governance, generate employment, ensure resource redistribution, streamline consumption of certain goods, reduce inflation and stimulate growth in the economy. Tax is therefore, a significant tool of fiscal and economic policy. Taxation is therefore a major element of public finance. A tax is not a voluntary payment or donation. Rather, it is an 'enforced contribution, exerted pursuant to legislative authority' and is imposed by government (Michaels,2019). A tax is usually a monetary charge on a person's or entity's income. Taxes may be imposed on individuals, entities, assets and on transactions. A tax may be direct or indirect. It is direct where it is levied on the person who is intended to pay it.

Companies Income Tax and Personal Income Tax are examples of direct taxes. A tax is indirect if the levy is imposed on the person who pays with the expectation to pass the burden to third parties. Indirect taxes are borne by someone other than the person responsible for paying them (Salawu,2017). For example, excise tax, import duties and value added tax are often included in the prices of the items purchased, thus ultimately, the seller sends the payments to the government while the buyer remains the real payer.

Taxes build capacity, legitimacy and consent. Thus, the imposition of tax is statutory to enable government meet its obligations. The Constitution of the Federal Republic of Nigeria 1999 (as amended) under Section 24(f) stipulates that, “it shall be the duty of every citizen to declare his income honestly to appropriate and lawful agencies and pay his tax promptly”. Companies also fall within the categories of persons that are taxable in Nigeria. Companies are taxed under the companies income tax introduced in 1961 with modification in 2007. The administration of the companies’ income tax in Nigeria is vested on the Federal Inland Revenue Services. The tax is payable by all companies at the rate defined by the Companies Income Tax Act.

### **Capital structure of a company**

Many studies including Pandey (2011) have identified various determinants of capital structure, which generally include tangibility of assets, Size, growth, profitability, and age of firms. The determinants so mentioned have direct connections with the leverage of a company as discussed subsequently. Gearing is the ratio of a company’s debt capital to its equity capital. The firm’s asset structure plays an important role in determining its capital structure. The degree to which the firm’s assets are tangible should result in the firm having greater liquidation value (Titman & Wessels, 2018).

Hall (2014) assert that firms that invest heavily in tangible assets also have higher financial leverage since they borrow at lower interest rates if their debt is secured with such assets. It is believed that debt may be available for use when there are durable assets to serve as collateral. It is further suggested that bank financing will depend upon whether the lending can be secured by tangible assets. Empirical results show a positive relationship consistent with theoretical argument between asset structure and leverage for the firms (Friend & Lang, 2018)

### **Theoretical framework**

This theory was propounded by Myers and Majluf (1984) and it maintains that financing adapts to mitigate problems created by differences in information between insiders (managers) and outside investors. The firm turns first to the financing sources where differences in information matter least. It begins with a firm with assets-in-place and a growth opportunity requiring additional equity financing. The pecking order theory explains why the bulk of external financing comes from debt. It also explains why more profitable firms borrow less: Not because their target debt ratio is low – in the pecking order, they don’t have a target – but because profitable firms have more internal financing available. Less profitable firms require more external financing, and consequently accumulate more debts.

### **Empirical Review**

Adereti (2021) did a study on value added tax and economic growth in Nigeria. He analyzed time series data on the gross domestic product (GDP), VAT revenue, total tax revenue and total (federal government) revenue from 1994 to 2008 using both simple regression analysis and descriptive statistical method. The findings of the study showed that VAT revenue accounts for as much as 95percent significant variations in GDP –Nigeria. A positive and significant correlation exists between VAT revenue and GDP. Both economic variables fluctuated greatly over the period though VAT revenue was more stable. No causality exists between the GDP and VAT revenue, but a lag period of two years exists and also, this could be true as VAT is not easily evaded as it is collected at source on the consumption of goods and services. This study will further verify to see if the result will comply with the above findings.

Adegbile and Fakile (2021) examined the relationship between company income tax and Nigeria's economic development for the period 1981 to 2007. They used GDP to capture the Nigerian economy which was measured against total annual revenue from company income tax for the same period. They employed the use of chi-square and multiple regression analysis method to analyze data obtained from both primary and secondary sources. Their variables included various taxes regressed against GDP with an R-squared of 98.6percent and an adjusted R squared of 98.4percent, revealing that company income tax impact on GDP is very high and impressive. It further showed that there is a significant relationship between company income tax and Nigerian economic development and that tax evasion and avoidance are the major hindrance to revenue generation. Overall, the study examined company income tax which calls for the need to see the impact of all tax revenues on the Nigerian economy.

Omole and Falokun (2019) investigated the impact of interest rate liberalization on the company financing strategies of quoted companies in Nigeria. These scholars aimed at ascertaining the extent to which interest rate liberalization impact on company financing decisions of companies quoted in the Nigerian stock exchange and the implications this will have for the effectiveness of interest rate policies. Their research was carried out using both descriptive and quantitative research techniques and their research indicated that the effects of liberalization on the financing strategies are significant. More importantly, the effect of liberalization on company performance is more revealing as indicated by the firms' turnover, gross profits and investments, all of which decreased marginally in a few cases but increased considerably in many others, after the liberalization of the money market. It was then concluded that interest rate liberalization had significant impact on company financing decision. It was then recommended that liberalizing the interest rates, though desirable for its influence on increased financial mobilization, would not be enough in itself and that effort is also required in the area of developing the capital market to absorb the likely increased demand for investible funds.

Chang (2019) examined company governance and management of earnings: empirical evidence from selected Nigerian-listed companies. The aim was to carry out an investigation on the effects of company governance variables on earnings management among selected listed firms from the manufacturing and banking sectors. A sample of 24 listed companies from the 2 sectors' population of 63 was examined to gather empirical data from 2008 to 2013 using multiple regression tools. Employing the panel data analysis approach, board independence, audit committee independence and audit committee size are insignificantly positively correlated with earnings management. Board size is insignificantly negatively correlated with earnings management while ownership structure is insignificantly negatively correlated with earnings management. Audit quality is positively correlated with earnings management, though not statistically significant. Based on these findings, the study concluded that company governance structures, as it were, have not helped to address earnings management. The researcher then recommended that investors should invest in companies with moderate-to-high debt-to-equity ratios as lenders are able to externally monitor companies and also that regulatory bodies should frequently discharge their supervisory roles by monitoring the companies' activities to ensure compliance.

Edewusi, and Ajayi (2019) examined the nexus between tax revenue and economic growth. The study assessed PPT, CIT and VAT on economic growth. Statistical bulletins of CBN and FIRS were used and data analyzed for short and long run using multiple regression analysis,co

integrations and other post estimation tests. Findings from the test revealed PPT exerted a positive significant impact, CIT positively and significantly and VAT also noticeable and positive effect on growth. The study advocated that government should make efficacious the tax system of the country as to curb practices that hampers the effectiveness of the system to generate the required revenue to cause a change in economic growth.

## METHODOLOGY

The research study employed an ex-post facto research design in carrying out the study. This research design was used because the facts already existed and the data already known and cannot be manipulated. Ex-post facto is a systematic empirical enquiry whereby a scientist has no direct control of the explanatory variables because he cannot manipulate these variables which already exist. Data for this study were gathered from secondary sources of data. The research data was obtained from various secondary sources which include Annual report of the company using various years as well as other researchers' journals and publications. In this study, secondary sources of data was employed and obtained from company's Report. The regression model shows the effect of independent variables on the dependent variable in each of the identified models which are in line with the research hypotheses earlier identified.

### Model 1

The relationship between company income tax and equity financing is expressed by the following equation:  $EFD = f(CIT)$ . The statistical model for model 1:  $EFD = \beta_0 + \beta_1CIT + \varepsilon$  :Where: EFD = Equity financing decision. CIT = Company income tax,  $\beta_0$ =regression intercept;  $\beta_i$ =parameters to be estimated; and  $\varepsilon$  = the error term incorporating other factors that are not considered in the model.

### Model 2

The relationship between company income tax and debt financing decision  $DFD = f(CIT)$ , The statistical model for model 2:  $DFD = \beta_0 + \beta_1CIT + \varepsilon$  Where: DFD = Debt financing decision,  $\beta_0$ =regression intercept;  $\beta_i$ =parameters to be estimated; and  $\varepsilon$  = the error term incorporating other factors that are not considered in the model.

### Model 3

The relationship between company income tax and retained earnings,  $RFD = f(CIT)$ . The statistical model for model 3:  $RFD = \beta_0 + \beta_1CIT + \varepsilon$ , Where: RFD = Retained earnings financing decision,  $\beta_0$ =regression intercept;  $\beta_i$ =parameters to be estimated; and  $\varepsilon$  = the error term incorporating other factors that are not considered in the model.

Simple regression statistical tool was employed in the study. The t-statistics was employed to determine the significance of the coefficients of the independent variables thus checking the coefficients against the expected signs. The  $R^2$  was used to measure the goodness of fit of the regression equation and the presence of the first order serial correlation will be detected using the Durbin Watson statistics. The F-statistics was used to test the overall significance of the model.

**DATA ANALYSIS**

The regression result of company income tax on financing decisions of Guinness, Nigeria

**Model 1**  
**Regression result**

Dependent Variable: LEFD					
Variable	Coefficient	Std. Error	t-Statistic	Prob.	
C	3.884465	0.256868	15.12240	0.0000	
LCIT	0.054453	0.014003	3.888763	0.0007	
R-squared	0.773229	Mean dependent var	3.779028		
Adjusted R-squared	0.714071	S.D. dependent var	0.225880		
S.E. of regression	0.120784	Akaike info criterion	-1.188670		
Sum squared resid	0.335539	Schwarz criterion	-0.861724		
Log likelihood	24.83005	Hannan-Quinn criter.	-1.084077		
F-statistic	13.07061	Durbin-Watson stat	1.317841		
Prob(F-statistic)	0.000002				

Source: Researcher's computation from E-views

This is given by the high value of the R-squared of 0.7732 (77.32 per cent) and the adjusted R-squared of 0.7140 (71.40 per cent). Adjusted R-squared of 71 per cent of the systematic variations in the performance of the equity financing has been explained by changes in income. In the same vein, the high value of F-statistics (13.0706) shows that the overall model is statistically significant. The overall significance of the short-run model implies the joint significance of all explanatory variables in explaining short-run changes in the performance of the company. Further examination of the result shows that there is no problem of autocorrelation in the model.

This is so because the Durbin-Watson (DW) statistic value of 2.03 falls within the acceptable region of no autocorrelation. From the policy stance, this means that the finding of this study can be applied for policy purposes in the Nigerian economy. The result also revealed that changes in the current period of company income has negative but significant effect on the performance of the company in the short-run. A one per cent increase in the current period of company income tax will result in a negative change in the current value of the equity financing of the company by 0.2882 or 28.82 per cent all things being equal. Similarly, the variations in the current value of CIT will lead to a significant and positive effect on the performance of the company in the short-run by 0.0544 or 5.44 per cent *ceteris paribus*.

Model 2

(Regression result)

Dependent variable: LDFD

Variable	Coefficient	Std. error	t-stat	Prob.
C	2.080533	7.762449	0.268025	0.7917

LCIT	0.338536	0.046223	7.323843	0.0000
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Source: E-view

$R^2 = 0.967376$ ,  $R^2(\text{adj}) = 0.861938$ ,  $\text{SER} = 0.288026$ ,  $\text{DW} = 1.744505$ ,  $f\text{-stat} = 116.8394$

The coefficient of multiple determination ( $R^2$ ) is 0.967376 and on adjusted  $R^2$  of 0.861938. The later indicates that 86 percent of variations in the observed behaviour of debt financing decisions is jointly explained by the independent variables namely; company income tax. This shows that the model fits the data well and has a tight fit. Also, the f-statistic is used to test for the significance of such good or tight fit. The model reports on effectively high f-statistic value of 116.8394 which when compared with the table value. This indicates that the high adjusted  $R^2$  value is better than would have occurred by chance; therefore the model is statistically robust. Using this criterion, therefore, company income tax is significant at one percent and 10 percent specifically a one percent increase in all the explanatory variables will prop up the debt financing than proportionate percentage point.

The constant term indicates that if all the variables held constant, debt financing will be improved by 2.080. The DW statistic (1.744) is used to test for the serial correlation is the residuals of the model. The calculated DW is 1.74. The decision rule is that if the calculated DW falls outside du and 4-du then there is a serial correlation in the residuals. This shows that our calculated DW=1.744 falls and this indicates that the estimates should be taken with caution. The goodness of fit of the model as indicated by the adjusted R-squared shows a good fit of the model that the model fits the data well. To test for the individual statistical significant of the parameters, the t-statistic of the respective variables were considered considering their probability values, computer software shows the constant term is positive while independent variables are statistically significant at one percent. The a-prior expectations about the signs of the parameter estimates are confirmation to economic theory.

Model three (Regression result)

Dependent Variable: LRFD

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.607200	0.176393	3.44231	0.0000
LCIT	2.679315	0.958493	2.79534	0.0000
R-squared	0.873332	Mean dependent var	3.241218	
Adjusted R-squared	0.821938	S.D. dependent var	1.824102	
S.E. of regression	0.288026	Akaike info criterion	5.271203	
Sum squared resid	1.301256	Schwarz criterion	0.342187	
Log likelihood	3.6738i0	Hannan-Quinn criter.	0.328130	
F-statistic	96.234	Durbin-Watson stat	1.117	
Prob(F-statistic)	0.000000			

The coefficient of multiple determination ( $R^2$ ) is 0.873332 and an adjusted  $R^2$  of 0.821938. The later indicates that 82 percent of variations in the observed behaviour of debt financing decisions is jointly explained by the independent variables namely; company income tax. This shows that the model fits the data well and has a tight fit. Also, the f-statistic is used to test for the significance of such good or tight fit. The model reports on effectively high f-statistic value of 96.234 which when compared with the table value. This indicates that the high adjusted  $R^2$  value is better than would have occurred by chance; therefore the model is statistically robust. The DW statistic (1.117) is used to test for the serial correlation in the residuals of the model. The goodness of fit of the model as indicated by the adjusted R-squared shows a good fit of the model that the model fits the data well. The a-prior expectations about the signs of the parameter estimates are confirmation to economic theory.

### **SUMMARY OF MAJOR FINDINGS**

The major findings of this study are as follows:

1. Company income tax significantly influence equity financing decision of Guinness, Nigeria
2. Company income tax significantly influence debt financing decision of Guinness, Nigeria
3. Company income tax significantly influence retained earning financing decision of Guinness, Nigeria

### **Conclusion/Recommendations**

This study was carried out to investigate empirically the effect of company income tax on company financing decisions in Guinness, Nigeria. The study concluded and affirmed the position that about 75 per cent of registered firms are not found in the tax net of the country and 65 per cent of the companies had not filed their annual returns for over two years. Arising from the results obtained, the study makes the following recommendations.

1. Government should make it possible for companies to evade tax and penalize any registered company that evades tax.
2. Moreover, the study recommended that the government should increase the tax rate but not without sensitizing the public.
3. Government should harness the potentials of taxation and promote tax system in order to increase the prosperity of the Nigerian economy.

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