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## **The Relationship Between Operating & Finance Lease Options and the Performance of Manufacturing Companies In Nigeria**

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### **Abstract**

The paper investigated the impact of operating and finance lease on the performance of manufacturing companies in Nigeria. Two research hypotheses were formulated to guide this study. The hypotheses investigated the relationship between operating lease option and the performance of manufacturing companies and the relationship between finance lease option and the performance of manufacturing companies in Nigeria. Ex-post facto research design was adopted for this study. A sample of 66 manufacturing companies listed on Nigerian stock exchange was selected and used for the study. A well validated structured questionnaire was used to collect data for the study. Data collected were analysed using Pearson product moment correlation coefficient statistical technique. Findings revealed that, there exist a significant relationship between finance lease option and the performance of manufacturing companies in terms of savings of capital, reduction of risk of obsolescence and maintenance of liquidity. Also, there exist a significant relationship between operating lease option and the performance of manufacturing companies in terms of savings of capital, reduction of risk of obsolescence and maintenance of liquidity. The study recommended that government and policy makers should improve the capital allowance to the lessor in such a way that the lessee could benefit in terms of low rent to be paid on leased equipment. Therefore their return on equity would be higher.

**Key words:** finance leases, operating leases, reduction of risk, risk of obsolescence

### **1. Introduction**

Investment is the stepping stone to industrialization and wealth accumulation of any nation. Thus, wealth accumulation refers to real investment as well as financial investments which contribute to the accumulation of capital. This implies an increment of the volume of income and productivity level due to the increase of production and acquisition of capital goods. Investment thus, takes into consideration new plant and equipment, construction of public works like dams, roads building, etc. (Jhingan, 2004:276). But this requires tremendous financial fund which can be acquired through equity, debt, leasing and other financing options. Therefore, a substantial level of dexterity and rational financial analysis are expected from financial directors and managers whose responsibilities are to maximize shareholders' wealth by minimizing the cost of production and maintain a sufficient level of liquidity to the firm or organization. According to Mbat (2001:8), one of the functions of the financial manager is the management of a firm's cash position to guarantee liquidity. This could be achieved through leasing in the sense that the lessee has the privilege to keep its cash and at the same time secure the possibility of getting additional funds from banks loan. Considering the fact that competitiveness and aspiration to the leading position are key words for the existence of firms, it follows that good financial strategies must be evolved in order to enable them achieve their set goals and objectives. In this regard, leasing thus becomes an important financing strategy for the success of businesses in modern times.

This is more so considering the fact that the volume of equipments and machineries needed by some firms are quite expensive and they could be leased instead of being bought in order to have enough capital for their operations (Akinbola and Otokiti, 2012).

Pandey (2010) defines leasing as an agreement binding two parties, the lessor and the lessee. The later is the user of the asset while the first is the owner. Under the contract, the owner gives the right to use the asset to the user, over an agreed period of time, for a consideration called the lease rental. The lessee pays the rental to the lessor as regular fixed payments, over a period of time.

Over the last ten years, leasing gained ground and became the safer way to have access to finance and it has contributed successfully to the promotion of micro entrepreneurship in countries like Indonesia, Pakistan, India, Ghana and Senegal (Opara, 2011:1).

As far as leasing is concerned in Nigeria, the Equipment Leasing Association of Nigeria (ELAN) was established in 1983, primarily to promote the leasing business. This association today is the sole authority on leasing in Nigeria and has equally earned considerable recognition from the global leasing industry, through its quantitative lease training and advisory programmes. According to ELAN (2012), the mechanism of the improvement of the leasing activity in Nigeria kicked off in 1960s. Since then, its contribution to the growth of the economy has been noticeable.

In recent years, some challenges have emerged in the operating perspective of leasing (ELAN, 2012). Nevertheless, the promoters of leasing decided not to relish effort in their laudable mission to take the Nigerian economy to the upper level. The leasing industry has witnessed a remarkable growth. According to Nwachukwu (2012), Managing Director, Leasing Company of Nigeria Limited (LECON), the rapid growth emanated particularly from the transformation of some core issues in the economy. We can mention here the improvement of economic precepts that incited firms and individuals to build their asset column relying on lease. However, it is crucial for the leasing industry to be improved and thereby take advantage of the considerable capital asset demand in the country. Total commitment and devotion will be needed from all parties to ensure a smooth practice of leasing.

Lease financing practices in Nigeria is governed by common law and certain tit bits of provisions. As a result, foreign lessors are shying away from Nigeria as they consider the country a risky investment climate. The ongoing privatization program of the government is a good opportunity to re-evaluate the leasing industry with a constructive mind. Unfortunately, regulatory and operational challenges are frustrating the growth of this promising financial sector (Madueke, 2012).

## **1.1 Statement of the hypotheses**

- i. There is no significant relationship between operating lease option and the performance of manufacturing companies in terms of saving of capital, reduction of risk of obsolescence, maintenance of liquidity and their profitability
- ii. There is no significant relationship between finance lease option and the performance of manufacturing companies in terms of saving of capital, reduction of risk of obsolescence, maintenance of liquidity and their profitability

## **2. Literature Review and Theoretical Framework**

### **2.1 The concept of leasing**

There are numerous definitions attached to the concept of leasing. Nonetheless, the totality of those definitions recognize the fact that the concept revolves around an asset which brings two parties into agreement(a contract) with one giving out the asset and the other party taking possession of it on rental basis. Wilkinson (2007) defines leasing as the way through which equipments are rented out for a determined duration. Leasing is an alternative means through which a firm secures the economic utilization of equipment for a stated duration.

Leasing is defined by Baker and Hayes (1946) as a mean to finance the acquisition of property. Leasing therefore can be seen as a way of acquiring asset through a documented agreement between the lessor (owner) and the lessee (the user). ELAN (2012) defines leasing as, “a contract between lessor (e.g. a Financial House) and a lessee (a Company) giving to lessee the possession and use of specific assets on payment of rentals over a given period. The lessor retains the ownership of the assets so that it never becomes the property of the lessee or any related third party during the tenure of the lease”.

According to the equipment Leasing Association of Great Britain lease concept is described as “a contract between lessor and lessee for the hire of a specific asset selected from a manufacturer or vendor of such asset by the lessee. The lessor retains ownership use of the asset. The lessee has possession and use of the asset on payment of specified rental over a period”. Lease financing can be categorized into different forms. The categorization depends upon the signed agreement by party involved. Notwithstanding this, the lessee in all cases makes a series of payment even though payment is usually due immediately after the contract is signed. In the event of breach of contract that can lead to contract termination, the lease equipment becomes the property of the lessor. However, lease arrangement gives an option to the lessee of either to purchase the equipment, or to undertake a new lease. This lease arrangement involves financial institutions on one hand, while on the other hand, it involves manufacturing, service, agricultural and oil & gas industries. Generally speaking therefore, lease financing techniques and terms of contract differ depending on the lessor, the equipment leased, the length of the lease and the prevailing interest rate. It is important for managers after evaluating and selecting lease financing as a preferred technique to ensure that the feasibility of the equipment must be determined and this should be proceeded with further analysis on the following:

- i. Feasibility under the lessee’s corporate indenture and other credit documents.
- ii. Feasibility of the asset itself, which should have a market value and should not qualify as a bondable property, which can be used as a basic for future bond issue.

Broadly speaking, there exist two categories of lease financing, namely: Finance lease and Operating Lease. This broad classification is important because it has implications on the accounting treatment, tax treatment, legal rights and obligations and the transfer of risk of obsolescence. Other variants may fall under any of these two categories.

### 2.1.1 The concept of financial Lease

Van Horne (1983:478) defines a finance lease as “...a non cancellable, usually multi-years contact in which the lease agrees to make a series of payment to a lessor for the use of an asset. The lessee acquires most of the economic values associated with outright ownership of the asset even though the lessor retains title to it”.

Osaze (1983:11) defines it as “a lease contract in which the lessee is obligated to pay agreed rentals periodically to the lessor over the tenor of the lease in return for possession and use of the asset under a lease”.

In finance lease, the lessee is usually expected to be responsible for maintenance and servicing of the asset leased and may have the opportunity of either buying the asset at the expiration of the initial duration allocated or returning the asset to the lessor or extending the lease for a secondary duration beyond initial (primary) tenure. Ownership and title to the leased asset is retained/ vested on the lessor, but all risks associated with the benefits accruing from the possession of the asset are substantially shifted to the lessee during the tenure of the lease. Johnson and Gentry (1974: 208-209) brought more clarification by identifying the characteristics of finance lease as follow:

- i. There is no formal transfer of title when the risks and benefits of the ownership of the leased asset are passed to the lessee. The lessee pays for ownership expenses of the leased property such as insurance, taxes and maintenance.
- ii. The lease is non-cancellable (unless some remote contingency forces the cancellation). It is fixed obligation to the lessee.
- iii. The total payments of the rental will allow the lessor to have a full recovery of his investment plus a fair return on the investment. Therefore finance lease is fully amortized and of long-term.

The lessee could acquire the property at a lower price or extend the lease at a fair rental if the asset is not completely amortized. The American Financial Accounting Standard Board (1976) identified the following features and characteristics as relating to finance lease:

- i. The lessee becomes the owner of the asset when the lease period expires.
- ii. There is provision for the purchase of the property at a cheap rate.
- iii. The duration of the lease equates at least 75 percent of the estimated economic usefulness of the property.
- iv. At least 90 percent of the fair value of the leased property is recovered by the lessor when the lease duration expires. This is more of a capital lease.

Hence, under this kind of lease agreement, the benefits and risks accruable from ownership are transferred substantially to the user throughout the tenor of the lease whereas the owner still keeps the right on the asset. It also means that the lessee is to take an undertaking to keep the equipment in good functioning condition, to keep it insured to its full replacement value and allow the lessor access for inspection. One of a financial lessor's principal concerns is the protection of its investment in the event of a lease default or an equipment casualty. Toward this end, finance leases usually include the provisions to make the lessor whole if any of these events occur (Contino, 2002:10). Rentals during this period are fixed such that the lessor recoups the total cost of his investment with the capital cost of the equipment, financing cost and all overheads. It is estimated that over 90% of the entire lease arrangements in Nigeria are finance leases with mostly commercial banks and merchant banks as major lessor

### **2.1.2 The concept of operating lease**

This is also known as a service lease. Osaze (1983:12) defines an operating lease as "... a contract under which the asset is not wholly amortized during the primary lease and the lessor does not necessarily depend on the rental during the period for his returns but looks to the recovery of the balance of his cost and profits from resale of the used asset at the expiration of the lease period." This implies that the lessors in the operating lease simply purchase an asset and lease it out at any rate and term which does not entirely cover both cost, interest and profit. It also implies that the asset may be leased to a number of different lessees in sequence and thus the lease period does not cover substantially the economic usefulness of the leased property. When the expiration of the first lease period reaches, the asset can be leased to the same or another lessee at a new rental.

The cancellable nature of an operating lease according to Weston and Brigham (1984:348) "... is beneficial factor for lessees. They argue that the implication of this clause is that the lessee can return the equipment if technological developments render it obsolete or if they no longer need it". In this line of analysis, Cantino (2002) referring to operating lease, posits that their short lease terms and easy cancellation provisions make operating leases attractive to users in several situations. One example is when the user anticipates using the equipment for a short time, such as with certain types of railcars or aircraft. Another is when the user wants the ability to change equipment if something better comes out. For this reason, users often lease computer equipment under operating leases because of constant technological improvements.

## **2.2 Empirical literature**

A lot of researchers have contributed to the enrichment of the literature on lease financing in general, but there are limited numbers of empirical research on the practice of lease financing in relation with the performance of companies. The most recent work in this perspective is that of Salam (2013) who carried out a research of this nature in Bangladesh. His research investigated on the link between lease finance and the Return on Equity (ROE)/Return on Assets (ROA) of organizations. The findings showed a positive correlation between lease finance and Return on Equity/Return on Assets (ROA) through simple regression statistics. A similar research was conducted a year before by Akinbola and Otokiti (2012) who established the relationship between the lease option and the profitability of Small and Medium Enterprises (SMEs) in Lagos state, Nigeria. Their study discovered that so far, the lease option has affected in a positive manner the gain of the SME's in Nigeria; also that lease option has a significant relationship with organizational output of the companies.

Still in the same line of reasoning, Anyalechi (2004) has carried out a research on the analysis of the impact of lease financing on corporate business performance in Nigeria using profit as a function of the volume of leased asset, equity debt and retained earnings. The study established that lease financing has been contributing to better performance (measured with return on assets/profitability) in Nigeria. Contrary to this approach of analysis, lease financing practice presents some defects which have to be considered.

Oko and Etuk (2013) through their work have examined and brought out the various risk situations in the Nigerian lease market relying on the study of selected quoted firms using questionnaire, profitability and risk evaluation indices of firms; with the aid of the correlation coefficient statistical tool for data analysis. The results revealed that lessors and lessees could be exposed to some risks such as fraud, taxation, title and funding. Still in this perspective, Chibuike (2001) painted the prospects and defects of equipment lease finance, which is one of the areas we are going to insist upon in this work. Another interesting work portraying the impact of lease financing is that of Henderson, Beattie, and Goodaere (2003). But contrary to the preceding researchers they introduced the concept of lease capitalisation in their work. Their findings revealed that capitalisation had a significant impact on six out of the nine selected ratios. However, In the course of this work, the researcher will contribute to the literature of this field of studies by investigating on the practice of lease financing in Nigeria in terms of benefits to the lessees. In fact, so far there is no empirical study investigating on lease financing practice and some variables such as: savings, liquidity, risk of obsolescence and the adequacy of the lease financing option. This work has focused on this gap in knowledge.

## **2.3 Theoretical framework**

### **2.3.1 The capital structure theory**

This theory was initiated by Modigliani and Miller (1958). The result of their work stipulates that the value of the firm is not affected by the pattern of the capital structure (equity or debt) opted for. Subsequently, the consideration of financial distress and agency cost in firm valuation by Jensen and Meckling (1976) brought a significant change on the exclusive debt financing approach of previous work (Hueng-Ming and Yildiray, 2006).

This theory is justified by the rational of lease financing option compare to debt financing option. In the same line of reasoning, Myers, Dill and Bautista (1976) considering the Modigliani and Miller perception, investigate the firm's lease versus debt financing decision. Their work reveals that, the tax differential between lessee and lessor triggers the consideration of lease. Few years ago a lot of researches have been carried out on leasing, and the majority were covering the issue of fiscal incentives for leasing. Additionally, eight reasons for leasing besides fiscal motivation were presented by Smith and Wakeman (1985). Further, some non fiscal factors such as financial distress, government regulation and firm size that influence a firm's decision to lease instead of debt financing were introduced by Graham, Lemmon and Schallheim (1998). This research falls in the same line of argument as it strives to ascertain other benefits of lease financing. Considering the fact that a rational allocation of capital is the most important finance function in the modern times, and considering also the difficulties faced by firms and organizations (lessees) to have access to fund for capital financing, a smart decision must be taken. Over the past few years these situations seemed to have found solution through the lease financing, considered as an optimal alternative to debt financing as a source of investment fund. These decisions in most cases involve expansion, acquisition, modernization and replacement of long- term assets. Therefore the aim of a firm should be to maximize of its value. The capital structure or financial leverage should be examined from the point of its impact on the value of a firm. Hence, a comparative analysis of shortcomings and advantages of debt can turn capital structure into a useful decision (Pandey, 2010: 342). This is more so in the context of this work, considering some benefits offered by the leasing option such as the tax benefits (relatively low rent offered by the lessor to the lessee sequel to the ownership tax benefits), avoidance of certain borrowing problems (less stringent financial requirements than traditional lenders), elimination of off balance sheet benefit (avoid burdening lessee's balance sheet with long term debt liabilities), etc.

## **3. Methodology**

Ex-post facto research design was adopted for this research. According to Kerlinger (1973), Ex-post facto is a step by step empirical enquiry in which the scientist does not have direct control of independent variables because they are inherently not subjected to manipulability.

In effect, there was no manipulation of the independent variables used in this work. At the time of study variables such as saving of capital, reduction in the risk of obsolescence, maintenance of liquidity, profitability and adequacy of lease option were already in existence.

The population of this research work was made up of all manufacturing companies quoted on the Nigerian stock market. Information from the Nigerian stock market revealed that there exist a total of 66 manufacturing companies that are listed on the Nigerian stock market. The required sample of the study was obtained through the use of simple random sampling technique. Foremost the names of each firm were written on separate sheets of papers. Draws were then randomly made 57 times and the names of the selected companies were then used for the study.

The main instrument used for this study was a structured questionnaire titled Lease Financing Practice Questionnaire. The questionnaire was a 30 items questionnaire designed by the researcher and aimed at gathering information from the respondents on the variables of study. Three sections (A, B and C) were constituted to make-up the questionnaire.

Section A contained items seeking information on the demographic characteristics of respondents such as, age, sex, working experience, position held in the firm. Section B was meant to elicit information on lease financing practices of operating lease, finance lease and combination lease while section C was meant to elicit information on the performance of lease finance practices in terms of savings of capital, reduction of risk of obsolescence, maintenance of liquidity and profitability. Items in section on section B and C were designed on 4-points Likert scale type taking “SA” for strongly agree, “A” for agree, “D” for disagree and “SD” for strongly disagree respectively. The items here were positively and negatively worded. The respondents were required to tick one of the four possible options against each item, to mention out the extent of their agreement or disagreement with the items.

The method of data analysis adopted in this work is based on each of the study hypothesis. Each of the hypotheses was restated and the variables in each of the hypothesis singled out. Appropriate statistical technique for testing is here under presented. All the hypotheses were tested at 0.05 level of significance using Pearson product moment correlation coefficient.

#### 4. Data Analysis and Discussion of Findings

##### 4.1. Test of hypotheses

###### Hypothesis One

There is no significant relationship between operating lease option and the performance of manufacturing companies in terms of saving of capital, reduction of risk of obsolescence, maintenance of liquidity and their profitability. Pearson product moment correlation coefficient statistical technique was used to test this hypothesis. The result is presented in Table 1

TABLE 1: Pearson’s product moment correlation analysis of the relationship between operating lease option and the performance of manufacturing companies in terms of saving of capital, reduction of risk of obsolescence, maintenance of liquidity and their profitability (n=50).

Variables	$\Sigma X$	$\Sigma X^2$	$\Sigma Y$	$\Sigma Y^2$	$\Sigma XY$	$r_{xy}$
operating lease (X)	961	19207				
Savings of capital (Y <sub>1</sub> )			827	14257	16396	0.76*
Reduction of risk of obsolescence (Y <sub>2</sub> )			669	9315	13108	0.48*
Maintenance of liquidity (Y <sub>3</sub> )			704	10364	13697	0.28*
Profitability (Y <sub>4</sub> )			639	8469	12473	0.40*

\* p < 0.05, df = 48, critical r =0.195

The result in Table 1 revealed that the calculated r-value of 0.76 for savings of capital, 0.48 for reduction of risk of obsolescence, 0.28 for maintenance of liquidity and 0.40 for profitability was found to be greater than the critical r-value of 0.195 needed for significance at 0.05 level of significance with 48 degrees of freedom. With this result, the null hypothesis is rejected, it therefore implied that there existed a significant relationship between operating lease option and the performance of manufacturing company in terms of savings of capital, reduction of risk of obsolescence, maintenance of liquidity and profitability.

#### 4.1.2 Hypothesis two

There is no significant relationship between finance lease and the performance of manufacturing companies in terms of saving of capital, reduction of risk of obsolescence, maintenance of liquidity and their profitability. Pearson product moment correlation coefficient statistical technique was used to test this hypothesis. The result is presented in Table 2

Table 2: Pearson's product moment correlation analysis of the relationship between finance lease option and the performance of manufacturing companies in terms of saving of capital, reduction of risk of obsolescence, maintenance of liquidity and their profitability (n=50).

Variables	$\Sigma X$	$\Sigma X^2$	$\Sigma Y$	$\Sigma Y^2$	$\Sigma XY$	$r_{xy}$
Finance lease (X)	936	18324				
Savings of capital (Y <sub>1</sub> )	827	14257	15979			0.73*
Reduction of risk of obsolescence (Y <sub>2</sub> )	669	9315	9315			0.44*
Maintenance of liquidity (Y <sub>3</sub> )	704	10364	13342			0.27*
Profitability (Y <sub>4</sub> )	766	12304	14669			0.49*

\*  $p < 0.05$ ,  $df = 48$ , critical  $r = 0.195$

The result in Table 2 revealed that the calculated r-value of 0.73 for savings of capital, 0.44 for reduction of risk of obsolescence, 0.27 for maintenance of liquidity and 0.49 for profitability was found to be greater than the critical r-value of 0.195 needed for significance at 0.05 level of significance with 48 degrees of freedom. With this result, the null hypothesis is rejected, it therefore implied that there existed a significant relationship between finance lease option and the performance of manufacturing company in terms of saving of capital, reduction of risk of obsolescence, maintenance of liquidity and profitability.

#### 4.2 Discussion of findings

The result of hypothesis one of this study revealed that there is a significant relationship between the use of operating lease option and the performance of manufacturing companies in terms of saving of capital, reduction of risk of obsolescence, maintenance of liquidity and profitability of the firms. This finding is in agreement with the result obtained by Graham, Lemmon and Schallheim (1998) who in their study discovered that there existed a significant relationship between utilization of operating lease option and the performance of the firm. The authors noted that the liquidity position of firms is well adjusted when operating lease option is used. The finding of this study is also in line with the finding obtained by Araga (1999) who recommended that operating lease option should be used by manufacturing firms as this will help them shield against the risk of obsolescence.

The findings of research hypothesis two of this study revealed that there existed a significant relationship between the use of finance lease option and the performance of the firms. This finding is in agreement with the finding obtained by Lasfer and Levis (1996) who discovered that there existed a significant relationship between finance lease option and the performance of the firm.

The author also noted that finance lease option greatly assist in the saving of capital by the lessee as there is not down payment required from the lessee initially and also, ownership of asset is usually transferred to the lessee. This finding is also in line with the finding obtained by Akinbola and Otokiti (2012) who found in their study that finance lease option greatly assist the companies in saving of capital and maintenance of liquidity of the firm.

## 5. Conclusion and Recommendations

### 5.1 Conclusion

This research work, which focuses on lease financing and the performance of selected manufacturing companies in Nigeria has led to some substantive results which have shown that; operating lease has greatly assisted manufacturing companies to save capital, to shield companies from the risk of obsolescence, grant them high level of flexibility and also give them room for maintenance of good liquidity position. This study also lead us to the conclusion that finance lease also known as capital lease is the most adequate lease financing option to Nigerian manufacturing firms. This is so because finance lease option gives room to take advantage of benefits of the operating lease by subscribing to updated lease option in the contract. Also, this is the only option that enable the lessee to acquire heavy and expensive equipments that can in the long run becomes a property of the lessee. In fact, in a finance lease option the lessee can acquire the equipment at the end of the lease contract at a very low price. This therefore makes finance lease option the best capital acquisition option. Lastly, combination lease option which is a kind of mixture of finance and operating lease affect significantly the performance of the manufacturing firms in Nigeria. However, this option is not highly used in Nigeria due to the fact that the majority of lessor are commercial banks who are not highly specialized in lease financing to offer in a proper way this kind of service.

### 5.2 Recommendations

In line with the findings and conclusions of the study, the following recommendations are proffered as a pointer to a brighter and better future of the effects of lease financing on the performance of manufacturing companies and organizations in Nigeria.

- 1.The government and policy makers should improve the capital allowance to the lessor such a way that the lessee could benefit in terms of low rent to be paid on leased equipment. Therefore their return on equity would be higher.
- 2.The government should encourage lessors (manufacturers of equipments) to establish in Nigeria. This action will save the cost of importing equipments which could be translated by lower rent cost to the lessee.
- 3.Based on our findings, the majority of respondents (79%) opined that the debt ratio is lower for lease financing than debt financing. Therefore managers should give great considerations to lease financing as a financing option, which could give them a better position to secure another line of credit.
- 4.Finance lease option, which was revealed as the most adequate lease financing option is highly recommended to manufacturing companies because it is the only option that can enable companies to definitely acquire equipment at a very low price by the end of the lease contract. It is also the only option that can reveal the real value of the firms to the shareholders.

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