



Lease Financing and Profitability: Evidence from Nigerian Quoted Conglomerates

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ABSTRACT

The paper examined the causal relationship between lease financing and profitability of Nigerian quoted conglomerates for the period spanning 2012-2017. The study focused on 6 conglomerates that are quoted on the Nigerian Stock Exchange as at 2017. Data were collated from published accounts of the affected companies. Data were analysed using descriptive and pooled ordinary least square multiple regression statistics. Unit root test was conducted using Augmented Dickey–Fuller. Estimated panel results indicated a negative and insignificant impact of fixed assets turnover on return on assets (ROA), lease financing (LFN) had a positive and insignificant impact on ROA, and long-term debt ratio had a negative and insignificant impact on ROA. Firm size was used to control possible problem of non-linearity and heteroscedasticity. Based on these findings, leasing option was recommended as one of the sources of debt financing to boost the capital of Nigerian conglomerates to enable them to absorb losses, multiply fixed assets and grow continuously, thus providing employment and income in terms of tax revenue, profits, dividends, and wages and salaries to households for national growth and development.

Keywords: Lease Financing, Profitability, Quoted Conglomerates

JEL Classifications: G3, G32

1. INTRODUCTION

Government's macroeconomic objectives of increased gross domestic product, price stability, exchange rate stability and employment for the citizenry cannot be achieved in a vacuum. The productive capacity of the private sector must be utilized for maximum results. Accelerating the growth potential of the private sector and achieving sustainable economic growth and development is important. Abor (2008) pointed out that corporate sector growth is vital to economic growth and development. Therefore, it is imperative for firms in developing countries to fund their activities and provide employment as well as income in terms of profits, dividends and wages/salaries to different economic units such as households, individuals and governments. Conglomerates have a gargantuan capacity to limit excessive competition, diversify business risks and overcome stagnant

growth and profitability. In some countries, governments often provide financial assistance to micro, small and medium scale enterprises as well as startups to enable them to kick-start and sustain their operations and overcome teething problems. Such assistance may take pre-eminence during economic recession which is often characterized by low level of disposable income, falling gross domestic product; massive business failure and job loss (Atseye et al., 2014).

Financing decisions are one of the most contentious areas in finance. Such decisions are taken based on the level of development of individual domestic financial markets. According to Amjed (2010) financial markets are almost perfect in developed countries. Instruments of financing are well-structured and sophisticated. The parameters for making financing decisions are mainly the costs and benefits of a particular source of financing in these

countries. Whereas in developing countries, financial markets have inadequate capacity to meet the financial needs of the corporate sector. Non-conventional securities particularly debt securities are not warmly welcomed by the markets. Therefore, firms rely on commercial bank loans and lease financing as sources of debt financing (Amjed, 2010 and Atseye et al., 2014). The decision to use debt and equity to finance firm's activities is known as capital structure decision. On the other hand, the decision to use both long-term and short-term debts and equity in financing a firm's activity is financial structure decision. The mix of debt and equity must be specific in terms of short-term debt or long-term debts, commercial banks loans or lease finance. According to William (1991), the use of debt and equity can be compared with respect to the characteristics of control and property rights. The debt instrument carries fixed rules and conventions that usually monitor the lending process. The repayment schedule of the principal loan amount and the interest payment as in the case of commercial bank loan are stipulated in the contract with debt holders having primary claims over the firm's cash flow from the assets. In a lease contract, interest as well as some element of principal is paid in form of periodic rent. The firm is often required to meet liquidity test by ensuring that the lender's investment is not in jeopardy. Equity owners on the other hand, have a residual claimant status over the cash flows from assets, earnings and liquidation (William, 1991). Thus, debt increases creditor's claims and equity increases ownership claim over the assets.

The Statement of Accounting Standard (SAS II), 1991 defined lease as a contractual agreement between an owner (lessor) and the other party (the lessee) which conveys to the lessee the right to use the leased asset for a consideration usually periodic payments called rents. Periodic rents accrued to the lessor as stream of income, while the lessee incurs the rents as expenses or debt obligations. Leasing is an alternative means of financing plant, equipment and property, and a contract between an owner of equipment and another party to whom the asset is to be given possession and use in turn for payment of specific rentals over an agreed period (Bello, 2016). The lessee may or may not be entitled to acquire title to the goods through the exercise of an option to purchase, usually at the end of the lease term. The lessor is required to finance the acquisition of equipment required by the lessee who would have selected the goods and dealt directly with supplier in determining their performance attributes and suitability (Salem, 2013). A common decision faced by firms is whether to buy an asset by issuing debt to finance the purchase or simply lease the asset. These alternative financing have attracted a lot of studies and empirical models. In a lease framework, the debate become enshrined in the phrase, lease or borrow, and lease or buy the fixed tangible assets (Bello et al., 2016). The inclusion of debt in a firm's capital to enhance its profitability is a subject intense debate. There are two schools of thought in this controversy. The conflict revolves around appropriate mix of debt and equity that guarantees profitability of the firm. The first school of thought called the traditional theory holds that judicious use of debt and equity can maximize the value of the firm. The second school of thought led by Modigliani and Miller (1958) contends that financing decision does not determine the profitability of the firm because the value of the firm is contingent upon the underlying

profitability and investment risk. That is under the perfect capital market assumption of no bankruptcy cost and frictionless capital markets; if no tax, the firm's value is independent of the financing decision. In the light of the foregoing, the paper attempted to investigate the appropriate combination lease as debt finance and equity to support the profitability drive of Nigerian quoted conglomerates.

1.1. Objectives of the Paper

The specific objectives were to:

- a. Examine the impact of fixed assets turnover (FAT) on profitability of Nigerian quoted conglomerates
- b. Examine the impact of capital structure (long-term debt ratio) on profitability of Nigerian quoted conglomerates
- c. Examine the impact of lease financing on profitability of Nigerian quoted conglomerates.

1.2. Research Hypotheses

- i. Ho: FAT does not have a positive and significant impact on profitability of Nigerian quoted conglomerates
- ii. Ho: Long-term debt ratio (capital structure) does not have a positive and significant profitability of Nigerian quoted conglomerates
- iii. Ho: Lease financing does not have a positive and significant impact on profitability of Nigerian quoted conglomerates.

2. LITERATURE REVIEW

2.1. Theoretical Framework

2.1.1. Traditional theory (1963)

The traditional theory was propounded by Ezra (1963). The theory states that a firm's capital mix of debt and equity increases the value of the firm and reduces the cost of capital. Therefore, the optimum capital structure is the point at which the value of the firm is highest and the cost of capital is at a minimum point. In other words, the theory holds at a given point, debt-equity mix will cause the market value of the firm to rise and the cost of capital to decline. According to this school of thought, optimum capital structure is a relevant argument, the existence of optimum capital structure as a point where cost of capital is minimum and the value of the firm is maximum is a relevant argument (Ezra, 1963). The traditional theory has implications for this current research;

- i. Lease option increases the debt stock of companies with attendant effect on finance cost and the value of the firms. The extent to which lease financing as one of the sources of debt financing affects the profitability of quoted conglomerates is contentious
- ii. Capital structure which can be defined mathematically as the ratio of long-term debts to total assets as a determinant of profitability is a subject of investigation
- iii. At what point will long-term debt be judiciously combined with equity capital to stimulate profitability of conglomerates?

2.1.2. Modigliani and Miller hypothesis (1958)

In a pioneer paper titled, "The cost of capital, corporate finance and theory of investment," Nobel Miller and Modigliani provided the formal proof of their famous MM irrelevant propositions. The Modigliani - Miller theory holds that financing decision of debt

and equity does not affect the value of the firm because the value of the firm depends on the underlying profitability and investment risk of the firm. In other words, under the perfect capital market assumptions of no bankruptcy and frictionless capital market, if no taxes, the firm's value is independent of the capital structure. Thus, it assumes that earnings before interest and tax would not have been related to the use of debt. The MM hypothesis has two propositions:

- i. The market value of the firm is independent of the proportion of debt-equity mix; and
- ii. Shareholders expect more and more returns as debt-equity ratio increases. The basic assumptions of the MM hypothesis are: The MM hypothesis is relevant to this study in the following ways:
 - i. Lease finance is a source of long-term debt, hence a component of capital structure. Therefore, the proposition that the market value of the firm is independent of the capital structure ie the proportion of debt-equity mix is a subject of investigation
 - ii. Leasing decisions are financing decisions which affect fixed assets. This study tested the impact of fixed asset turnover on financial performance of quoted conglomerates in Nigeria.

2.1.3. Trade-off theory (1973)

The theory was developed by Krans and Litzenberger in 1973. The trade-off theory states that the optimal capital structure is a balance between interest tax shield and cost of financial distress. Therefore, the value of the firm is equal to the value of all equity finance plus present value of tax shield or tax deductible interest expenses less present value of cost of financial distress. Trade-off theory holds that a company chooses how much debt finance and how much equity finance to use by balancing the costs and benefits. The theory when applied to this study poses a question of how much debt including lease option should be traded for equity to enhance the profitability of Nigerian quoted conglomerates.

2.2. Empirical Review

Many empirical studies have been conducted in different countries as well as different business environments. For instance, Meziane (2007) studied the financial drivers and implications on real estate assets using a sample of 2343 UK quoted companies. Pooled time series and cross - sectional data were used, results showed that real estate companies that own real assets have higher market value and growth potential than companies that lease their real estate which tend to have slow growth rate. Therefore, leasing encourages growth while purchase of fixed tangible assets eventually results in maturity, hence enhanced market value of companies. These findings are corroborative of Lasfer and Levis (2008) who showed that high growth firms are more likely to lease plant and machinery. Granted that these companies were likely to suffer assets substitution problem, the results implies a reduced agency conflicts. The results also showed that leasing can be relied upon to finance asset growth because high growth companies are less likely to find cheap sources of borrowing to acquire assets. Siam and Qutaishat (2007) examined the effects of financial lease on the financial performance of charter companies in Jordan. The study found a positive effect of cash and reduced risk on profitability of firms in Jordan. In another study by McCue (2007), factors

associated with lease financing in the hospital industry where indentify. These include market, mission, operating and financial factors. Result also indicated that owned hospital management company where likely to spend lease on leasing.

Moreover, Joseph (2009) assessed the relationship between leasing competence and perceived performance of SMEs and also examined the relationship between lease structure and perceived performance of SME in Uganda. The study results indicated significant positive relationship between leasing competence and perceived performance and also lease structure and perceived performance maintained a significant positive relationship. Samaila (2009) Examined the impact of financial lease on financial performance of Conglomerate companies in Nigeria during the period 2005- 2006. The study reported a positive impact of finance lease on financial performance of Conglomerate companies in Nigeria. The study strongly recommended the use of financial lease in operating conglomerate companies. Mohammed et al. (2012) studied the factors influencing profitability of leasing firms in Pakistan, using a sample of 28 companies for the period 2006-2008. Results showed that size, net investment in lease finance and liquidity had a positive relationship with profitability, whereas leverage and age had a negative relationship with profitability. From the stand point of the lessee, debt substitutability has been advanced as the rationale for use of lease financing. In line with this, Eric (2012) studied a sample of French SMEs 11,436 for the period 1999-2005. Results showed that SMEs use leasing more at a young age and leveraged subsequently. Therefore, leasing limits the tendency to borrow from banks. Salem (2013) investigated the casual relationship between firm performance using return on assets (ROA) and ROE with different SMEs on lease finance. The results showed that an increase in the proportion of operating lease leads to an increase in firm performance of leasing companies.

In general therefore, leasing can be said to be an alternative mechanism to facilitate access to finance. It enables the use of capital equipment in particular new/young enterprises without credit track record and with limited possibilities to provide collateral. Empirical results have also shown that leasing exposures are associated with relatively low risk compared to other forms of financing. See for example, Schmit (2005), and De Laurentis and Mattei (2009). The presence of physical collaterals contributes very largely to this reduced risk profile. Erickson and Trevino (2004), study total leasing in the air line industry using pecking order approach. Result that pecking other theory which advocate that a firm should use internal sources of finance before external, is relevant to the study (Schmit, 2005). Furthermore, Orabi (2014) assessed the impact of leasing decision on the financial performance of industrial companies listed on the Amman Stock Exchange in the period 2002-2011. The study revealed that lease financing has statistically significant effect on the liquidity, and profitability of the companies. The study finally concluded that lease financing increases the profitability of companies, but raises the corporate risk of companies accordingly. Jabbarzadeh, et al. (2012) analysed the effect of off-balance sheet financing on profitability. The study showed a significance effect of lease financing as off-balance sheet on profitability. Moreover, Salam (2013) examined the effects of lease finance on the financial performance of SME's located in

Bangladesh. The study established that firms performance depend on lease finance activities, signifying that SMEs in Bangladesh should be consistently involved in their lease finance practices because lease finance has a momentous impact on improving their financial performance. In another study, Aurangzeb and Shujaat (2012) determined whether any relationship exists between financial lease and low profitability. The author researchers found that the relationship of profitability with change in fixed assets due to financial lease are inversely related i.e., when profitability of the companies decreases they tend to move to finance their fixed assets through financial lease and vice versa. Nevertheless, Hassan (2009) examined the impact of finance lease on the profitability of Nigerian banks from the period 2001-2008. The study employed the use of ordinary least square (OLS) regression to analyse the data obtained from annual financial statements of Nigerian banks. The study revealed that finance lease had a significant positive impact on the profitability of Nigerian banks. Moreover, researches on lease financing and liquidity showed a negative relationship in most cases. Damodaran (2009) empirically examined the combination of leases, debt and value of US firms. The study reported a skewed estimate of profitability of leverage and value among US firms For instance, Bello and Almustapha (2016) examined the impact of lease financing on the liquidity of companies in the Nigerian oil and gas. The arguments for effects of leasing on the financial performance of a company have focused mainly on four elements including tax differential, debt substitutability, agency costs and free cash flows.

Duke et al. (2012) studied the effect of the proposed new lease standard by the Financial Accounting Standards Board and the International Accounting Standards Board on existing outstanding operating leases. Specifically, the case examined the effect of the proposal that all firms report existing operating leases as capital leases upon the initial adoption of the proposed standard. By applying a constructive capitalization model to two firms who rely on operating leases for financing, FedEx and UPS, the study found that both companies would have to record billions of dollars of liabilities that had only appeared in the footnotes of their financial statements under the current lease standards. In addition, the firms would experience a decline in retained earnings and key financial ratios, such as the debt-to-equity, return-on-assets, and interest coverage ratios, by reporting operating leases as capital leases under the new proposed standard. Furthermore, the magnitude of the lease capitalization effect is much smaller for UPS than for FedEx. A study by Vasantharao (2012) on capital market frictions, leasing and investment, revealed that firms with high information leased more than those with low agency costs. Also firms with significant tax-loss forwards were unable to take full advantage of tax benefits of asset ownership, hence they leased more. The coefficient on size was positive and size squared was negative indicating that largest firms used less lease financing. The coefficient on Q is positive as higher growth firms leased more. Lease financing is a factor that has been discussed in several studies and also in general literature. There are still lacunas in the knowledge concerning lease financing as one of the sources debt financing and its implications for the firm financial operations.

3. MATERIALS AND METHODS

The paper adopted ex-post facto research design to analyse lease financing and profitability of Nigerian quoted conglomerates during the period 2008-2017. The design is apt for this study because historical data on leasing and profitability of quoted conglomerates have already existed in the annual reports and statement of accounts of the affected companies.

3.1. Model Specification

The popular models in empirical literature are stated as follows:
 $ROA = f$ (leasing index, total asset turnover index, fixed asset turnover, debt ratio, equity ratio, lease expense, size of firm)

$ROE = f$ (liquidity, leverage ratio, interest coverage ratio, firm size, debt/equity ratio, operating lease or finance lease)

These models have been modified into one equation:

$$ROA = f(LFN, TAT, FAT, FSE, LTDR) \tag{1}$$

$$ROA = \beta_0 + \beta_1 LFN + \beta_2 FAT + \beta_3 FSE + \beta_4 LTDR + \epsilon_0 \tag{2}$$

Logging the variables in order to avoid heteroscedasticity thus,

$$\log ROA = b_0 + b_1 \log LFN + b_2 \log FAT + b_3 \log FSE + b_4 \log LTDR + v_t \tag{3}$$

3.1.1. Description of variables

ROA = Return on asset (proxy profitability of quoted conglomerates)

LFN = Proxy for lease financing measured by lease expenses divided by total assets or operating lease finance divided by total asset. FAT = Fixed asset turnover (another proxy for leasing) = Sales divided by net fixed assets

FSE = Firm size which is the natural logarithm of total assets = logTA

LTDR = Long-term debt ratio (proxy for capital structure) = Total of long-term debt to long-term assets + long-term debt

β_0 = Constant term

$\beta_1, \beta_2, \beta_3, \dots, \beta_3$ = Regression parameters

ϵ_0 = Stochastic error term.

3.1.2. Technique of data analysis

Data will be analysed using descriptive statistics and OLS multiple regression model. The multiple regression model is given by:

$$Y = b_0 + b_1 x_1 + b_2 x_2 + b_3 x_3 + \dots + b_n x_n$$

Table 1: Unit-root test result by Augmented Dickey fuller method

Variables	5% Critical level	First difference	Order of integration
logROA	-3.1003	-5.354241	I (0)
logLFN	-4.0691	-10.38406	I (1)
logFAT	-2.9527	-4.967311	I (1)
logFSE	-2.9527	-3.327148	I (1)
logLTDR	-2.9499	-3.237393	I (0)

Table 2: Regression estimation

Variable	Coefficient	Std. error	t-statistic	Prob.
C	-0.200997	0.116769	-1.721324	0.1458
LOGLFN	-0.002407	0.005338	-0.450901	0.6709
LOGFAT	-0.030498	0.033578	-0.908274	0.4054
LOGFSE	0.013464	0.005093	2.643481	0.0458
LOGLTDR	-0.298169	0.153314	-1.944822	0.1094
AR(12)	0.115228	0.166683	0.691302	0.5202
R-squared	0.831093	Mean dependent var		0.041773
Adjusted R-squared	0.662187	SD dependent var		0.027830
S.E. of regression	0.016175	Akaike info criterion		-5.108208
Sum squared resid	0.001308	Schwarz criterion		-4.891174
Log likelihood	34.09514	F-statistic		4.920432
Durbin-Watson stat	1.848022	Prob (F-statistic)		0.042557

Where Y is the dependent variable, b_0 is constant term, b_1, b_2, \dots, b_n regression coefficients and x_1, x_2, \dots, x_n are independent variables

In this study, $Y = ROA =$ dependent variable

x_1, x_2, x_3, x_4 and x_5 are independent variables represented by LFN, FAT, FSE, LTDR respectively.

4. EMPIRICAL RESULTS

The study tested the variables for unit root problem using Augmented Dickey fuller test. The result of the stationary test showed that ROA and LTDR were stationary at level as shown in Table 1, while LFN, FAT and FSE were stationary at first difference.

The result of Table 2 indicates that approximately 83% (R-square) of the systematic variation in the dependent variable (ROA) is explained or accounted for by the independent variables (LFN, FAT, FSE and LTDR). This is endorsed by the R-bar square which is 66%. The result also showed that at least or all the independent variables are significant with the probability of the f-statistic (0.042557) < 0.05 . The result of the DW statistic (1.85) approximately "2" indicates the absence of serial autocorrelation in the model. Outside the independent variables, the ROA will operate at a negative units of -0.200997.

The result of LFN shows that a one unit increase in LFN will retard ROA by 0.002407 units and has an insignificant impact on the ROA because the P-value (0.6709) is > 0.05 . For FAT, the result shows that a one unit increase in FAT will negatively affect ROA by 0.030498 units and has an insignificant impact on the ROA because the P-value (0.4054) is > 0.05 , and also, for FSE, a one unit increase in FSE will positively affect ROA by 0.013464 units and has significant impact on the ROA because the P-value (0.0458) is < 0.05 . Lastly, for LTDR the result shows that a one unit increase in LTDR will negatively affect ROA by 0.298169 units and has an insignificant impact on the ROA because the P-value (0.1094) is > 0.05 . Result revealed that lease financing positively and insignificantly impacted on profitability of quoted conglomerates. This finding is corroborative of previous findings. For instance, Siam and Qutarishat (2007) found that leasing option has a positive impact on profitability. See also for instance, Bello

and Mustapha (2016), Hazan (2009) found similar results. Lease financing positively affects profitability. Finding also indicated that long term debt ratio as a proxy for capital structure negatively impacted on profitability. However the impact is insignificant. The implication is that prudent level of debt can support a firm financial activities without reducing the profit on account of finance cost. Fixed asset turn-over also has a negative and insignificant impact on profitability of quoted conglomerates. This result is new and increases the knowledge gap. Judicious use of debt to boost profitability is in line with the theoretical prediction by the traditional theorist.

5. CONCLUSION

The study empirically examined the effect of leasing option on the profitability of Nigerian quoted conglomerates with a view to promoting economic growth and development. The paper established that leasing suits the level of development of the Nigerian financial market and should be utilized as debt financing in order to boost the capital of firms for enhanced financial operation. Judicious application of debt enhances profitability, hence our recommendation of prudent use of debt in a firm's capital structure.

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