

## Operating Lease financing and financial Performance of State owned sugar manufacturing firms in Kenya

Isabwa Harwood Kajirwa<sup>1</sup>

Omete F. Ikapel<sup>2</sup>

<sup>1</sup>Department of Business Management,  
University of Eldoret, P.O. Box 1125-30100, Eldoret, Kenya,

### Abstract

This study analyses the effect of operating lease finance on financial performance of state owned sugar firms in Kenya. The study used the retrospective research design in collection of data. A target population of all the four state owned sugar firms was considered in the study for the period 2004-2014. The firms included Muhoroni Sugar Company, Chemilil Sugar Company, Nzoia Sugar Company and Sony Sugar Company. Secondary data was the main source of data obtained from financial statements and annual reports. The data was analyzed using regression analysis and Pearson product moment correlation coefficient. The study found that operating lease finance negatively affects return on assets (ROA) ( $r = -.475$ ,  $p = 0.008$ ,  $<0.05$ ). The study recommended that state owned sugar manufacturing firms should reduce the proportion of operating lease finance in their capital structure as it negatively affects financial performance.

**Key words:** Operating lease finance, return on assets, capital structure.

### 1.0 Introduction

Operating lease is a contract that allows for the use of an asset, but does not convey rights of ownership of the asset (Lorigan, 2014). Leasing is a contract between an owner of equipment, the lessor and another party, the lessee giving the lessee possession and use of a specific asset in return for payment of specific rentals over an agreed period (Kisaame, 2002). An operating lease is usually signed for a period much shorter than the actual life of the asset, and the present value of lease payments are generally much lower than the actual price of the asset. At the end of the life of the lease, the asset reverts back to the lessor, who will either offer to sell it to the lessee or lease it to somebody else. The lessee usually has the option to cancel the lease and return equipment to the lessor, sometimes at a cost.

Operating lease is advantageous to a business because operating lease finance is used to hide financially leveraged balance sheets by presenting capital leases as operating leases. Although an operating lease is, many a times, more expensive as compared to an outright purchase or a capital lease for the same equipment due to the guarantee of service obscured in an operating lease in

addition to the obsolescence risk assumed by the leasing company. However, this is justified by the lessee through the convenience of relying on fully operational equipment in addition to avoiding the obsolescence cost. An operating lease reduces the lessee's liabilities thus allowing it to borrow more than if it used a mortgaged loan or a capital lease. Leases offer a certain degree of flexibility, compared to having to purchase the asset. Operating lease finance includes short term operating lease obligations, long term operating lease obligations and a combination of both short term and long term operating lease finance obligations.

Leasing is the way by which many businesses finance plant, property and equipment or just any asset. Leases can either be operating leases or finance leases. We focus on operating lease financing as it is the most popular among business firms in Kenya. Operating leases finance contracts are cancellable, are mostly short term and can be cancelled at the option of the lessee with the proper notice (Mohammad & Shamsi, 2008). The use of Operating lease finance has increased more than the use of outright purchase in state owned sugar manufacturing firms, with the trend gaining traction in the national and county governments in Kenya. Data from the financial statements revealed a progressive growth in the use of operating lease finance among the state owned sugar manufacturing firms.

The value for outstanding operating lease obligations in the firm's financial statements was millions of shillings which were long overdue. The firm's financial performance has decreased considerably prompting closure of some firms in Kenya.

According to Muhammad *et al.*, (2012) operating lease expense is tax allowable and should translate to high financial performance, yet this is not the actual situation in the state owned sugar manufacturing firms in Kenya. Operating lease finance has been used by the sugar manufacturing firms as an alternative means of financing but the inability to pay for the leased property creates a dilemma as to whether to opt fully for outright purchase.

### **1.1 Concept of financial performance**

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 study adopted the use of accounting returns approach, Return on assets as it was the most commonly used financial indicator in the measurement of financial performance of a firm (Kieso *et al.*, 2005).

According to Penman (2010), return on assets is a measure that is commonly used to measure the financial performance of a firm's operations. ROA measures the income available to debt and equity investors per dollar of the firm's total assets (Brealey *et al.*, 2011). That is, it measures financial soundness of the firm in terms of its assets. As mentioned above, it also indicates the overall financial health of a firm (Bodie *et al.*, 2011). It was therefore used in the regression model as a measure of financial performance. Specifically, it is the ratio of revenues generated over a firm's total assets.

## **1.2 Lease financing and information asymmetry theory**

The Information Asymmetry theory was proposed by Myers and Majluf (1984). They argued that information asymmetry influences the capital structure of firms and demonstrated that if managers can issue safe debt, the adverse selection problem due to information asymmetry could be reduced. Therefore, consistent with Myers & 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. Sharpe & 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 (Ezzell and Vora, 2001). By financing via true lease the firm puts the lease obligation at par with other administrative expenses that have higher priority than normal debt, making leasing a highly desirable financial contract in the presence of 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 *et al.*, (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 Parastatal sugar manufacturing firms.

## **1.3 Operating Lease finance and financial performance**

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 Return on assets in operating lease finance. The study applied ordinary least square (OLS) model and Logistic models for estimation of results. They found that an increase in the proportion of operating lease led to an increase in firm performance of leasing companies as measured by ROA. Salam (2013), endeavored to find the casual relationship between firm performance using ROA and ROE with different Small and medium enterprises on lease finance. The results showed that an increase in the proportion of operating lease led to an increase in firm performance of leasing companies as measured by ROA. According to Eric (2012) in a study on French Small and medium enterprises for 11436 firms for the year 1999 with long term debt, leasing, equity, short term assets, short term liabilities, EBITDA, financial fees, fiscal debt and firm age as variables, the results showed that an increase in the proportion of operating lease led to an increase in firm performance as measured by ROA. Lasfer and Levis (2008), examined the relationship between lease finance and ROA for Small and

Medium enterprises. The findings showed that an increase in the proportion of operating lease led to an increase in firm performance as measured by ROA. According to Kisaame (2002) who researched on Small and medium enterprises in Uganda, the results revealed that businesses with leasing competence were on average more profitable as measured by ROA. Similarly, Abor (2007), on Debt Policy and Performance of SMEs, Evidence from Ghanaian and South African Firms found that an increase in operating lease led to an increase in firm performance as measured by ROA.

#### **1.4 Research hypotheses**

The following hypothesis was tested in this study

**H<sub>01</sub>:** Operating lease finance has no significant effect on a firms' financial performance measured by return on assets (ROA).

#### **1.5 Research Methodology**

The study employed a retrospective research design as it uses existing data that has been recorded. The design was adopted because it was meant to look back at past events. For example, data already in financial statements during a given financial year. A time span of 10 years between 2004 – 2014 was considered in this study. The study targeted four state owned sugar manufacturing firms in Kenya; Muhoroni, Nzoia sugar, Chemilil and Sony sugar. This study was purely a census study. The study used Secondary data available in their financial statements. Pearson product moment correlation was used to assess for significant association between dependent variable; return on assets (ROA) and the independent variable, Operating lease finance. Regression analysis was used to identify significant predictors of ROA controlling for confounders, and a P-value of less than 0.05 was considered significant. The regression model was as follows:

$$ROA_{it} = \beta_0 + \beta_1 M_{it} + e$$

#### **Where**

$M_{it}$  = Operating lease finance to total assets of the firm  $i$  at time,  $t$

$ROA_{it}$  = Return on Assets of firm  $i$  at time  $t$

$\beta_0$  = intercept;  $\beta_1$  = coefficient

$e$  = error term;

#### **1.6 Empirical Results**

Pearson product moment correlation was used to assess the correlation between dependent variables and the independent variable. The results showed that there was significant but weak negative correlation between operating lease finance and financial performance as measured by ROA ( $r = -0.469$ ,  $p = 0.026$ ,  $\alpha < 0.05$ ), as shown in Table 4.1.

**Table 4.1: Correlation between operating lease finance and financial performance (ROA)**

Performance	Operating lease finance
ROA	r = - 0.469 p=0.026

**Source: (Survey Data, 2015)**

**Regression analysis**

A simple linear regressions model was done on operating lease finance and ROA and the results showed that operating lease finance significantly negatively affected ROA ( $p < 0.05$ ), as shown in Table 4.2.

**Table 4.2: Regression coefficients**

Model	Un standardized Co- efficient		Standardized Co- efficient	T	P- value	95% Confidence interval
	B	Std. Error				
<b>Constant</b>	.407	.908	1.951	4.154	.053	-.015- .824
<b>Operating Lease finance</b>	-.475	.895	1.929	2.922	.008	-2.218- 1.677

a. Dependent Variable: ROA

**Source: (Survey data, 2015)**

The results of Table 4.2 indicate that there is significant negative effect between operating lease finance and firm performance as measured by ROA ( $\beta_2 = -.475$ ,  $p\text{-value} = .008$ ,  $\alpha < 0.05$ ). Hence we reject the null hypothesis ( $H_{01}$ ) and conclude that operating lease finance significantly affects a firm's performance as measured by ROA. The findings of this study were consistent with the findings of Kisaame (2002), Eric (2012), Muhammad *et al.*, (2012) and Salam (2013), albeit with slight differences. These differences could be attributed to disparity in firm characteristics, sample size and market characteristics. From table 4.3, the findings indicate that the model coefficient of determination (adjusted R Squared) was .45, implying that 45.1% of the total variation in a firms' financial performance is explained by Operating lease financing. This implies that there are other factors that affect Return on assets other than operating lease finance which were not captured in this study. These factors could be managerial efficiency, finance costs and market structure among others.

**Table 4.3: Multiple linear regression model summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.906 <sup>a</sup>	.820	.451	.044910

Predictors: (Constant), Operating lease finance

**Source: ( Survey data, 2015)**

## **1.7 Conclusions and Recommendations**

We conclude that for state owned sugar manufacturing firms in Kenya, operating lease finance negatively affects financial performance as measured by ROA. Firms should therefore cautiously apply the use of operating lease financing in their financial structure. A clear objective should be defined as to whether to maximize shareholder equity or return on assets. We recommend that firms should opt for other alternative methods of financing such as outright purchase and corporate bond financing other than operating lease finance as operating lease finance negatively affects financial performance. Further state owned sugar firms should reduce the proportion of operating lease finance in their capital structure as it negatively affects financial performance.

## **REFERENCES**

1. Abor, J., (2007). "Debt Policy and Performance of SMEs, Evidence from Ghanaian and South African Firms," *Journal of Risk Finance*, 8, 364-379.
2. Alan, M. (2008). *International Financial Reporting, A practical Guide*.
3. Bodie, Z., Kane, A. & Marcus, A.J. (2011). *Investments and Portfolio Management: Global Edition* (9th Ed.). New York: McGraw-Hill/Irwin.
4. Brealey, R.A., Myers, S.C. & Allen, F. (2011). *Principles of Corporate Finance* (10th Ed.). New York: McGraw-Hill/Irwin.
5. Chau, D. K. Y., Firth, M., and Srinidhi, B. I. N. (2006). Leases with Purchase Options and Double Moral Hazard. *Journal of Business Finance and Accounting*, 33, 1390-1401.
6. Eric, S. (2012). Determinants of the choice leasing vs. bank loan: Evidence from the French SME, Working paper, University of Durham.
7. Ezzell, J. R., and Vora, P. P. (2001). Leasing Versus Purchasing: Direct Evidence on Corporation's Motivations for Leasing and Consequences of Leasing. *Quarterly Review of Economic and Finance*, 41, 33-47.
8. Gilligan, T. W. (2004). Lemons and Leases in the used Business Aircraft Market. *Journal of Political Economy*, 112, 1157-1180.
9. Kieso, D. E., Weygand, J. J., Warfield, T. D., Young, N. M., and Wiecek, I. M. (2005). *Intermediate Accounting* (7th ed. Vol. 1): Wiley.
10. Kisaame, J., (2002) Financing of Small and Medium-Sized Enterprises. Paper presented at a United Nations Conference on Trade and Development, Kampala.
11. Lasfer, M.A. and Levis, M. (2008). The Determinants of Leasing Decision of Small and Large Companies. *European Financial Management*, 4, 159-84.

12. Lorigan, p. (2014). Definition of Operating Leases: Retrieved on June 5, 2014, from <http://www.linkedin.com/today/post/article/20140605230933-182358> [definition-of-Operating-leases](#)
13. Mohammad, S. A., and Shamsi, B. (2008). Determinants of financial leasing development in Jordan. *Studies in Business and Economic Journal*, 14(2).
14. Muhammad, J.K., Naveed, K., and Hammad, H.M. (2012). Factors Influencing the Profitability of Leasing Firms in Pakistan: Application of OLS and LOGIT Model.
15. Myers, S. C., and Majluf, N. S. (1984). Corporate Financing and Investment Decisions when Firms have Information those Investors do not have. *Journal of Financial Economics*, 13, 187-221
16. Penman, S.H. (2010). *Financial Statement Analysis and Security Valuation*. (4TH Ed.). New York: McGraw-Hill/Irwin.
17. Salam, A. (2013). Effects of Lease Finance on Performance of SMEs in Bangladesh. *International Journal of Science and Research*, 2(12), 2319 -7064.
18. Sharpe, S. A., and Nguyen, H. H. (1995). Capital Market Imperfections and the Incentive to Lease. *Journal of Financial Economics*, 39, 271-294.