EFFECT OF LEASE FINANCE CONDITIONS ON THE FINANCIAL PERFORMANCE OF SMALL AND MEDIUM SIZED ENTERPRISES IN KENYA
(A Case Study of Nairobi County)

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Abstract: Small and Medium Sized Enterprises (SMEs) are the backbone of most economies in the world. Most of these companies use external financing sources like debt and equity capital to finance their activities. However, in general, in the area of SMEs' access to finance, there are market imperfections - not only in times of crisis, but on an on-going basis as a fundamental structural issue, based on uncertainty and asymmetric information between the demand side (entrepreneur) and the supply side (financial intermediary). The objective of this research was to find out the effect of lease finance conditions on the financial performance of small and medium sized enterprises in Kenya. In this research the researcher analyzed the effect that various conditions of lease finance have on the financial performance of the SMEs. This study used descriptive research design as it sought to establish the relationship between the independent and dependent variables. Data collection was done through questionnaires and analyzed by SPSS. The study concluded that for the SMEs to acquire a good cash flow developed from its increased liquidity they must embrace flexible lease charges. Flexible lease charges improve company's budgetary planning and even its control which are the desired ingredients for financial performance of SMEs.

Keywords: Lease Charges Flexibility, Lease Term Flexibility and Leased Asset Management.

1. INTRODUCTION

In developing economies, the existence of a vibrant leasing industry is critical to SME's that typically have difficulties accessing loans due to lack of collateral (International Finance Corporation, 2008). A lease is a contractual agreement between a lessee and lessor. The agreement establishes that the lessee has the right to use an asset and in return must make periodic payments to the lessor, the owner of the asset. Ernest and Young (2012) defines a lease as a contract in which the right to use an asset is conveyed, for a period of time, in exchange for consideration. A leasing contract is thus a contract between the lessor on one hand and the lessee on the other. The lessor retains ownership of the asset. The lessee has possession and use of the asset on payment of specified rentals over a period (Akinbola et al., 2012).

Statement of the Problem

SMEs form a key part of economies throughout the world. In Kenya, SMEs have the potential to contribute significantly to economic growth and poverty reduction through increased production and employment. This role has long been recognized by the Government of Kenya. Vision 2030, Kenya's long-term development plan, places a strong emphasis on the sector. While SMEs face many constraints, the lack of appropriate financial products and services invariably appears in surveys and analysis as one the leading hurdles to realizing growth. As in other areas, a broad-based approach is needed to build market driven financial solutions for the SME segments.

Most entrepreneurs face challenges in finding a mode of financing that will not strain their cashflow and require for collateral because some businesses will require a substantial initial capital outlay. An ideal way to finance small businesses is through leasing as the item leased acts as the collateral and the lessor retains the right to the item. The entrepreneur might prefer leasing option as he has the option to change or return the item after sometime if he realizes that the product is not giving him good value for money.

This study sought to identify whether leasing as mode of financing affects the financial performance of the SMEs to enable the entrepreneur make an informed decision. There are various conditions that are related to leasing and each condition will be fundamental in enabling an entrepreneur take up lease finance. These conditions include the lease charges flexibility, lease term flexibility and leased asset management. The conditions have different merits and as such forms the basis of decision making. Firms that have used leasing have experienced tax advantages, reduced initial cost outlays, increased cash flows, increased solvency, reduced financial distress, increased profitability and leasing has not affected their financial position as it is an off balance sheet mode of financing.

Similar studies on leasing have been conducted in other parts of Africa such as in Nigeria, effects of leasing as a source of finance on the profitability of SMEs in Lagos state (Akinibola, 2012). In Uganda, Kampumure (2009) conducted a study on leasing competence, lease structures and perceived performance of SMEs in Uganda. However, no empirical evidence exists in Kenya correlating lease finance with financial performance of SMEs. A knowledge gap therefore exists regarding the effects of lease finance conditions on the financial performance of SMEs in Kenya. This study therefore sought to establish the effects of lease finance conditions on the financial performance of SMEs in Kenya.

Objectives

  i. To determine the effect of Lease Charges Flexibility on the Financial Performance of SMEs.

  ii. To determine the effect of Lease Term Flexibility on the Financial Performance of SMEs.

 iii. To determine the effect of Leased Asset Management on Financial Performance of SMEs.

Theoretical Review

Thünen-Series of Applied Economic Theory

Leasing is an alternative to bank loans with growing importance for the financing of small and medium sized enterprises (SMEs) in Europe. This theory analyses a high quality dataset on commercial leasing requests in Germany, focusing on small firms and analyzing for the first time the influence of demographic characteristics of the entrepreneur on the probability and use of leasing. It is the first leasing study based on firm-internal data of a leasing company. To the best of our knowledge, it presents the first multivariate analysis on the use of leasing by firms in Germany. We find good agreement with hypotheses about the influence of characteristics of the financial contract, the firm and the entrepreneur on leasing, derived from theoretical considerations (Alesina et al., 2008).

Real Option Theory

Real option theory posits that a discounted cash flow analysis is inadequate for capital budgeting purposes when the choices entail different degrees of ongoing management flexibility (Dixit and Pindyck 1994, Trigeorgis 1996). Any inherent flexibility in the use of an asset has a value separate from the expected cash flows. Many researchers identify a lease as a transaction type containing an embedded option and resulting flexibility to the lessee (Kenyon and Tompaidis 2001, Trigeorgis 1996, Grenadier 1995). This theory comes to assist decision makers in making more robust lease versus purchase decisions through the development and illustration of a model encompassing real option principles. This criterion can be added to other decision relevant factors, such as, relative after-tax discounted cash flows and financial reporting concerns in choosing between a lease and a purchase (Copeland and Weston 1988).
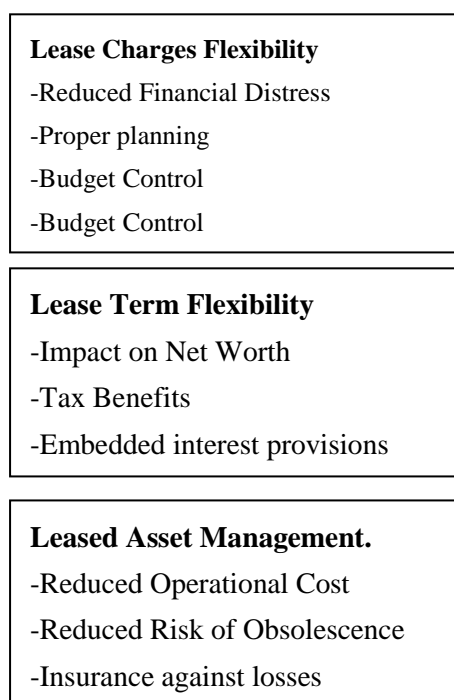
Theory of Contractual Provisions in Leasing

Leasing is an important source of external financing for U.S. corporations. It has been estimated that a third of the capital equipment used by U.S. corporations is leased. However, the motivations for leasing are still not completely understood. While the finance literature has analyzed corporate leasing policy extensively, much of the discussion has been confined to tax-related incentives to lease or buy (Miller and Upton, 1976; Lewellen et al., 1976).This theory demonstrate that, in this setting, the decision by a manufacturer regarding whether to offer his capital equipment under a leasing or a sales

contract, as well as the contractual provisions in the leases he offers, allows him not only to reveal the true quality of his equipment, but also to segment the market for capital equipment among different kinds of entrepreneurs, thus maximizing his profit. In equilibrium, high type manufacturers choose to lease their capital equipment to entrepreneurs, while lower type manufacturers choose to sell the equipment outright (Jennergren,2004).

2. CONCEPTUAL FRAMEWORK

A conceptual framework is a research tool envisioned at assisting a researcher to develop awareness and understanding of the situation under enquiry and to communicate it. When clearly articulated, a conceptual framework has prospective usefulness as a tool to assist a researcher to make meaning of consequent findings. It forms part of the package for negotiation to be inspected, tested, reviewed and reformed as a result of investigation and it explains the possible connections between the variables. Conceptual frameworks are products of qualitative processes of theorization (Jabareen, 2009).

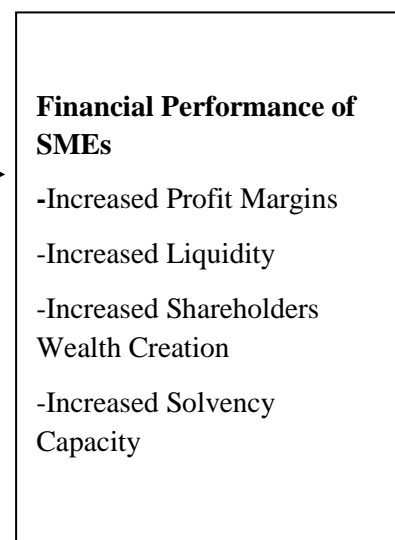**Independent Variables**   **Dependent Variable**

Lease Charges Flexibility
-Reduced Financial Distress
-Proper planning
-Budget Control
-Budget Control

Lease Term Flexibility
-Impact on Net Worth
-Tax Benefits
-Embedded interest provisions

Leased Asset Management.
-Reduced Operational Cost
-Reduced Risk of Obsolescence
-Insurance against losses

Financial Performance of SMEs
-Increased Profit Margins
-Increased Liquidity
-Increased Shareholders Wealth Creation
-Increased Solvency Capacity

Fig 2.1: Conceptual Framework

Research Gaps

There exists a gap in information on accounting for leases and its effect on a company's overall performance. There is no sufficient research evaluating the winners of the future; whether those leasing companies which are large in size and affect economies of scale or those which are associated with business houses. Leases involve agency costs due to the separation of ownership and control of capital; a lessee may not have the same incentive as an owner to properly use or maintain the capital. This observation presents a research gap. A characteristic feature of leasing is separation of ownership and control of the leased asset with the lessee receiving the benefits of use and the lessor receiving the value of the lease payments plus the residual value of the asset. In practice this separation is not, however, discrete, but there is a continuum of different types of lease contracts where the degree of control over the asset between the lessor and the lessee varies. This invites a research on the same.

3. RESEARCH METHODOLOGY

A descriptive research design was used for the study in order to produce accurate description on various issues relevant to the problem being studied. The target population of this study was 308 SMEs from Nairobi County and in different sectors of the economy. The researcher sought to get information from the finance managers of these 308 SMEs in

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Nairobi. For this study stratified random sampling was used. The researcher divided the population according to the economic sectors from which representative samples were selected. This research therefore relied on a sample of 102 respondents. Primary data was collected by administering a semi-structured questionnaire. Secondary data on the other hand was collected through review of both empirical and theoretical data from books, journals, dissertations, magazines and the internet. A pilot study was conducted prior to data collection in order to test the reliability of the questionnaire. During the pilot study, the researcher sent 10 questionnaires to some finance managers who were requested to fill them so that the researcher could specifically know which questions were relevant to the study. The data processing and analysis was done bearing in mind the objectives of the study. All the data collected was processed and analyzed. A correlation test was conducted and the study employed the use of P-Values, T-Tests and Chi Square tests to determine the extent to which the variables are related and to test the assumption of normality. A multiple linear regression was conducted for this study.

Model

$Y=\beta_0+\beta_1 X_{1+}\ \beta_2 X_2+\ \beta_3 X_3+\ \varepsilon$

Where;   Y= Financial Performance

β_0=Constant

X1= Lease Charges Flexibility

X2= Lease Term

X3= Leased Asset Management

β1, β2 & β3= Regression co-efficient

ε =Error term

4.   RESULTS

Correlation of Variables

Correlation analysis is a process of statistical assessment used to study the strength of an association between two, numerically measured, continuous variables. This particular type of analysis is useful when a researcher wants to establish if there are possible connections between variables. It is repeatedly misinterpreted that correlation analysis determines cause and effect; however, this is not the case because other variables that are not present in the research may have impacted on the results. Correlation analysis for this study was conducted in order to determine the direction and the strength of the relationship between the dependent variable and independent variables. Consequently, Pearson correlation coefficient was used to determine the magnitude and the direction of the relationships between the dependent variable and independent variables. Pearson Correlation Coefficient was computed to show the relationship existing between the variables and the results were presented in Table 4.1

Table 4.1: Correlation of Variables

		Lease Charges Flexibility	Lease Term Flexibility	Leased Asset Management	Financial Performance
Lease Charges Flexibility	Pearson Correlation	1	0.012	-0.038	0.076
	Sig. (2-tailed)		0.909	0.710	0.046
	N	96	96	96	96
Lease Term Flexibility	Pearson Correlation	0.012	1	0.013	0.071
	Sig. (2-tailed)	0.909		0.900	0.049
	N	96	96	96	96
Leased Asset Management	Pearson Correlation	-0.038	0.013	1	0.085
	Sig. (2-tailed)	0.710	0.900		0.041
	N	96	96	96	96

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Financial Performance	Pearson Correlation	0.076	0.071	0.085	1
	Sig. (2-tailed)	0.046	0.049	0.041	
	N	96	96	96	96

According to Sekeran (2008), the values of the correlation coefficient are supposed to be between -1 and +1. A value of 0 implies no relationship, +1 correlation coefficient indicates that the two variables are perfectly correlated in a positive linear sense, that is, both variables increase together while a values of -1 correlation coefficient indicates that two variables are perfectly correlated in a negative linear sense, that is, one variable increases as the other decreases. The researcher conducted a correlation analysis with the aim of identifying the strength of the relationship between the variables. The variables tested were the independent variables against one dependent variable separately but the findings were summarized in table 4.19. The independent variables were lease charges flexibility, lease term flexibility and leased asset management. The dependent variable was financial performance. The general findings of the study indicated that lease finance conditions had a positive correlation to financial performance of small and medium enterprises in Kenya. This was evident from the results obtained in table 4.19 which shows that for a correlation test between lease charges flexibility, the study registered a positive Pearson correlation of 0.076 in which case was significant with a 0.046 significant level. This was an indication therefore that lease charges flexibility was an important element of consideration if small and medium enterprises have to perform financially. On the other hand, a test of correlation between lease term flexibility and financial performance also registered a positive Pearson correlation of 0.071 which was also significant at 0.049 significant level. Finally, a correlation between lease asset management and financial performance had equally a positive relationship with a Pearson correlation of 0.085 with a 0.041 significant level. The study found that all these variables increased with an increase in financial performance.

Regression Analysis

Regression analysis was done in order to measure the ability of the independent variables to predict an outcome in the dependent variable where there is a linear relationship between them. In order to test the hypotheses of the regression model that there is no significant relationship between lease finance conditions and financial performance of small and medium enterprises in Kenya, Analysis of Variance (ANOVA) was used (Cooper & Schindler, 2010). According to Anderson *et al*. (2002) Analysis of Variance can be used to test the relationship between independent variables and the financial performance by SMEs and to test the goodness of fit of the regression model; that is how well the model fits the data.

Cooper and Schindler (2010) claimed that regression analysis can also be used to determine the strength of the relationship between the independent and dependent variables and to determine the combined effect of all the independent variables on the dependent variable. The coefficient of determination (R^2) was used to measure the change in dependent variable explained by the change in independent variables. F –test was carried out to estimate the significance of the overall model and to define the relationship between the dependent variable and independent variables; t- test was used to test the significance of the individual independent variables to the dependent variable. In fitting the multiple linear regression model, a regression analysis conducted was summarized in tables 4.2 and 4.3

Table 4.2: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics	
					R Square Change	F Change
1	.816	0.665	.643	.58814	0.017	0.544

Table 4.2 indicated the model summary which indicates the overall model. The R value represents the simple relationship and is 0.816 which indicates a high degree of correlation between the dependent and independent variables. The R Square indicates how much the total variation in the dependent variable can be explained by the independent variable. It is also called the coefficient of determination. In this case, it is 0.665 which means the independent variables determines 66.5% of the dependent variable. The remaining percentage of determination was subject to other variables that contributed to the financial performance of small and medium enterprises.

Table 4.3: ANOVAa

Model			Sum of Squares	Df	Mean Square	F	Sig.
1	Regression		16.587	3	5.529	0.544	.000b
	Residual		934.746	92	10.160		
	Total		951.333	95			

6   Dependent Variable: Financial Performance

7   Predictors: (Constant), Leased Asset Management, Lease Term Flexibility, Lease Charges Flexibility

Table 4.3 was the ANOVA table, which reports how well the regression model fitted the data which indicated that it predicted the dependent variable. This table indicated that the regression model predicted the dependent variable significantly well. The sig of .000 indicated the statistical significance of the regression model that was run. Here, p = 0.000, which is less than 0.05, and indicates that, overall, the regression model significantly predicted the outcome variable and therefore it was a good fit for the data. In fitting the regression model, the researcher determined the regression coefficients which showed the extent to which each independent variable contributed to the dependent variable and the results were shown in table 4.4

Table 4.4: Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	25.015	3.223		7.763	0.000
	Lease Charges Flexibility	-0.077	0.109	-0.074	-0.711	0.479
	Lease Term Flexibility	0.078	0.114	0.070	0.681	0.497
	Leased Asset Management	0.079	0.101	0.081	0.785	0.435

a. Dependent Variable: Financial Performance

The fitted model was as shown below

$$Y= 25.015 - 0.077X_1 + 0.078X_2 + 0.079X_3 + \varepsilon$$

Where:

Y = Financial Performance

X_1 = Lease Charges Flexibility

X_2 = Lease Term Flexibility

X_3 = Leased Asset Management

5.   CONCLUSION

The study developed its conclusions from the major findings. Conclusions were classified according to the objectives of study. Regarding lease charges flexibility and financial performance, the study concluded that indeed flexibility of lease charges is imperative since it led to balanced cash flows within the SMEs. Equally, the study concluded that SMEs should adopt flexible charges since it will attract a wider clientele which will in turn increase profitability and reduced capital expenditure in their operations. On the same note, the study concluded that for the SMEs to acquire a good cash flow developed from its increased liquidity, they must embrace flexible lease charges. The study finally concluded that flexible lease charges improves company's budgetary planning and   even its control which are the desired ingredients to financial performance of SMEs

Suggestions for Further Research

In the future it is suggested that researchers include more variables on the existing research, apply a time series model or the research to be carried in different sectors.

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