

Effect of Leasing on the Financial Performance of the County Government of Trans Nzoia.

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Abstract:

Lease financing is of late increasingly becoming a viable option to many organisation and county governments when it comes to funding projects and delivering crucial services. However, it is important for county governments to understand how cost effective the option is as compared to the traditional methods of procuring funds services. 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. Therefore, the study sought to investigate the effect of leasing on financial performance of Trans Nzoia County government. The specific objective of this research paper was to analyze the effect of finance lease on the financial performance of Trans Nzoia County Government. The study was based on the Agency theory, the theory of Information Asymmetry, and the theory of Managerial Risk Aversion. The study adopted a descriptive survey research design where the population of the study was 10 departments of the County government of Trans Nzoia and entailed a sample of 10 county officials who were selected using purposive sampling method. The research instrument used was a 5 point Likert scale questionnaire and interview schedule was used as tool of collecting data. The measures of financial performance were taken as the dependent variables while amount of Finance lease, taken as the independent variables. The primary 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 county government of Trans Nzoia. From the regression results, finance lease, had positive effects on ROA. Financial performance of the county government of Trans Nzoia is affected by the level of lease financing. The study recommends that county governments should be careful with the use of leasing as a method of financing their operations as evidence suggests that value is added through the use of leasing since there is a positive correlation between leasing and financial performance. This study will benefit county governments, as well as other organisations who may want to explore the use of leasing to enhance their financial performance.

Index Terms- Leasing, Financial performance, Finance lease, County Government.

INTRODUCTION

Over the years, Leasing has been consented as one of the cornerstones of modern financial sources and a field of crucial decision for corporate organizations globally. (Salam, 2013). The contractual agreement represents the lease between the two Parties, the lessee and the lessor, and gives the contract to the lessee the right to use certain assets for a specific time period owned by the lessor in return for periodic payments paid by the tenant for the owner. The use of leases have largely spread because of the advantages offered by the leases as an alternative to owning originally included leases many magazines including ships, aircraft, land, and buildings. 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).

It's the goal of the Kenyan government as well as county governments to ensure that services are procured in a more efficient, satisfactory and cost effective manner. In pursuit of this concept the Jubilee government lately urged county governments to embrace this idea by introducing the leasing of some specialised medical equipment to all County Referral Hospitals. Counties are devolved units in a devolved system of government. These units are, through the constitution, charged with the responsibility and mandate to deliver certain services to residents of their respective counties. The study is designed to analyze the effect of lease financing on service delivery in Trans Nzoia County. 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(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 Leasing

Leasing is a possibility for organisations to expand their access to short- and medium-term financing. From an economic perspective, leasing can be defined as “a contract between two parties where one party (the lessor) provides an asset for usage to another party (the lessee) for a specified period of time, in return for specified payments” (Fletcher et. al., 2005). This is also reflected in accounting-related definitions: According to Accounting Standard (AS) 19, a lease is an agreement whereby the 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. A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. An operating lease is a lease other than a finance lease.

Leasing is referred to as asset based financing. As lessors retain ownership of the assets they lease throughout the life of the contract, these leased assets are therefore an inherent form of collateral in such contracts (compared to traditional bank lending which will either be unsecured or make use of different types of collateral and typically not physical assets such as equipment which are inherent in leases). Conventional bank lending focuses on the loan repayment by the borrower from two sources: a primary source, the cash flow generation, and a secondary source, credit enhancements and collateral (if any). Leasing is focused on the lessee's ability to generate cash flows from the business operations to service the lease payments (Gallardo, 1997), as the lessor retains legal ownership of the asset. Hence, leasing separates the legal ownership of an asset from its economic use. Ownership of the asset may or may not pass to the customer at the end of the lease contract. Contracts, where legal ownership of the asset passes directly to the customer at the start of the agreement, are not considered to be leases.

Based on contractual arrangements, the lessee is allowed to use an asset which is owned by the lessor; the lessee pays specified periodic rentals. The lessor relies on the lessee's ability to generate sufficient cash flows to pay the lease rentals (rather than to rely on the lessee's other assets or track record/credit history). Leasing enables also borrowers with limited track record / credit histories and collateral to access the use of capital equipment, often even in cases where they would not qualify for traditional commercial bank lending (Gallardo, 1997; Berger and Udell, 2005).

1.2 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) General 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. Accounting returns focus on how firm earnings respond to different managerial policies. This paper focuses on one accounting based performance measure: return on assets (ROA). This a most commonly used measure for financial performance and therefore provided the most comparable results. ROA was used separately to measure a firm's financial performance.

1.3 Leasing and Financial performance

Leasing play a vital role to meet up the financial needs of various sectors of an economy and thus contribute to the economic development of the country as well as to the deepening of the country's financial system. Lease financing has been a popular mean of financing over the years to the entrepreneurs. Salaam (2013). 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).

1.4 Statement of the Problem

Many organisations and governments have ventured into lease financing as an alternative way of raising funds to meet the expectations of the people they serve or the public generally. 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, 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 leasing is likely to be advantageous for financially distressed companies that can't fulfill the requirements for getting bank loans. Thirdly, most organisations 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 organization 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 as well as county governments employ 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). Several studies have been conducted (Meyer, 1977; 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 firms, none has been done for county governments in Kenya. Therefore this study seeks to bridge the gap by looking into the effects of lease financing on the performance of the Trans Nzoia County government.

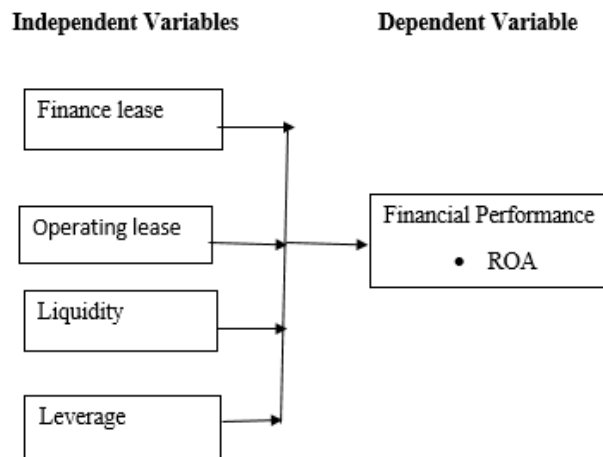
1.5 Objectives

The general objective of this study was to analyse the effect of leasing on financial performance of Trans- Nzoia County Government. The study was guided by the following specific objective:- To analyse the effect of finance lease on financial performance of Trans Nzoia County Government.

1.6 Research Questions

The study was guided by the following research question:-Does finance lease have effect on financial performance of Trans Nzoia County Government.

2. CONCEPTUAL FRAMEWORK



Source: Author(2016)

3. RESEARCH DESIGN

This study adopted descriptive research design and focused on the effect of leasing on the financial performance of the county government of Trans Nzoia. The study employed descriptive research design for it portrayed an accurate profile of situations. The information provided was then be used to generalize the findings of the study.

3.1 Population of the Study

The population of the study was all the 10 departments of the county government of Trans Nzoia.

3.2 Sample and Sampling technique

Denscombe (1998) says that the sample ought to be carefully selected to represent the population adequately with the researcher ensuring that the subdivisions entailed in the analysis are accurately catered for. Purposive sampling method was adopted since the study targeted information from management officials. Questionnaires were delivered to all the targeted respondents in the county government for data collection.

3.3. Research Instruments and Data Collection Methods

The data collection instrument was the questionnaire. A questionnaire is a potent tool that can capture valuable data from the targeted population. Questionnaires in this study were appropriate in collecting data from the sample population and upholding confidentiality. They were prepared in the form of Likert-Scale type (showing respondents agreement or disagreement) by constructing into five point scale where the lowest scale represent strongly disagree and the highest scale represent strongly agree (Likert, 1932). The questionnaires distributed to the respondents were organized into two parts; the first part comprises the demographic question regarding the respondents, and the second part contains items relating to the variables, both the independent variable and the dependent variable on the effect of leasing on the financial performance of the county government of Trans Nzoia County. The data collected was both qualitative and quantitative.

3.4 Data Processing and Analysis

The data was analyzed using qualitative and quantitative techniques. Qualitative method involved content analysis and evaluation of text material. Quantitative method involved the use of statistical tools of descriptive analysis such as Statistical package for social sciences (SPSS).

4. RESEARCH FINDINGS

4.1 Reliability Test

The consistency of the questionnaire, particularly the Likert-type scale, is measured using the reliability analysis which is essential in reflecting the overall reliability of the variables that it is measuring. To carry out the reliability analysis, Cronbach’s Alpha (α), as the most common measure of scale reliability was used with a value greater than 0.700 being very acceptable (Cohen and Sayag, 2010) Cronbach’s (1951), states that a reliability value (α) greater than 0.600 is also acceptable.

The value for Cronbach’s Alpha (α) was found to be 0.678 for all variables. When these calculated reliability values are close to 0.7000, and compared with the minimum value of alpha 0.600 advocated by Cronbach’s (1951), then the responses generated for all of the variables’ used in this research were reliable enough for data analysis

4.2 Test for normality Test for normality

An assessment of the normality of data is a prerequisite for many statistical tests because normal data is an underlying assumption in parametric testing. To test the normality of data, Kolmogorov-Smirnova and Shapiro-Wilk tests of normality were used and conducted on SPSS version 22. According to Field (2009), when the test is non-significant ($p > 0.05$) it shows that the distribution of the sample is not significantly different from a normal distribution. Accordingly, the result of test showed in table 1. below that all variables were found to be normal and the presence of normality was accepted at $p > 0.05$.

Table 1: Test for normality of variable

Variables	Kolmogorov-Smirnov ^a			Shapiro-Wilk		
	Statistic	df	sig	Statistic	df	Sig
Finance Lease	.304	98	.354*	.933	98	.112
Financial Performance	.204	98	.203*	.932	98	.453

a. Lilliefors Significance Correction
 Source: 2016 SPSS data analysis

*. This is a lower bound of the true significance.

4.3 Assessment of Multicollinearity

Multicollinearity exists when there are strong correlations among the predictors and the existence of r value greater than 0.800, tolerance value below 0.100 and Variance Inflation Factor greater than 10 in the correlation matrix are the causes for the

Multicollinearity existence (Field, 2009). Tolerance is a statistic used to indicate the variability of the specified independent variable that is not explained by the other independent variables in the model.

Table 2: Showing Collinearity Statistics

Variables	Tolerance	Variance Inflation Factor
Financial Leases	0.695	1.789
Financial Performance	0.946	1.319

Source: Data analysis, 2016 SPSS

From the Collinearity table 2 above, the tolerance levels for all variables are greater than 0.100 and the Variance Inflation factor values are less than 10, and also the correlation matrix of all the variables have the paired values among the predictors being less than 0.800, from Pearson Correlations Matrix this indicates that there were no Multicollinearity problems that would have altered the analysis of the findings, they rather led to the acceptance of r value, tolerance and Variance Inflation factor values.

4.4 Correlation between the independent variables and also with the dependent variable.

The results show the acceptable reliability of the research variables, with the correlation among predictors not being high, indicating there were no Multicollinearity problems among variables. As of the relationship between the dependent variable, Financial Performance, and the independent variables; Financial Lease, findings are significant. The study also established that there were strong correlations between the dependent variable, Financial Performance and independent variable: - Financial Lease ($r = 0.239$), with ($P < 0.01$) level of significant, shows a strong support for the research question. The correlation analysis was utilized to reject or accept research questions.

4.5 Regression Results for Financial Performance

The regression result explored the necessary indicators of Financial Performance by using the variables identified in the model. As shown in table 3 below, the appropriate indicators of the variable used to identify the Financial Performance were explored. That is, the value of R squared used to identify how much of the variance in the dependent variable Financial Performance was identified by the model. The larger the value of R squared, the better the model. The overall contribution of independent variable; Financial Lease, accounted for 59% ($R^2 = 0.5896$) of the variation in Financial Performance, the rest 41% were other variables not included in this study.

Table 3. Regression result for Financial Performance

R = 0.7679 $R^2 = 0.5896$ Adj. $R^2 = 0.5287$ Std. Error of the Estimate = 2.8455							
d = 2.0155 F = 12.7154 P = 0.0000							
Variables	Unstandardized Coefficients		Standardized Coefficients			Collinearity Statistics	
	B	Std. Error	Beta	t-value	Sign.	Tolerance	VIF
Constant	32.786	9.337		8.364	0.000		
Financial Lease	1.248	0.490	0.579	4.186	0.367	0.695	1.789

$P < 0.01$, 95% level of Confidence, N = 98 Source: Data analysis, 2016 SPSS

From the table 3 above, the summary shows the significance of the model by the value of F-statistic ($P = .000$) and $F = 12.7154$ which implies that there was a strong relationship between the predictors and the outcomes of the regression variables and, are at best, fit the model to predict Financial Performance. The beta (β) sign also shows the positive (+ve) negative (-ve) effect of the independent variables coefficient over the dependent variable. In table 3 above, beta sign of all the independent variables shows the positive effect of predicting the dependent variable. That means, any increase in the independent variables leads to increase in the dependent variable, Financial Performance.

Therefore, based on the coefficients of the dependent variable (β sign) all the questions proposed by the researcher are acceptable because they all stated that the positive relationship with the dependent variable is met. But based on the statistical significance of the independent variable over the dependent variable at 0.05 level of significance, all the four independent variables significantly contributed to Financial Performance at ($P > 0.01$) level of confidence. Thus, this implies that; Financial Lease is the most important determinant of Financial Performance in which the county should give more emphasis for greater financial performance.

4.6 Relationship between variables

A regression equation was used in stats to find out what relationship, if any, exists between sets of data (independent variables and the dependent variable). Regression is useful as it allows you to make predictions about data.

Inferential statistics was carried out using regression model to establish the effect of finance lease on financial performance. The regression model established how and to what extent the independent variables explained the dependent variable. The study regressed financial performance (Y) and the predictor (independent variable) finance lease and the results are as shown in table 5 below.

Table 5. ANOVA

Model	Sum of Squares	DF	Mean Square	F	Sig.
Regression	514.098	4	104.777	12.7154	.0000 ^b
1 Residual	278.960	94	5.5 84		
Total	793.058	98			

a. Dependent Variable: Financial Performance

b. Predictors: (Constant), Financial Lease

From the table 5 above, the significance value is 0.0000 which is less than 0.05, hence the model was considered statistically significant in predicting how the independent variables predict the dependent variable. The regression effect is statistically significant indicating that the prediction of the dependent variable is accomplished better than if done through chance. The F calculated ($F = 12.7154$) which is greater than 5% level of significance showing that the overall model was significant.

Table 6. Regression coefficients

Variables	Unstandardized coefficients		Std. Coefficients	T	Sig.	Correlations			Collinearity	
	B	Std. Error	Beta			Zero Order	Partial	Part	Tolerance	VIF
Constant	32.786	9.337		8.364	0.000					
Finance Lease	1.248	0.490	0.579	4.186	0.367	0.626	0.495	0.217	0.637	2.328

From table 6 above, Financial Lease explained 12.48%, of Financial Performance within various department of Trans Nzoia County. Therefore the regression equation was formulated as: $Y = 12.48 X_1 + \mu$

This meant that a unit increase in the value of the Financial Lease would lead to 1.248 increase in Financial Performance level within the various department of Trans Nzoia County. The possible value of Y when all independent variables are equal to zero would be 32.786

5.DISCUSSIONS OF THE SPECIFIC RESEARCH QUESTION

5.1 Effect of finance lease on financial performance of the County government of Trans Nzoia.

From the results of analysis, Finance Lease plays a vital role to meet up the financial needs of the county government. 59.2% of the respondents agreed with this while 40.80% strongly agreed. This was also confirmed by the regression analysis with the $F = 12.7154$ showing a strong relationship between Financial Performance and Financial lease. The Finance lease, also called capital lease is a long term lease running into several years. It has appositve effect on financial performance since it has low rates.

6. CONCLUSION

The study concluded that among other factors that might have an effect on institution financial performance major focus should be paid on finance lease, so as county governments as well as other organizations or institutions can have greater financial performance. On the basis of the afore-mentioned findings, the following deductions are expedient: The correlation and linear regression analysis employed for testing the two hypotheses revealed that; leasing option has a significant effect on the financial performance of the County Government of Trans Nzoia, and that there is a positive and significant relationship between finance lease and financial performance.

7. RECOMMENDATIONS

The recommendations for this study include: firstly, that leasing companies should improve on their rates by reducing rents on leasable equipment so that organisations, whether county governments or SME's can benefit more from this form of finance option, secondly leasing organizations should endeavour to understand the real requirements and scope of work of various organisations so that they can provide real lease solutions that suit the corporate needs of the organizations. Leasing companies should sensitise organisations on the actual benefits of leasing so that the option can be explored by many who need it for their expansion.

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