THE EFFECT OF LEASE FINANCING ON THE FINANCIAL PERFORMANCE OF COMPANIES LISTED AT THE NAIROBI SECURITIES EXCHANGE

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DECLARATION

I, Munene Winfred, declare that this project is my original work and has not been published and/or submitted for any award in any other university.

Signed …… Date……

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This Project report has been submitted with my approval as the University Supervisor

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DEDICATION

To my family

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LIST OF ABBREVIATIONS

ATS: Automated Trading System

BAT: British America Tobacco

FASB: Financial Accounting Standards Board

IAS: International Accounting Standard

KCB: Kenya Commercial Bank

NASI: NSE All Share Index

NPV: Net Present Value

NSE: Nairobi Securities Exchange

PPE: Plant, Property and Equipment

ROA: Return on Assets

ROE: Return on Equity

SME: Small and Medium Enterprises

UK: United Kingdom

US: United States

VAT: Value Added Tax

ABSTRACT

The economic benefits of leasing can be derived from the firm's choice of leasing relative to borrowing and acquiring the asset. The essence of leasing is reflected in the proposition that leasing provides customized financing with potentially unique cash flow and tax features. Unlike borrowing, the ownership of the asset remains with the lessor and the lessor can deduct tax allowances generated by the leased equipment. The objective of the study was to determine the effect of lease financing on the financial performance of firms listed at the Nairobi Securities Exchange. This study adopted descriptive research design. The population of the study was all the 62 listed companies in the NSE but data for only 30 firms was available for the period under study. Secondary data was collected for the firms for the period 2009 – 2013 from the financial statements. The measures of financial performance was taken as the dependent variables while amount of Finance lease, operating lease, liquidity, size of the firm and leverage was taken as the independent variable. The collected secondary data was analyzed using Statistical Package for Social Science (SPSS) version 22. A regression analysis was conducted on the data set to determine the effect of leasing on the ROA for the firms listed at the NSE. From the regression results, lease financing and size of the firm had negative effects on ROA while liquidity and leverage had positive effects on ROA. All these effects were however insignificant at 5% level of confidence. The R^2 showed that the model explained 2.3% of variance in ROA and it was not fit as the *F*-statistic was also insignificant at 5% level of significance. The study concludes that lease financing does not influence the financial performance of listed firms in Kenya. While the relationship could be negative, it failed the significance tests at all the acceptable levels of significance. Financial performance of firms in Kenya is therefore not affected by the level of lease financing. The study recommends that firms should be careful with the use of lease financing as a method of financing their operations as evidence suggests that no value is added through the use of lease financing. Some evidence suggested a negative relationship between lease financing and ROA which may suggest that lower levels of lease financing could be acceptable. It may therefore be important for the firms to examine what value lease financing may add to them when other financing options are available.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Firms achieve their objectives of maximizing shareholders wealth by making successful investment decisions, which generate positive net cashflows. The leasing decisions concerns whether the firm should lease equipment, or borrows money and buy the equipment. Therefore it is a financing decision. Corporate managers should examine the cost of both: Leasing and borrowing in order to select the cheaper method of financing which increase the market value of the firm (Mohammad and Shamsi, 2008).

Kenya has recently seen an enormous growth in the leasing of business assets like cars and trucks, computers, machinery, manufacturing plants and agricultural land in addition to the traditional common leases of houses, office space and automobiles (Ombija, 2007). The obvious explanation for this growth is the advantage to the lessee being able to use an asset without having to buy it. However, the lessee is obligated to make periodic payments, usually monthly or quarterly. The lease contract also specifies who is to maintain the asset (Osaze, 1993)

The leasing industry in Kenya is expected to grow in the coming years as the government changes its policy on purchase of assets. The Budget Policy Statement (2013/14) presented in the National Assembly by the cabinet secretary in charge of finance, Hon. Rotich, had provided for an estimated Kshs. 3 billion for leasing of government vehicles and other assets. Kihara (June 17, 2013) points that the shift in government policy to adopt leasing solutions is likely to spur ripple effects within the private sector. With the government leasing about 1200 vehicles to equip the police force, it's likely to eliminate

asset and maintenance risks, enhance flexibility on fleet composition and reduce administrative burden.

1.1.1 Lease Financing

Osaze (1993) and International Accounting Standard (IAS) 17 defines a lease as an agreement whereby a lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time." Generally, all lease arrangements will fall into one of the following three types of lease financing: a sale and lease back arrangement, direct leasing and leveraged leasing. Leases can also be classified as either operating or finance/capital leases. While these types of leases differ in their legal, tax and accounting treatments, they are all viewed, in the theory of finance, as part of the financing decisions of the firm.

Operating leases contracts are cancellable and are mostly short term and can be cancelled at the option of the lessee with the proper notice. In contrast, a non-cancellable lease takes the form of finance lease, is long term in nature and obligates the lessee to make lease payments until the lease expiration. The expiration date generally corresponds with the useful life of the asset (Mohammad and Shamsi, 2008).

Some of the common advantages of leasing as that accrues to a firm are: less costly, financing at fixed rates, protection against obsolescence, flexibility and off balance sheet financing. (Gudikunst & Roberts, 1978; Krishnan & Moyer, 1994; Lasfer, 2007 and Miller & Upton, 1976)

In operating lease, the lessee debits the rents due and payable in the statement of income and no asset is shown in the balance sheet (Marton et al., 2008). The lessee also declares the asset as an off balance sheet item. While in the case of a capital lease the leased item is capitalized then depreciated over its useful life. A corresponding liability for future lease payments is recorded at the net present value of the future payment (IAS 17)

1.1.2 Financial Performance

This is a measure of an organization's earnings, profits, appreciation in value as evidenced by the rise in the entity's share price (Asimakopoulos, et al., 2009). Measures of financial performance fall into two broad categories: investor returns and accounting returns. The basic idea of investor returns is that, the return should be measured from the perspective of shareholders e.g. share price and dividend yield. Accounting returns focus on how firm earnings respond to different managerial policies e.g. ROE and ROA (Alan, 2008).

This paper focused on return on assets (ROA). ROA was used separately to measure a firm's financial performance (Griffin and Mahon, waddock and Grave and Roman and Agle). ROA is defined as the ratio of net income after tax to total assets, and ROE is defined as the ratio of net income after tax to outstanding capital. In this study financial performance was determined by ROA.

1.1.3 Leasing and Ffinancial Performance

Leasing improves financial performance by influencing the cost of capital (reducing the leverage level) improves the working capital of the firm (since the untied cash can be

invested in cash generating project and efficiency in utilization of the assets as it was discussed in the literature review (Tarus,1997)

According to Stulz and Johnson (1985) the non-cancellable long -term leases help mitigate the underinvestment problem due to debt overhang identified by Myers (1977). The underinvestment problem is mitigated because of the legal standing of leases to all outstanding fixed claims. By segregating the claim on new project's cash flows, leasing, unlike debt, limits the wealth transfer from stockholders to existing bondholders. This helps firms undertake some positive NPV projects which are otherwise foregone with risky/unsecured debt financing. Sharpe and Nguyen (1995); Ezzell and Vora (2001) find that leasing reduces external financing costs due to asymmetric information.

Brick et al. (1987) argue that the principal reason for the existence of leasing is the differential tax benefits accruing to companies, financial institutions and individuals from owning assets. Whereas a marginally profitable company may not be able to reap the full benefit of accelerated depreciation, a high income taxable corporation or individual may be able to realize such. In such a case, the former may be able to obtain a greater portion of the overall tax benefits by leasing the asset from the latter party as opposed to buying it.

Due to competition among lessors, part of the tax benefits may be passed on to the lessee in form of lower lease payments. However, the attraction to lease an asset as opposed to buying it is not due to the existence of taxes per se, but due to the divergence in abilities of the various parties to realize the tax benefits associated with owning an asset (Miller & Upton, 1976).

1.1.4 The Nairobi Securities Exchange

NSE was first constituted in 1954 (operating under the name the Nairobi Stock Exchange) as a voluntary association of stock brokers registered under the societies act. However, dealing in shares and stocks in Kenya had started in the 1920s. At the time, Africans and Asians were not permitted to trade in shares and as such dealing in shares was confined to resident European community until independence in 1963 (NSE, 2014).

Over the years, the NSE has evolved with the following as the key milestones in the evolution process. First was in 1988 when the 1st privatization through the NSE was done for the sale of 20 per cent government shares in Kenya Commercial Bank (KCB) to the public. Second privatization of Kenya Airways in 1996 when the government offered 51 per cent of fully paid and issued shares, recording the largest issue of share in the history of NSE. Third was the implementation of the Automated Trading System (ATS) in September 11, 2006, paving the way for live trading at the NSE. Fourth was the introduction of the NSE All Share Index (NASI) in 2008 as an overall indicator of market performance. Fifth was the introduction of trading of government bond under the ATS in November 2009. The last major milestone was the change of name from Nairobi Stock Exchange to Nairobi Securities Exchange in July 2011, reflecting the evolution of the entity into a full service securities exchange which supports trading, clearing and settlement of equities, debt, derivatives and other associated instruments.

NSE has 62 listed companies with a market capitalization of about Kshs. 2.2 trillion as of May 9, 2014. This makes it the largest stock market within the Eastern Africa region. Capital market authority in June 2001 made IASs mandatory for accounting and financial

reporting by all listed companies (World bank. 2001). Reporting of leases is guided by IAS 17.

1.2 Research Problem

The economic benefits of leasing can be derived from the firm's choice of leasing relative to borrowing and acquiring the asset. The essence of leasing is reflected in the proposition that leasing provides customized financing with potentially unique cash flow and tax features. Unlike borrowing, the ownership of the asset remains with the lessor and the lessor can deduct tax allowances generated by the leased equipment. Where the lessee and the lessor have the same tax status, borrow and lend at the same rate of interest, and have similar expectations regarding the salvage value of the asset, there is no advantage to leasing over purchasing (Miller & Upton, (1976), Myers, Dill & Bautista, (1976) & Lewellen, Long, and McConnell, (1976)). However, in practice, these perfect capital market conditions are not satisfied, resulting in a number of rationales for leasing.

The arguments advanced on the effects of leasing on the performance of the firm as opposed to purchase of assets includes the tax differential effects (Miller & Upton, 1976; and Subrahmanyam, 1987)), debt substitutability (Ang & Peterson, 1984), agency costs and free cash flows (Smith & Warner, 1979). On the tax differential it is argued that if the lessee (firm) pays little or no corporation tax, it will pass on the capital allowances to the lessor, part of which will be returned to the lessee through lesser rental payments. Secondly, leasing can be seen as a substitute for debt finance because it reduces debt capacity. However, given the fact that lessors have first claim on the assets leased,

leasing is likely to be advantageous for financially distressed companies that can't fulfill the requirements for getting bank loans.

Thirdly, most companies characterized by a divorce between ownership and control are likely to suffer from the free cash flow problem where managers undertake negative NPV projects (Flath, 1980). Finally, leasing enables the firm to invest the cash it could use to buy new equipment in more profitable venture.

Firms are faced with great challenge of maximizing shareholders wealth in amidst of turbulent business environment. Firms listed in the NSE employee lease financing because the banks in Kenya charge high interests that keep on fluctuating, the tax implications and the fact that leasing conserves cash (Kibet et al., 2013).

While several studies have been done in developed markets (Meyer, 1977; Stulz & Johnson, 1985; Bootle, 2002; Graham et al., 1998; Ezzell & Vora, 2001; Robicheaux et al., 2008; Yan, 2002; Ushilova & Schieurann, 2011, among others) to determine the effects of lease financing on the performance of the firm, little has been done for developing markets like Kenya. Previously Tarus (1997) did a research on the factors that influences the growth of finance lease in Kenya. He found that many firms employs lease financing because it helps in conservation of cashflows and guards the firm against obsolesce despite having a complex accounting practice and legal regulation but nothing was said about how it affects financial performance. This study therefore, sought to fill this gap and answer the question as to: What are the effects of lease financing on the financial performance of firms listed at the Nairobi Securities Exchange?

1.3 Research Objectives

The objective of the study was to determine the effect of lease financing on the financial performance of firms listed at the Nairobi Securities Exchange.

1.4 Value of the Study

This study is very important to various stakeholders in the economy. First, the study will generate new knowledge by giving a multidimensional view on the effects of leasing financing on the financial performance of firms listed at the Nairobi Securities Exchange and contribute to academic research that it is supposed to serve.

Secondly, the findings of the study will inform finance and corporate executives tasked with the responsibility of making financing decisions in corporate Kenya. From the findings of the study, it's hoped that these executives have been guided and better informed when they consider lease or purchase decisions for their firms.

Thirdly, the investors will be assisted in making rational investment decisions based on the financing decisions taken by executives in various firms. By understanding the implications of leasing vis a vis purchase of assets on the financial performance of the firm, the investors will be better placed to identify firms with greater potential to grow their wealth if they invest in such stocks.

Fourthly, creditors will be assisted in making assessment of the company's risks in terms of default. Depending on the findings of the study, creditors will be better informed on

whether to provide pure credit facilities or provide leasing options especially for highly levered firm (s) facing financial distress. Finally, policy makers and the business community in general will be guided when formulating policy options and regulation on lease financing in the country.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter presents a review of the relevant literature on the study area to better present the knowledge gap the study seeks to fill. Specifically, the chapter discusses the leasing theories and empirical evidence of the effects of lease financing the financial performance on the firm. The chapter concludes with a summary.

2.2 Theories of Leasing

There are several theories/motivations advanced as to why firms engage in leasing. These theories are discussed below:

2.2.1 Agency Costs Theory

The main theoretical explanation for the relationship between the ownership structure and profitability is based on the agency theory, first formalized by Jensen and Meckling (1976). Agency conflicts can arise between bondholders and shareholders and/or between managers and Shareholders and can lead to asset substitution and underinvestment. Smith and Warner (1979) argue that long-term non-cancellable leases (financial or Capital leases) can help mitigate the asset substitution problem because the non-cancellable lease commits the lessee to use the leased asset over the life of the lease contract.

In the presence of risky debt in the firm's capital structure, equity holders may underinvest by giving up positive NPV investments because the project's benefits accrue to the existing debt holders and the existing debt load makes it too costly for the firm to borrow in external capital markets. This creates the underinvestment problem due to debt

overhang as identified in Myers (1977). Stulz and Johnson (1985) argue that the non-cancellable long-term leases should help mitigate the underinvestment problem due to debt overhang.

However, in case of short term operational leases, agency costs may also arise between lessor and lessee due to the separation of ownership from usage of asset. Since the lessees have no right to the residual value of the asset, they have no incentive to take proper care of it. This probably explains the reason why corporations lease office facilities much more frequently than manufacturing or Research & Development (R&D) facilities.

Robicheaux et al. (2008) examines whether lease financing, used to control the agency costs of debt, is used as a substitute or complement to mechanisms such as corporate governance, managerial incentive compensation used to control agency costs of equity. They find leasing is complementary to governance and incentive compensation suggesting that firms try to control simultaneously the agency costs of debt as well as external equity.

For the purpose of the study at hand, this theory implies that lease financing brings about efficiency on the part of management of the firm, which in turn would be expected to contribute to the financial performance of the firms listed at the NSE.

2.2.2 Information Asymmetry

Myers and Majluf (1984) argue that information asymmetry influences capital structure of firms. They demonstrate that if managers can issue safe debt, the adverse selection problem due to information asymmetry could be reduced. Pecking orders of capital

structure arise in their model, where retained earnings followed by safe debt, risky debt and as a last resort equity are used in that order to finance the operations (Donaldson, 1961).

Consistent with Myers and Majluf (1984) one can argue that leasing, being similar to secured debt should also mitigate the adverse selection problem. Gilligan (2004) argues that leasing may reduce adverse selection in durable goods markets by increasing the average quality of used goods offered for sale.

Smith and Wakeman (1985) and Sharpe and Nguyen (1995) found that leasing aids in alleviating financial contracting costs. They argue that financing with a lease may reduce the cost of external funds that arise due to asymmetric information or from agency problems that give rise to costly monitoring as per Smith and Warner (1979) and Ezzell and Vora (2001). By financing via true lease the firm puts the lease obligation on par with other administrative expenses that have higher priority than normal debt. This makes leasing a highly desirable financial contract in the presence asymmetric information as it puts leasing at the top of the pecking order of external financing options.

Moral hazard problem arises because the salvage value of the leased asset accrues to the lessor. This leaves the lessee with little or no incentive to maintain the asset in order to preserve its salvage value. Lessors do recognize these issues and include various provisions in the lease contract such as penalty clauses, metered lease payments to reduce abuse of the leased asset. Chau, Firth and Srinidhi (2006) argue that leases with a purchase option can completely mitigate the moral hazard problem. From the above discussions it is clear that leases help mitigate the asset substitution problem due to

agency and costly external financing due to information asymmetry and hence reduce any excess cost the firm could have incurred if they didn't have complete information. Reduction in excess cost will help improve the financial performance of firms listed in the NSE.

2.2.3 Managerial Risk Aversion

Managers are usually less diversified than regular shareholders because managers have their human capital and current and future compensation tied to the firm's performance or value. Flath (1980) and Smith and Wakeman (1985) argue that the ownership structure should affect the decision to lease assets. A higher level of managerial ownership is mostly associated with higher levels of lease financing. Flath (1980) argues that in closely held lessee firms, leasing is more likely as the ownership of capital assets makes reduction of risk through diversification more difficult and leasing mitigates this concern by allocating usage rights of the underlying asset to the lessee while leaving ownership rights with the lessor.

Leasing reduces the concentration of wealth and facilitates more efficient allocation of risk bearing by shifting ownership risk from risk-averse lessees to less risk-averse lessors. Mehran, Taggart, and Yermack (1999) provide empirical evidence that CEO stock ownership, proxied by the fraction of common shares owned by firm's CEO, has significant positive effect on lease financing. Mehran et al. (1999) argue that when CEOs have larger ownership stakes, their interests are more closely aligned with shareholders and also have more control over the firm. Thus, CEOs with large equity ownership use

more leasing in order to reduce exposure to technological obsolescence and other asset-specific risks.

Smith and Wakeman (1985), argues that in addition to managerial stock ownership, managerial incentive compensation can affect the incentives to lease. For example, a manager whose bonus depends on the return on invested capital could argue in favor of leasing rather than purchasing property, plant and equipment as the denominator in the performance measure could increase drastically with purchasing. Robicheaux et al. (2008) offer empirical evidence that firms with higher CEO stock ownership and option compensation use more lease financing.

2.3 Determinants of Financial Performance of Listed Companies

The financial performance of firms is influenced by both internal and external factors. Internal factors focus on firm's specific characteristics e.g. technology, market diversification and innovation. The external factors concerns both industry features and macroeconomic variables e.g. competition and inflation (Hellen, et al., 2010). Muhammad, et al. (2012) found that the financial performance of firms is influenced by: Size, Leverage, Liquidity and Age in addition to net investment in lease finance

Leverage is measured by the ratio of total debt to equity (Debt/Equity). This ratio shows the degree to which a business is utilizing borrowed money. This ratio represents the potential impact on capital and surplus of deficiencies in reserves due to financial claims (Adams & Buckle, 2000).

Liquidity refers to the degree to which debt obligation falling within a year can be paid from cash or assets that will be turned into cash .It is important for working capital management. It is measured by dividing current asset by current liabilities (Haron & Azmi, 2005)

Another determinant is age, since the time period makes companies more mature and also enables firms handle various business problems (Malik, 2011).Older firms may also benefit from reputation effects, which allow them to earn a higher margin on sales. On the other hand they might have employed some bureaucratic processes which are out of touch with the changes in the market and this may have an inverse relationship with profitability (Demerguc-Kunt &Maksimovic, 1998).

In addition size of the firm affects financial performance. Large firms can exploit economies of scale and scope and thus being more efficient as compared to small firms (Kasharma, 1998). The size is determined by dividing net sales by total assets (Robicheaux et al., 2008).

2.4 Empirical Eevidence

The arguments for effects of leasing on the financial performance of a firm have focused mainly on four elements including tax differential, debt substitutability, agency costs and free cash flows.

Leasing is likely to overcome agency costs of debt. Meziane (2007) did a study on the financial drivers and implications of leasing on real estates assets. He sampled 2,343 UK-quoted companies over the period 1989-2002, resulting in 17,862 pooled time-series and

cross-sectional observations. The total sample of companies was first split into leasing propensity defined as the ratio of leased assets (leasehold and operating leases on real estate) over the sum of freehold and leased real estate. Thus, a leasing propensity of 0 percent referred to companies that used only freehold real estate, while a leasing propensity of 100 percent indicated that companies rely only on leased real estate. Other variables that were used as control variables were size, (size is the log of year-end market value of equity), the growth rate in turnover, Leverage (the ratio of long-term debt over the sum of long-term debt and market value of equity), efficiency (the ratio of cash over current assets and inventory) and finally the effective tax rate (computed as tax liability over profit before tax). The results indicated that companies that own real estate are likely to be mature, i.e. value companies, while firms that lease their real estate tend to be at growth stage. The findings were consistent with Lasfer and Levis (1998) who show that high-growth firms are more likely to lease plant and machinery. Given that these companies were likely to suffer from assets substitution problem, the results implied that leasing reduces agency conflicts. The results suggested that growth companies are less likely to find cheap borrowing to acquire their assets. Instead, they rely on leasing to finance their growth.

A study was done by Vasantha (2012) on capital market frictions, leasing and investment. He collected panel data on all S&P 100, S&P 400 and S&P 600. The data panel consisted of 7012 firm-year observations. He used the ratio of rental expenses with net PPE as a comprehensive measure of lease ratio. Operating lease ratio, was calculated as rental commitments /net PPE (rental commitment variable only includes non-cancellable leases), net cash flow, i.e., net income plus depreciation and amortization as measure of

cash flow, liquidity was measured as the average ratio of daily absolute return to the dollar trading volume on that day, for credit rating was market based . Tobin's Q was used to measure firm's growth opportunities, the firm size was measured as a log of sales and capital investments were measured as capital expenditures.

He found out that firms with high information leased more and those with low agency costs leased less. In addition he found out that firms with significant tax-loss carry forwards were unable to take full advantage of tax benefits of asset ownership, hence they leased more. The coefficient on size was positive and size squared was negative indicating that largest firms used less lease financing .The coefficient on Q is positive as higher growth firms leased more.

Muhammad, et al. (2012) did a study on the factors influencing the profitability of leasing firms in Pakistan. They analyzed a pool of data of 28 leasing companies for a period of 2006-2008. The variables used to determine profitability were size, leverage liquidity, age and net investment in lease finance. The study applied ordinary least square (OLS) model and Logistic (Logit) models for estimation of results. The results indicated that size, net investments in lease finance and liquidity had a positive relationship with the profitability of leasing companies whereas leverage and age had a negative relationship with the profitability of the leasing companies.

Debt substitutability has been advanced as one of the reasons why firms do employ lease financing. Eric (2012) did a study on French SME for 11436 firms for the year 1999. The variables used were long term debt, leasing, equity, short term assets, short term liabilities, EBITDA, financial fees, fiscal debt and firm age. The results suggested that SME use leasing all the more the leasing so when they are young, leveraged, less solvent

when they are small size and present a strong likelihood of bankruptcy. Thus, leasing pushes back the limits of banking debt for firms that have no access (firms with a high leverage) and would be more often used when a firm can no longer bear the costs associated with the ownership good or can start up a new activity. Secondly, the results suggested a strong and significant relationship between credit rationing and the use of leasing.

Tarus (1997) did a research on factors influencing the growth of lease in Kenya. He used descriptive research design and collected data through questionnaires both structured and unstructured while his population consisted of all companies listed in the stock exchange. He found that many firms employs lease financing because it helps in conservation of cashflows and guards the firm against obsolesce despite having a complex accounting practice and legal regulation

Salam (2013) did a research to find the casual relationship between firm performance using ROA and ROE with different SMEs to concerning and did not concerning on lease finance. The results emphasized of 23 medium enterprises SMEs and 30 small enterprises SMEs were investigated the relationship between lease financing and ROA and ROE. The results found that medium enterprises were statistically significant positive correlated in a linear between lease finance and ROA and ROE. This was the same with the small enterprises.

Studies have been done on leasing of agricultural land in Kenya. Letoluo (2003) did a study of the influence of farmland leasing on household livelihood in Narok. He did a survey with eighty respondent selected randomly and ten informants were interviewed.

He found that leasing of farmland increased revenue to the farmers who later shifted from pastoralism to doing business.

2.5 Summary of Literature Review

In traditional corporate finance, the decision of buying versus leasing is mostly discussed in the context of the Modigliani and Miller (1958) world of perfect capital markets, where in general the capital structure is irrelevant for the determination of the firm value. But in real financial markets, there are market imperfections. In the area of access to finance for SMEs, a market imperfection/failure is not only present during a deep recession or a financial crisis but also on an on-going basis as a fundamental structural issue (Akerlof, 1970 & Arrow, 1985).

In general therefore, leasing can be said to be an alternative mechanism to facilitate access to finance. It enables the use of capital equipment in particular for new/young enterprises without credit track record and with limited possibilities to provide collateral. Further, it can be argued that leasing is a tool to mitigate market weaknesses in SME lending. Empirical results show that leasing exposures are associated with relatively low risk compared to other forms of financing (Schmit, 2005, & De Laurentis and Mattei, 2009). The presence of physical collaterals contributes very largely to this reduced risk profile (Schmit, 2005).

Overall, academic literature underlines the advantages of leasing as an additional financing form for enterprises. It is an alternative mechanism to facilitate access to finance, especially so for SMEs.

However, while a lot of research has been done of the effects of leasing in financial performance of firms in developed markets, very little if any, studies have been done in the emerging markets like Kenya. This study therefore addresses itself to this research gap and seeks to establish the effects of leasing on the financial performance of firms listed at the NSE.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the research methods that were used to answer the study objectives. Specifically, the chapter discusses the research design, the population of the study, sample and sampling procedure, data collection and concludes with the data analysis methods.

3.2 Research Design

This study adopted descriptive research design and focus on the effect of lease financing on the performance of firms listed in the NSE. Descriptive research design is used to answer two fundamental questions: "what is going on?" and "why it is going on?" It is mostly used in casual relationship (De Vaus, 2000). In this paper it was used to explain how lease financing affects financial performance for firms listed at the NSE. The method has also been used successfully by Tarus (1997).

3.3 Population of the Study

The population of the study was used on all listed companies in the NSE. There were 62 listed companies at the securities market (NSE, 2014). A census of all listed companies in the NSE that have reported use of lease financing in the financial statements over the past 5 years (between 2009 and 2013) was undertaken for the purpose of this study.

3.4 Data Collection

Secondary data was used for this study. A content analysis on the published financial statements for each of the listed companies over the past 5 years was analyzed and those that have reported use of lease finance were selected. The dates (year) the lease transactions were contracted was identified and listed for purpose of analysis.

The measures of financial performance was taken as the dependent variables while amount of Finance lease, operating lease, liquidity, size of the firm and leverage was taken as the independent variable. The independent variables used for this study have been picked on the basis that Salam (2013) had used the same in seeking to get the relationship between financial performance and lease financing in SMEs in Bangladesh.

3.5 Data Analysis

The collected secondary data was analyzed using Statistical Package for Social Science (SPSS) version 20. A regression analysis was conducted on the data set to determine the effect of leasing on the ROA for the firms listed at the NSE. Salam (2013) argues that ROA is the most commonly used measures of financial performance and was used to measure performance in this study. The correlation coefficient (R^2) and the coefficient of determination (R) of the data set (for each determinant of financial performance) was calculated to determine the causality relationship between lease finance and financial performance. Other tests carried out on the model include test of Normality, Durbin Watson Test of Serial Correlation, Test of Heteroskedasticity and Test of Model Specification. The findings from the analysis was organized, summarized and presented

using tables, so as to achieve the objectives of the study as well as answer the research question.

For the purpose of this study the following linear regression equation was used:

$$Ri = a + b_1X_1 + b_2X_2 + b_3X_3 + b_4X_4 + \mu_e$$

Where:

R_i = Measures of financial performance (ROA) (Net income after tax/Total assets)

a = the constant

b=the coefficient

X_1 = Leasing Financing (Total Lease financing /Total Assets)

X_2= Liquidity (Current Assets/Current Liabilities

X_3= Size (Net Sales/Total assets) for banking institution the net sales will be equivalent to total interest charged while for the insurance companies it will be the net premiums.

X_4=Leverage (Debt/Equity)

μ_e=random error term

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

The study sought to use data from all the listed firms on the Nairobi Securities Exchange. This study is based on 30 listed firms that had complete data for all the variables in the study for the five year period under review. The chapter presents the results of the study as well as the discussions from the results.

4.2 Descriptive Statistic

This section presents the results of the study. The first results show the descriptive summary of the variables used in the study. The second part shows the correlation analysis results while the third part presents the regression results.

Table 4.1: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ROA	30	-54.50	19.66	-1.0946	10.70065
Lease	30	.00	2.02	.0722	.36798
Liquidity	30	.40	72.35	4.5780	13.49763
Size	30	.04	2.90	.5240	.60527
Leverage	30	.18	7.72	3.0746	2.40716
Valid N (listwise)	30				

Source: Research Data (2014)

Table 4.1 shows that the ROA had a mean of -1.0946 with a standard deviation of 10.7. Leasing had a mean of 0.07 with a mean of 0.37. Liquidity had a mean of 4.58 with a standard deviation of 13.5. Further, leverage had a mean of 3.07 with a standard deviation of 2.41.

4.3 Correlation Analysis

Table 4.2: Correlation Matrix

	Y	X_1	X_2	X_3	X_4
Y	1	.002	.039	-.074	.131
X_1	.002	1	-.051	-.138	.234
X_2	.039	-.051	1	.151	-.222
X_3	-.074	-.138	.151	1	-.429*
X_4	.131	.234	-.222	-.429*	1

*. Correlation is significant at the 0.05 level (2-tailed).

Source: Research Data (2014)

Table 4.2 shows the correlation matrix for the variables used in the study. The results show that none of the correlations were beyond 0.5 suggesting that the independent variables were not serially correlated. Thus, all of them could be used in a multiple regression analysis.

4.4 Regression Analysis

Table 4.3: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.153	.023	-.133	11.38875	2.061

Source: Research Data (2014)

Table 4.3 shows the model summary. R value was 0.153 which suggests that the independent variables had a low influence on financial performance. As shown by the R^2, the model accounted for only 2.3% of the variance in ROA. In Table 4 below, the F statistic of 0.15 was insignificant at 5% level, p = 0.961. This suggests that the leasing model used was not fit to explain the relationship between leasing and financial performance. The Durbin-Watson statistic of 2.06 shows that there was no autocorrelation among the independent variables.

Table 4.4: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	78.021	4	19.505	.150	.961[b]
	Residual	3242.592	25	129.704		
	Total	3320.613	29			

Source: Research Data (2014)

Table 4.5 shows the coefficients of each of the independent variables in the study. As shown, leasing had a negative but insignificant effect on ROA, p = 0.876. The results also show that liquidity had a positive effect on ROA but it was insignificant, p = 0.722. Size of the firm had a negative effect on ROA but was also insignificant, p = 0.900. Lastly, the results show that leverage had a positive but insignificant effect on ROA, p = 0.534.

Table 4.5: Coefficients

	Unstandardized Coefficients		Standardized Coefficients		
Model	B	Std. Error	Beta	t	Sig.
1 (Constant)	-2.985	4.886		-.611	.547
Leasing	-.930	5.917	-.032	-.157	.876
Liquidity	.058	.161	.073	.360	.722
Size	-.492	3.879	-.028	-.127	.900
Leverage	.634	1.007	.143	.630	.534

Source: Research Data (2014)

$Y= a-.32X_1+.73X_2-.028X_3+.143X_4$

4.5 Chapter Summary

The study found that leasing had a negative but insignificant effect on ROA at 5% level of significance. This means that financial performance of listed firm in Kenya is unaffected by lease financing. This could be attributed to the low levels of lease financing currently utilized by the listed firms as majority of the leases were operating lease and very few were finance leases.

The study also found that firm leverage had a positive but insignificant effect on ROA at 5% level of significance. Therefore, financial performance of listed firms in Kenya is not affected by the levels of leverage used by firms. The average leverage was very low which also suggests low levels of leveraging that may contribute to the present findings.

The study found that liquidity had a positive but insignificant relationship with ROA at 5% level of significance. This suggests that liquidity does influence financial performance of listed companies in Kenya. While current assets were on average 4 times that of current liabilities, this level has not significantly influenced performance of firms.

The study showed that size of the firm had a negative but non-significant relationship with ROA at 5% level of significance. This shows that size of listed firms at the NSE did not influence their financial performance. This is consistent with a number of prior studies that have found size to be insignificant factors in explaining firm performance.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter shows the summary of research findings, the conclusions made from the results, and the recommendations for policy and practice. The chapter also discusses a few limitations encountered as well as suggestions for future research.

5.2 Summary of Findings

The study sought to examine the relationship between lease financing and financial performance of listed companies in Kenya. Secondary data from the annual reports of 30 firms were collected and used in the analysis. The study used a multiple regression analysis to examine how lease financing influence financial performance measured as the return on assets.

The descriptive results showed that lease financing averaged 0.07 while performance (ROA) averaged -1.09. The results showed that liquidity had a mean of 4.58 and leverage had a mean of 3.07. The descriptive results also showed that size had a mean of 0.52. The correlation matrix showed that none of the independent variables were serially correlated.

From the regression results, lease financing and size of the firm had negative effects on ROA while liquidity and leverage had positive effects on ROA. All these effects were however insignificant at 5% level of confidence. The R^2 showed that the model explained 2.3% of variance in ROA and it was not fit as the F-statistic was also insignificant at 5% level of significance.

5.3 Conclusion and Recommendation

The study concludes that lease financing does not influence the financial performance of listed firms in Kenya. While the relationship could be negative, it failed the significance tests at all the acceptable levels of significance. Financial performance of firms in Kenya is therefore not affected by the level of lease financing.

The study also concludes that liquidity of a firm does not influence the financial performance of listed firms in Kenya. As it was shown, there is evidence of a positive relationship but the effect was not significant at all acceptable levels of significance. Thus, the financial performance of listed firms in Kenya is not affected by the levels of firm liquidity.

The study also concludes that leverage of a firm does not affect the financial performance of listed firms in Kenya. The results showed some evidence of a positive relationship but the effect was not significant at all acceptable levels of significance. Thus, the financial performance of listed firms in Kenya is not affected by the levels of firm leverage.

The study concludes that size of the firm does not influence the financial performance of listed firms in Kenya. While the relationship could be negative, this relationship failed the significance tests at all the acceptable levels of significance. Financial performance of firms in Kenya is therefore not affected by the size of the firm.

First, the study recommends that firms should be careful with the use of lease financing as a method of financing their operations as evidence suggests that no value is added through the use of lease financing. Some evidence suggested a negative relationship between lease financing and ROA which may suggest that lower levels of lease financing could be acceptable. It may therefore be important for the firms to examine what value lease financing may add to them when other financing options are available.

Secondly, the study recommends that since size of the firms does not affect financial performance, small firms should not be timid to explore ways of performing better in the market as their size is not currently detrimental to their performance. In fact, there is some evidence that smaller firms could outperform the large firms in terms of their ROA given the negative relationship. This can be done through improved efficiency in the smaller firms as they are not as complex as their larger counterparts.

Thirdly, the study recommends that firms should rethink on their leverage ratios as the current ratios were insignificant in explaining their performance. There is however some evidence that higher leverages could lead to higher financial performance and therefore listed firms should increase their current leverages in order to reap the benefits that may be brought about by higher leveraging. This can be done through more debt financing.

Lastly, the study recommends that firms should improve on their liquidity since there is evidence that higher liquidity may lead to higher ROA. While at present these ratios are low and do not significantly affect their performance, an improvement of these ratios may

help improve their bottom-line. More liquidity means that firms can meet their immediate obligations without hurting their finances and are therefore preferred. The liquidity ratios can be improved by reduction of current liabilities.

5.4 Limitations

The study could not use all the data for 62 listed companies because of data deficiencies. Some data, especially on lease financing, were unavailable for most of the firms or for some years in some firms and therefore such firms were dropped from the final analysis. Thus, only 30 firms were used in the final analysis. This is almost half of the listed firms and therefore a fair representative sample of the entire market.

It was not possible to separate between finance leases and operating leases as some of the firms did not separate the same under their lease payments. Thus, the study used the total lease figures to proxy for lease financing. In most cases, only lease prepayments were reported in the annual reports, together with their amortization charges per year but no lease payments for the current year under the expenses in the notes to the accounts. In such cases therefore, the study resorted to the use of lease commitments that were reported by all firms as is the requirement by IAS 17.

5.5 Suggestions for Further Research

The study suggests that more studies need to be done in this area in Kenya as research on lease financing in Kenya is still largely unavailable. The study suggests that future studies should focus on how lease capitalizations influence financial performance of companies. This is because IASB and FASB suggested that all non-cancellable minimum lease payments with lease terms of more than one year be capitalized. This was meant to abolish off-balance sheet accounting for operating leases by extending the current accounting treatment for finance leases to all leases. It would therefore be important to study how such capitalization would influence financial performance of firms.

Further researches also need to be done on the determinants of lease financing among firms in Kenya. It may also be important for future studies on this area to employ panel analysis techniques to examine these relationships as opposed to the present OLS method used.

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APPENDIX

Appendix 1: List of Listed Companies in Kenya

AGRICULTURAL

1. Eaagads Ltd Ord 1.25
2. Kapchorua Tea Co. Ltd Ord Ord 5.00
3. Kakuzi Ord.5.00
4. Limuru Tea Co. Ltd Ord 20.00
5. Rea Vipingo Plantations Ltd Ord 5.00
6. Sasini Ltd Ord 1.00
7. Williamson Tea Kenya Ltd Ord 5.00

COMMERCIAL AND SERVICES

8. Express Ltd Ord 5.00
9. Kenya Airways Ltd Ord 5.00
10. Nation Media Group Ord. 2.50
11. Standard Group Ltd Ord 5.00
12. TPS Eastern Africa (Serena) Ltd Ord 1.00
13. Scangroup Ltd Ord 1.00
14. Uchumi Supermarket Ltd Ord 5.00
15. Hutchings Biemer Ltd Ord 5.00
16. Longhorn Kenya Ltd

TELECOMMUNICATION AND TECHNOLOGY

17. Safaricom Ltd Ord 0.05
18. AUTOMOBILES AND ACCESSORIES
19. Car and General (K) Ltd Ord 5.00
20. CMC Holdings Ltd Ord 0.50
21. Sameer Africa Ltd Ord 5.00
22. Marshalls (E.A.) Ltd Ord 5.00

BANKING

23. Barclays Bank Ltd Ord 0.50
24. CFC Stanbic Holdings Ltd ord.5.00
25. I&M Holdings Ltd Ord 1.00

26. Diamond Trust Bank Kenya Ltd Ord 4.00
27. Housing Finance Co Ltd Ord 5.00
28. Kenya Commercial Bank Ltd Ord 1.00
29. National Bank of Kenya Ltd Ord 5.00
30. NIC Bank Ltd 0rd 5.00
31. Standard Chartered Bank Ltd Ord 5.00
32. Equity Bank Ltd Ord 0.50
33. The Co-operative Bank of Kenya Ltd Ord 1.00

INSURANCE

34. Jubilee Holdings Ltd Ord 5.00
35. Pan Africa Insurance Holdings Ltd 0rd 5.00
36. Kenya Re-Insurance Corporation Ltd Ord 2.50
37. Liberty Kenya Holdings Ltd
38. British-American Investments Company (Kenya) Ltd Ord 0.10
39. CIC Insurance Group Ltd Ord 1.00

INVESTMENT

40. Olympia Capital Holdings ltd Ord 5.00
41. Centum Investment Co Ltd Ord 0.50
42. Trans-Century Ltd

MANUFACTURING AND ALLIED

43. B.O.C Kenya Ltd Ord 5.00
44. British American Tobacco Kenya Ltd Ord 10.00
45. Carbacid Investments Ltd Ord 5.00
46. East African Breweries Ltd Ord 2.00
47. Mumias Sugar Co. Ltd Ord 2.00
48. Unga Group Ltd Ord 5.00
49. Eveready East Africa Ltd Ord.1.00
50. Kenya Orchards Ltd Ord 5.00
51. A.Baumann CO Ltd Ord 5.00

CONSTRUCTION AND ALLIED

52. Athi River Mining Ord 5.00
53. Bamburi Cement Ltd Ord 5.00

54. Crown Berger Ltd 0rd 5.00
55. E.A.Cables Ltd Ord 0.50
56. E.A.Portland Cement Ltd Ord 5.00

ENERGY AND PETROLEUM

57. KenolKobil Ltd Ord 0.05
58. Total Kenya Ltd Ord 5.00
59. KenGen Ltd Ord. 2.50
60. Kenya Power & Lighting Co Ltd
61. Umeme Ltd Ord 0.50

GROWTH ENTERPRISE MARKET SEGMENT

62. Home Afrika Ltd Ord 1.00

Appendix 2: Research Data

Company	ROA	Lease	Liquidity	Size	Leverage
Kakuzi	0.117	0.000	4.669	0.558	0.384
Rea Vipingo	0.128	0.005	2.762	0.948	0.490
Sasini	0.044	0.000	2.146	0.287	0.403
Express	- 54.497	0.043	0.401	0.631	1.216
KQ	- 0.005	0.001	0.863	1.043	2.745
NMG	0.211	0.016	2.241	1.210	0.432
SGL	0.062	0.016	1.189	0.993	1.120
TPS Serena	0.044	-	1.303	0.469	0.613
Scangroup	0.089	0.014	2.108	0.383	0.837
Uchumi	0.133	0.000	0.767	2.904	3.618
Safaricom	0.123	0.006	0.610	0.850	0.690
Car and General	0.059	0.002	72.347	1.141	1.381
Sameer	0.047	0.011	3.073	1.145	0.392
Barclays	19.657	0.004	1.207	0.094	3.003
CFC	0.015	0.000	1.247	0.039	5.105
I&M	0.018	0.001	1.217	0.051	5.553
DTB	0.028	0.003	1.164	0.062	7.723
HFCK	0.020	0.000	1.352	0.054	6.001
KCB	0.032	0.000	1.154	0.078	6.071
NBK	0.024	0.002	1.133	0.069	5.663
NIC	0.028	0.001	1.173	0.053	6.092
SCB	0.039	0.001	1.144	0.064	6.247
Equity	0.047	0.005	1.311	0.090	4.287
Cooperative	0.032	2.020	1.120	0.066	6.159
Jubilee	0.048	0.002	1.265	0.190	4.626
Pan Africa	0.041	0.000	1.230	0.308	5.069
Centum	0.120	0.000	24.460	0.137	0.184
Carbacid	0.199	0.000	0.406	0.407	1.124
EABL	0.182	0.012	1.210	0.979	2.638
Athi River Mining	0.078	0.001	1.067	0.417	2.372