http://journals.uonbi.ac.ke/index.php/adfj
ISSN 2522-3186

ADFJ ISSN 2522 - 3186.

African Development Finance Journal

VOLUME 7 (II)

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Date Received: February, 18, 2024

Date Published: April, 15,2024

Does Capital Structure mediate the relationship between Corporate Governance and Firm Value? Evidence from Kenyan Listed Firms

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Abstract

Whereas capital structure decisions are critical for a firm's financial well-being, enhancing corporate governance practices could more directly influence the value and performance of the firm. Thus, this study investigated the impact of capital structure on the relationship between corporate governance and firm value using longitudinal data from 30 Nairobi Securities Exchange-listed firms. A census survey in Kenya from 2012-2021, involving 30 firms, found a random effects model most suitable for investigating nonfinancial firms, with panel specification tests confirming this. The hypothesis testing revealed that capital structure significantly influences FV, but the four-step mediation analysis revealed that capital structure does not mediate the relationship. The absence of capital structure as a mediator suggests that governance effects are not influenced by how companies fund investments and operations. Thus, corporate governance's effect on firm value is neither impacted nor determined by a company's capital structure. It is apparent that good corporate governance standards and judicious leverage separately play crucial roles in establishing a firm's value.

Keywords: *Corporate governance, capital structure, firm value, panel random effects model*

Introduction

Corporate governance not only encourages shareholder trust and alignment but also promotes long-term growth, both of which significantly influence the firm's overall value. Moreover, ignoring good governance can trigger decreased trust, increased management risks, and a diminished perception of stakeholder value. (Mans-Kemp et al., 2018). Effective governance procedures are crucial for companies and organizations to enhance stakeholder value and performance, ensuring survival and prosperity in the contemporary business landscape. Kong, Famba, Chituku-Dzimiro, Sun and Kurauone (2020) emphasize the crucial role that corporate governance (CG) plays in influencing the dynamics among shareholders, who have financial interests in the firm. Thus, responsibility in management involves managers maximizing shareholder wealth while considering stakeholder interests. This balanced approach leads to better long-term performance and value creation for the company. Acting responsibly enhances trust, reputation, and overall firm value by fostering a balanced decision-making process.

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The relationship between a company's capital structure and its profitability and total value is complex and debated, with the exact nature of this impact being fiercely disputed. Capital structure (CS), including debt and equity financing, significantly impacts a company's financial performance and worth. The Modigliani-Miller (1958) theorem initially suggested that financial decisions, including capital structure, do not affect firm value in perfect capital markets. However, later debates, particularly by Modigliani and Miller (1963), suggested that adjusting capital structure, particularly by increasing debt, can enhance firm value due to tax benefits. In real-world imperfect markets with taxes, interest payments on debt are tax-deductible, leading to lower tax burdens and potentially higher after-tax profits. Empirical studies support Modigliani and Miller's (1958) theoretical assumptions by examining firm characteristics, temporal elements, and industry categories, while Gitman and Zutter (2012) define capital structure as the firm's equity-to-debt ratio, reflecting cost-effective financing strategies to maximize post-tax profitability, and Yazdanfar (2012) emphasizes that the concept of capital structure mirrors an attempt for cost-effective financing choices to maximize post-tax profitability.

A firm's primary objective is to maximize its overall value, benefiting all stakeholders (Shuaibu et al., 2019). This concept is supported by Bistrova and Lace (2012), who argue that firm value is closely linked to its financial position. Prioritizing this not only enhances shareholder value but also attracts other stakeholders, highlighting the importance of a strong financial position for long-term sustainability and growth. Firm value (FV) is a measure of a company's financial health, based on its assets and liabilities, and profits from its resources (Modigliani, 1980), while Putu et al. (2014) assert that it is the overall value of a firm's securities, calculated using appropriate methods and pricing models, and Dang, Nguyen and Tran (2020) argue that FV is the total of a firm's current and expected profits, as determined by appropriate techniques and pricing models. Firm value evaluation methods include examining financial records and using metrics like Tobin's Q, the discounted cash flow (DCF) method, and market-to-book value. Tobin's Q (1969), is a simple and reliable method for assessing undervaluation or overvaluation. Additionally, it is versatile for industry comparisons and has predictive power for future investments and economic expansion. Thus, the method was adopted for a comprehensive analysis in the relationship.

Research Problem

Empirical research suggests a complex and uncertain relationship between corporate governance and firm value, with varying results ranging from positive to negative (Bakay et al., 2021; Latif, Kamardin, Moh'd

& Adam, 2013; Onguka et al., 2021; Mukyala et al., 2020; Ararat et al., 2017). The results may appear inconclusive due to the diversity of corporate governance procedures and approaches among firms and countries, as well as the disparity in measurements used to assess both CG and firm value. Additionally, the CG framework's complexities can lead to ambiguity in outcomes and distinguish it from other factors like macroeconomic conditions, industry trends, and firm-specific attributes, causing challenges in interpreting FV. Thus, this study aimed to address these gaps by investigating the correlation between corporate governance, capital structure, and firm value in non-financial firms listed on the Nairobi Securities Exchange.

The NSE's market value disparities among non-financial firms are a cause for investigation into the relationship between corporate governance practices and market value, particularly if the relationship varies based on firms' capital structure. The study explores the intricate link between corporate governance and firm value by suggesting the existence of a mediator, an intermediary factor that influences both, to improve understanding and move beyond the traditional focus on their direct relationship. The research intends to elucidate the reasons behind the varying conclusions in current empirical literature regarding the relationship between corporate governance and firm value through this investigation.

Significant differences exist in the outcomes of the relationship between corporate governance (CG) and firm value (FV) between developed and developing markets (Gerged and Agwili, 2019; Gerged, 2021), where various factors, including regulatory frameworks, political systems, economic conditions, and cultural influences, play crucial roles in shaping this relationship across different markets. Additionally, developing markets often have weaker institutional structures and less stable economic and political environments, leading to mixed findings in prior empirical studies. These differences, combined with less predictable economic and political conditions, introduce greater variability and complexity into the relationship between corporate governance and firm value. This variability makes it difficult to draw clear conclusions from empirical studies, resulting in mixed findings in existing literature. Similarly, the lack of a universally agreed-upon definition for corporate governance, capital structure, ownership structure, and firm value has resulted in inconclusive and divergent empirical results due to the absence of standardized definitions (Onguka et al., 2021). The relationship between CG and FV is complex and uncertain, with ambiguous empirical evidence failing to conclusively determine whether strong CG practices lead to higher FV or if higher FV results in better CG practices. This area of study is crucial in corporate finance and

governance research. The unclear relationship between CG and FV raises questions about the causality. It's unclear whether good governance practices make firms more valuable or if valuable firms are more likely to have good governance practices. Understanding this causal direction helps policymakers and practitioners identify where to focus their efforts to improve firm performance, as changes in one variable might lead to changes in the other. Thus, this study filled these voids by examining the correlation between CG, CS, and FV of non-financial firms listed at the Nairobi Securities Exchange.

Research Objective

The objective of this study is to explore the mediating role of capital structure in the relationship between corporate governance and firm value of non-financial firms listed at the Nairobi Securities Exchange.

Literature Review

Theoretical Literature

The relationship between corporate governance, capital structure, and firm value is explored using various theoretical perspectives, including agency theory, stewardship theory, and pecking order theory. These theories aim to explain and clarify the relationship between these factors. Agency theory, a key theory in understanding the relationship between CG, CS, and firm value FV, is primarily responsible for the debate on whether capital structure influences the CG-FV relationship, as advocated by Jensen and Meckling (1976). CG is crucial for firms to sanction operations and enhance value. By implementing strong CG practices, firms can increase transparency, accountability, and ethical behavior, gaining trust from investors and stakeholders. Additionally, a well-balanced capital structure reduces costs and increases financial flexibility. Thus, strong governance structures may influence capital structure decisions, as they may be viewed more favourable by creditors, potentially leading to better access to debt financing at lower costs. Increased sanctions often necessitate stricter regulation and ethical standards for firms, leading to improved governance practices. This commitment to compliance enhances trust and reputation among stakeholders, boosts investor confidence, and increases firm value. Effective governance helps firms avoid costly penalties and legal issues, thereby enhancing their overall value.

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Empirical Literature Review

The relationship between CG and firm value is not well-defined, with mixed findings from previous studies. These findings suggest that the relationship is complex and may vary depending on factors like industry, country, governance mechanisms, and firm characteristics. Some have exhibited a negative relationship, suggesting that stronger governance is associated with lower firm value, possibly due to the costs of implementing and maintaining effective governance structures. Others have established a neutral relationship, suggesting no significant impact of governance on firm value, possibly due to other factors like market conditions or external shocks. Lastly, some revealed a positive correlation between robust governance and increased firm value, suggesting that effective governance practices like board independence, size, and audit committee independence improve decision-making and performance.

Onguka, Iraya and Nyamute (2020) used Baron and Kenny's four-step approach to investigate the mediating role of CS in the relationship between CG and FV in NSE-listed firms. They assessed CG, CS, and FV using a composite score, considering board independence, size, and composition. Further, Tobin's Q was used to determine CG's FV, and the DER to explore CS based on audited financial accounts from 64 NSE-listed corporations. The study found that CS did not significantly impact the relationship between CG and FV, suggesting that CG significantly influences FV. Analogous outcomes are exhibited by Bashir, Bhatti, and Javed (2020) who analyzed the dynamic components of corporate governance in Pakistan, utilizing a range of performance measures from non-financial firms listed at the PSX.

In Pakistan, the study by Huynh, Hoque, Susanto, Watto and Ashraf (2022) examined the impact of CG on FP and the mediating role of CS in non-financial sector companies from 2011 to 2021. The research used secondary panel data from financial statements and the Securities and Exchange Commission of Pakistan, with 150 selected for analysis. The study used OLS panel regression with a one-lag right-hand strategy and qualitative data collection to assess the effect of CG on FP. The findings showed that CG increased financial distress costs by increasing the debt-to-equity ratio, and CS partially mediated the relationship between CG and company performance. This implies that the relationship between CG and firm performance is not solely direct but also mediated through its influence on capital structure decisions. Firms with robust governance practices maintain an optimal capital structure, contributing to improved performance. Thus, effective governance enhances firm performance both directly and indirectly through its effects on the capital structure.

Okiro et al. (2015) presented conflicting findings concerning the influence of corporate governance and capital structure on the performance of firms traded on the East African Community securities exchange. They used agency theory to develop a comprehensive framework to explore whether effective corporate governance enhances firm performance by integrating capital structure considerations. The study analyzed 56 firms, representing 57% of the total, from 2009 to 2013. Results showed a significant positive correlation between corporate governance and firm performance, with a positive and significant mediating effect of capital structure on the relationship. The study underscores the importance of capital structure within a corporate governance framework and the role of corporate governance in enhancing firm performance. The study findings align with Itan and Chelencia's (2022) research on the relationship between Indonesian family firm performance and corporate governance, examining 117 firms on the Indonesian Stock Exchange between 2016 and 2020, focusing on capital structure as a mediator.

Additionally, Bashir, Bhatti, and Javed (2020) conducted a comprehensive analysis of corporate governance in Pakistan, focusing on non-financial companies listed at the PSX. They explored how capital structure interacts with corporate governance practices and financial performance metrics. Using Baron and Kenny's (1986) four-step process, the study examined various corporate governance aspects, including insider and institutional shareholdings, top twenty shareholder composition, board size, independence, audit committee effectiveness, and duality. The analysis incorporated financial leverage and control factors such as liquidity, size, age, market-to-book ratio, cash ratio, and tangibility ratio. Their sample included 113 non-financial firms randomly selected based on data availability, spanning various industries. Panel estimating methodologies, including fixed or random effects, were employed, along with time-fixed effects to address time-variant effects. The study found that capital structure does not significantly impact the relationship between dynamic corporate governance components and financial performance metrics. Additionally, it identified relationships between financial leverage and top twenty shareholdings, as well as between financial performance and financial leverage.

Conceptual Framework

The relationship between CG, CS, and FV is based on agency theory. Governance mechanisms, such as board structures and diversity, aim to align the interests of managers and shareholders, reducing agency costs and improving firm performance. This leads to increased firm value. The interplay between governance and CS is complex, with strong governance resulting in better capital allocation decisions,

resulting in an optimal capital structure and increased firm value. Conversely, poor governance may lead to suboptimal choices and lower firm value. The conceptual model is presented in Figure 1.1

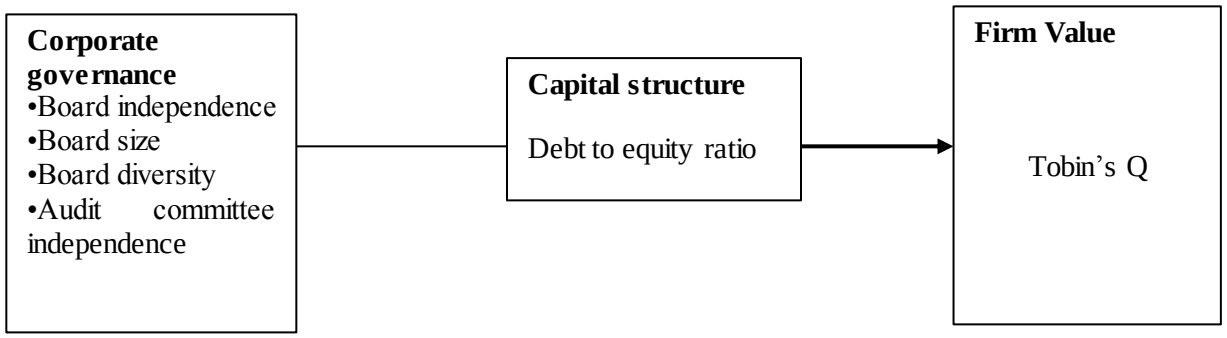

Figure 1.1 Conceptual Model

Research Hypothesis

H_{01}: There is no significant mediating effect of capital structure on the relationship between corporate governance and firm value of listed non-financial firms at the NSE.

Methodology

The study uses a longitudinal approach to analyze the relationships between three secondary sources, CG, CS, and FV, over time. The study used descriptive analysis to analyze data distribution, identify outliers, and establish links between variables, while Pearson correlation analysis was employed to determine correlation direction and strength. Diagnostic tests were conducted to assess normality, multicollinearity, stationarity, homoskedasticity, autocorrelation, and model specification. Additionally, panel regression analysis was then used to test the hypothesized relationship, and Barron and Kenny's four-step mediation model was applied to assess the mediating influence of capital structure on the corporate governance and firm value relationship. The notion of mediation, in which one variable influence another, is important to the research. The mediation process involves a mediator influencing the dependent variable (path a), an independent variable affecting the mediator (path b), and a dependent variable influencing the independent variable (path c), ensuring effectiveness and efficiency. After controlling for pathways, a and b, path c becomes statistically insignificant.

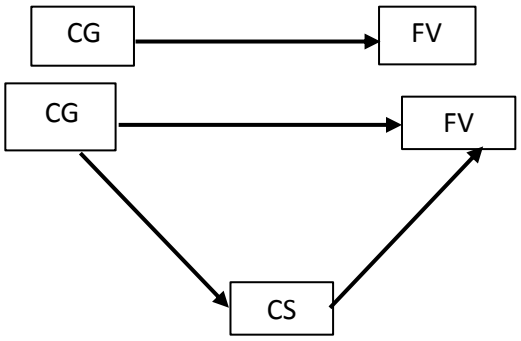

Figure 1: Simple Mediation Model

The study utilized a simple regression model (3.2a) to determine the significant effect of CG on FV. This is the total effect given by:

(c = ab + c')

$FVit = \beta 0 + cCGit + \varepsilon it$ ……..... (a)

Where FV = firm value, CG = corporate governance, β0 = constant, c = path coefficient and ε = error term. In the second step, the influence of CG on CS was established using a simple regression model (3.2b), which should also be significant.

$CSit = \beta 0 + aCGit + \varepsilon it$ …… (b)

where β0 = constant, a = path coefficient, CG = corporate governance, CS =capital structure, and ε = error term.

Instep 3, a simple regression analysis was conducted, with CS acting as a predictor of firm value. CS should significantly impact FV while controlling for CG.

$FVit = \beta 0 + bCSit + \varepsilon it$ …… (c)

where FV = firm value, CG = corporate governance, CS = capital structure, β0 = constant, b = path coefficients, and ε = error term

The model aims to determine if capital structure reliably predicts firm value while accounting for corporate governance. It involves a multiple regression analysis that considers both corporate governance and capital structure to predict firm value. If the impact of capital structure is positive, partial mediation is retained for step four. If the impact of capital structure remains significant after controlling for corporate governance, full mediation is supported. If both corporate governance and capital structure predict firm value, partial mediation is justified. A variable has an intervening effect when β_2 is significant and β_1 has a lesser impact on overall value contrasted to step one results.

FVit = β_0 + aCGit + bCSit+ εi…………………………………………………………(d)

Where FV = firm value, CG = corporate governance, CS = capital structure, β0 = constant, a and b are the path coefficients, and ε is the error term.

Findings and Discussions

Descriptive Statistics, Diagnostic Test and Correlation Analysis

Table 1: Statistics

Variable	N	Mean	SD	Min	Max
Board independence	300	0.67	0.208	0.2	1
Boad size	300	0.818	2.831	3	17
Audit committee independence	300	0.853	0.266	0	1
Board diversity	300	0.17	0.168	0	0.667
Capital structure	300	0.371	0.422	0	1.93
Firm value	300	3.072	0.853	0.9	5.7

The findings established that board independence among non-financial organizations was consistent, with a mean of 0.670, a standard deviation of 0.208, and a variance of 0.043, suggesting minimal variation. The data distribution was platykurtic, with a strong leftward skew. Additionally, the descriptive statistics for board size showed a mean of 0.818, a standard deviation of 0.2.831, a variance of 0.801, a minimum of 3, and a maximum of 17. The data indicated nominal variation in board sizes among listed non-financial firms, with a nearly symmetrical distribution and a moderate peak, suggesting a significant difference in board sizes. Further, the audit committee independence varied marginally among listed non-financial firms, with a mean of 0.853, a standard deviation of 0.266, a variance of 0.071, a minimum of 0, and a maximum of 1. The coefficient of variation was 0.312, indicating minimal variation. Despite this, the data distribution was negatively skewed and platykurtic, suggesting a flatter shape than a normal distribution with a stronger inclination to the left. Moreover, the analysis revealed that board diversity among listed non-financial firms exhibited a higher coefficient of variation, indicating a broader range. The mean value was 0.170, with a standard deviation of 0.168 and a variance of 0.028. The diversity ranged from a minimum of 0 to a maximum of 0.667. Thus, the data distribution displayed symmetry and a positive kurtosis.

Diagnostic Tests

Diagnostic tests play a crucial role in validating results by evaluating the assumptions of the statistical model, including normality, homoscedasticity, and linearity in linear regression. These tests also identify

outliers and influential points, providing further insight into the data. Additionally, they assess the model's overall goodness-of-fit and detect multicollinearity which is a regression analysis issue where multiple independent variables are highly correlated, can lead to unreliable coefficients and misleading interpretations. Detecting this issue involves calculating the variance inflation factor for each variable. The results are presented in Table 2.

Table 2: Multicollinearity Tests Results

Variable	Tolerance	VIF
CG Index	0.893	1.120
CS	0.98	1.021

The study exhibited no multicollinearity issues between capital structure and corporate governance variables, allowing them to be included in the regression model without risking inflating standard errors or misleading interpretations. The low variance inflation factor (VIF) values and high tolerance values suggest that both variables are effective predictors of the dependent variable in the model.

Correlation Analysis

Table 3 outlines the relationships between different variables. Capital structure displayed a positive but weak and statistically insignificant association with corporate governance ($r = 0.019$, $p > 0.05$), while firm value demonstrated a weak yet significant positive correlation with corporate governance ($r = 0.120$, $p < 0.05$). The correlation between capital structure and firm value was positive but weak and statistically insignificant ($r = 0.084$, $p > 0.05$), suggesting that capital structure may not significantly influence firm value in this context.

Table 3: Correlation Analysis Results

	CG	CS	FV
CG	1.00		
CS	0.019	1.00	
FV	0.1204*	0.084	1.00

* This implies that a p-value less than 0.05, indicating statistical significance in a two-tailed test.

The study aimed to assess the mediation effect of capital structure on the relationship between CG and FV in non-financial companies listed on the NSE. The variables included CG, CS, and FV. The CG composite

score was calculated using board independence, board size, audit committee independence, and board diversity. The CS was defined by the proportion of debt to equity, while FV was represented by Tobin Q. The study used Baron and Kenny's causal steps approach, consisting of four phases and four regressions. The null hypothesis was tested using the following method.

H_{01}: Capital structure does not significantly mediate the relationship between corporate governance and the value of non-financial firms listed at the Nairobi Securities Exchange.

The study used Baron and Kenny's causal steps approach to examine the mediation effect of capital structure on the relationship between CG and FV in non-financial companies listed on the NSE. The researchers found a positive and significant relationship between CG and FV, and a significant indirect effect through capital structure. This suggests that while CG directly influences FV, part of this effect is also mediated by the company's capital structure. This approach offers valuable insights into the complex interplay between corporate governance, capital structure, and firm value in the NSE context (see Table 4)

Table 4: Estimation Results of Corporate Governance and Capital Structure

Overall Model Fit Statistics						
Model: Random Effect (GLS) Regression			**Number of observations**			300
Panel Variable: ID (strongly balanced)			**Number of groups**			30
Time Variable: TIME, 2012 to 2021			**Obs. per group**		minimum	10
R^2	within	0.002			average	10
	between	0			maximum	10
	overall	0.001	**Wald chi2 (1)**			0.65
Corr	(u-i, x)	0	**Prob chi2**			0.421
Parameter Estimates Statistics						
CS	**Coefficient**	**Std Error**	**z-stat**	**Prob**		
Constant	0.837	0.032	26.15	0		
CG	0.009	0.011	0.8	0.421		

The study found that CG did not predict CS at 95% confidence interval, with approximately 0.1% of variance in FV predicted by CG. The parameter estimates revealed that CS was insignificantly influenced by CG, failing to meet the conditions of the 2nd step of the mediation process using the causal step approach. As a result, the other steps (3rd and 4th) were not tested. The results confirmed that the CG-FV linkage was

not mediated by CS, leading to the failure to reject hypothesis that postulated an insignificant mediating influence of CS on the CG-FV relationship.

Conclusions and Recommendations

The findings indicate that corporate governance directly impacts firm value, without capital structure being a significant intervening factor. Consequently, the relationship between strong corporate governance practices and higher firm valuations is not substantially affected by whether a company has a capital structure tilted more towards debt or equity financing, since the positive impact of good corporate governance on firm value seems to hold regardless of the firm's capital structure decisions. Therefore, these findings diminish the importance of capital structure choices in realizing the benefits of corporate governance implementations on enhancing firm value, as the capital structure composition appears to neither facilitate nor hinder the value-enhancing effects of robust corporate governance mechanisms within this research context. In essence, while capital structure is undoubtedly a vital financial decision for companies, these results suggest that it does not play a critical role in mediating or transmitting the positive relationship between corporate governance quality and firm valuations or performance, implying that the impact of corporate governance on firm value is more direct and independent of capital structure considerations. The study acknowledges limitations in data quality and the limited number of corporate governance proxies used. Despite these constraints, the study ensures the robustness of its results. It employs a correlation and descriptive methodology, providing valuable insights into variable relationships but unable to establish causation or fully explore complex interactions.

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