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

ADFJ ISSN 2522 - 3186.

African Development Finance Journal

VOLUME 7 (III)

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Date Received: April, 24, 2024
Date Published: June, 17,2024

Corporate Governance and Financial Performance of Deposit Taking Sacco's in Kenya

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Abstract

The purpose of this study was to empirically explore the relationship between corporate governance (CG) and financial performance (FP) within deposit-taking SACCOs in Kenya. A panel dataset comprising data collected from 163 SACCOs was utilized to test this relationship. CG was assessed using metrics such as board size, board independence, board financial expertise, board diversity, and board activity, while FP was measured through return on assets (ROA). The panel regression model was selected as the estimation technique after conducting the Hausman specification test. The empirical results revealed a robust and statistically significant positive relationship between CG practices and FP outcomes among the SACCOs studied, underscoring the importance of effective governance structures in enhancing financial performance. These findings have practical implications for policy development aimed at strengthening governance frameworks within SACCOs, potentially improving their operational efficiency and sustainability. They also contribute to management practices by highlighting the strategic importance of board composition and activities in driving financial outcomes. For future research, exploring additional dimensions of CG, such as executive compensation or risk management practices could provide deeper insights. Comparative studies across different types of financial cooperatives or longitudinal analyses to capture temporal dynamics could further enrich our understanding of how governance influences financial performance in diverse institutional contexts. Additionally, qualitative research approaches could complement quantitative findings by exploring stakeholder perspectives and organizational behaviors related to governance practices, offering a more comprehensive view of governance's impact on SACCO performance.

Keywords: *corporate governance, financial performance, deposit taking Sacco's*

Introduction

The concept of corporate governance dates back to the influential work of Berle and Means (1932), who emphasized the importance of separating corporate ownership from control. Financial performance (FP) is heavily influenced by the implementation of effective corporate governance (CG) mechanisms that mitigate principal-agent conflicts (Affes & Jarboui, 2022). These conflicts arise when the interests of dispersed shareholders diverge from those of powerful, self-interested managers (Ahmed et al., 2018). To address this issue, principals monitor the actions of agents through various CG mechanisms. By imposing these governance structures, companies can not only curb managers' opportunities to exploit informational

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advantages for personal gain but also compel them to act in ways that enhance shareholder value (Al-ahdal, 2020).

The relationship between CG and FP has become a focal point of discussion in academic conferences, corporate boardrooms, and policy debates worldwide. Despite the extensive research on the CG-FP link, empirical findings remain mixed, with studies reporting positive, neutral, or negative correlations. This variability underscores the complexity of the CG-FP relationship and suggests that the effectiveness of CG mechanisms can vary widely depending on contextual factors and specific corporate environments (Mwatu & Abdul, 2018). As a result, the ongoing discourse continues to explore how different CG practices impact FP, aiming to identify the most effective strategies for aligning managerial behavior with shareholder interests (Mwangi & Nyaribo, 2022).

The motivation for this study stems from a series of high-profile corporate scandals that have rocked the global business landscape, including the collapses of major corporations such as Lehman Brothers, Enron, Parmalat, Tyco, and Skandia (Kyere & Ausloos, 2021). These scandals have exposed significant flaws in corporate governance (CG) practices and highlighted the need for more robust oversight mechanisms. The global financial crisis of 2008 further underscored these deficiencies, prompting governments around the world to implement stricter regulations aimed at preventing similar collapses in the future. As a result, many firms have been compelled to re-evaluate and enhance their CG practices to promote greater transparency and ensure that management actions align with shareholder interests (Junior, 2022).

The wave of corporate failures has underscored the critical importance of a strong CG system in safeguarding FP and maintaining investor confidence. These events have driven home the realization that robust governance frameworks are essential for the stability and success of companies (Indrawati & Hanif, 2023). In response, there has been a concerted effort across the corporate sector to strengthen CG mechanisms, with a focus on enhancing transparency, accountability, and overall governance standards. This shift aims to restore trust in corporate management and ensure that shareholders can rely on the integrity and competence of those running the companies in which they invest (Hasan-Udin et al., 2023).

The increased scrutiny of CG practices has been fueled by extensive media coverage, which has brought issues of managerial accountability, transparency, and governance failures into the public eye. Terms such as hostile takeovers, weak boards of directors, protection of minority shareholders, and investor activism have become common in everyday discourse, reflecting the heightened awareness and concern over CG issues (Hassan et al., 2023). This heightened visibility has put pressure on companies to adopt more stringent CG and has spurred greater activism among investors seeking to protect their interests (Gohar & Batool, 2015). As a result, the landscape of CG is continually evolving, with firms striving to implement best practices to prevent future scandals and ensure sustainable FP (Gagan, 2023).

In Kenya, the landscape of deposit-taking SACCOs has witnessed significant regulatory developments prompted by events like increased mergers and acquisitions, financial institution collapses, and the adoption of alternative banking practices, necessitating enhanced governance strategies (Mwangi & Nyaribo, 2022). As outlined in the Banking Act Cap 488, Kenyan banking institutions have aligned their CG frameworks to bolster competitiveness and FP. Effective CG, crucial for robust banking oversight as noted by Feng et al. (2020), remains pivotal in the SACCO sector for ensuring performance and accountability to shareholders (Fatmasari & Mardiana, 2023). Collaborative efforts involving the Capital Markets Authority, other financial regulators, boards of directors, management teams, shareholders, and external auditors are instrumental in promoting sound governance practices. Strong governance not only fosters investor confidence and goodwill but also correlates positively with profitability, whereas deficiencies in governance often undermine financial sustainability and stakeholder trust.

Research Problem

Corporate governance has emerged as a crucial determinant of FP among financial institutions worldwide. Recent global financial crises and corporate scandals have underscored the critical need for robust CG frameworks to ensure stability, transparency, and accountability. In Kenya, deposit taking SACCOs plays a significant role in the financial sector, particularly in providing financial services to underserved communities. However, challenges such as insider lending, regulatory shortcomings, and inadequate risk management have posed considerable threats to their financial health and operational stability (Mwatu & Abdul, 2018). These challenges highlight the imperative for effective CG practices tailored to the unique context of SACCOs, aiming to mitigate risks, enhance governance transparency, and improve overall FP.

Empirical research on the relationship between CG and FP has yielded inconsistent findings globally, with studies reporting varied impacts ranging from positive associations to no significant correlations or negative effects (Farooq et al., 2022). In the Kenyan financial sector, which includes SACCOs, these findings underscore the need for context-specific investigations into how different CG mechanisms influence financial outcomes. SACCOs in Kenya operate within a distinctive socio-economic environment characterized by diverse ownership structures, regulatory frameworks, and governance practices compared to larger financial institutions. This context necessitates a nuanced understanding of how specific CG practices, such as board composition, internal controls, and shareholder engagement, interact with organizational dynamics to influence FP (Esokomi & Mutua, 2018). By exploring these dynamics, this study aims to fill the existing knowledge gap and provide empirical insights that can inform policy interventions aimed at strengthening SACCOs' governance frameworks and enhancing their financial resilience.

Moreover, the recent collapses of several SACCOs in Kenya have heightened concerns about the sector's governance standards and their implications for financial stability. The regulatory environment governing SACCOs is evolving, with ongoing efforts to align local practices with international standards while addressing sector-specific challenges. However, the effectiveness of these regulatory reforms in promoting sound CG practices and improving FP outcomes remains uncertain. Therefore, this study seeks to contribute to the discourse by investigating how regulatory changes and internal governance mechanisms influence SACCOs' ability to manage risks, maintain financial health, and sustain growth. By examining these factors comprehensively, the research aims to provide actionable recommendations for policymakers, regulators, and SACCO management to enhance CG practices, mitigate risks, and foster sustainable FP in Kenya's SACCO sector.

Research Objectives

The objective of this study is to determine the relationship between corporate governance and financial performance of deposit taking Sacco's in Kenya.

Theoretical Review

The current study is firmly rooted in agency theory, which serves as a fundamental framework linking CG mechanisms to the FP of firms. First articulated by Jensen and Meckling (1976), agency theory explains how firms are structured around a dynamic where shareholders delegate authority to managers to act on their behalf, creating a separation of ownership and control that can lead to conflicts of interest known as agency costs. These costs arise when managers prioritize their own interests over those of shareholders. Effective CG mechanisms, such as board oversight and executive compensation structures, are crucial tools in mitigating these agency costs by monitoring managerial behavior and aligning incentives with shareholder interests (Erena et al., 2022). This approach aims to improve firm performance by ensuring that decisions maximize shareholder value (Dwaikat, 2023).

In the context of agency theory, a key challenge emerges from the information asymmetry between managers (agents) and shareholders (principals). Managers typically possess more information, which can create problems like adverse selection and moral hazards that undermine shareholder value (Ali & Alim, 2021). Governance mechanisms like board sub-committees comprised of independent directors play a pivotal role in addressing these issues by enhancing transparency and accountability. These committees oversee managerial decisions to reduce the risk of managerial opportunism and ensure that strategic choices align with long-term shareholder interests (Aluchna & Kuszewski, 2020).

Furthermore, agency theory emphasizes the critical role of board composition and structure in shaping firm performance. Studies indicate that boards with a higher proportion of independent directors are more effective in monitoring managerial actions and mitigating agency costs (Bawuah, 2023). Independent directors are less likely to be swayed by management and more inclined to represent shareholder interests impartially. This independence fosters better decision-making within the board, strengthens strategic oversight, and creates an environment conducive to achieving sustainable financial performance (Bui & Krajcsak, 2023). Therefore, this study aims to deepen our understanding of how agency theory informs the relationship between corporate governance practices and firm financial outcomes, especially in diverse economic contexts where aligning managerial actions with shareholder interests is crucial.

Empirical Review

The empirical studies delving on the linkage between CG and FP have yielded contradictory findings. Farooq et al. (2021) conducted a study in Pakistan involving 474 non-financial listed firms over seven years. They used a governance index focused on board committees and ownership structure, finding significant enhancements in Tobin's Q, indicating improved market valuation due to better CG quality.

Similarly, Bui and Krajcsak (2023) explored 303 listed firms in Vietnam, employing a CG index encompassing board responsibilities and transparency indicators. Their research, utilizing generalized method of moments (GMM), revealed a positive correlation between effective CG and FP metrics such as Tobin's Q and ROE. Despite observing reduced transparency during the COVID-19 pandemic, the study emphasized correlation rather than causation, signaling a need for deeper causal analysis to fully understand the relationship between CG practices and FP outcomes.

Mansour (2022) investigated CG compliance across 84 entities in Jordan, using panel data to link attributes like shareholder rights and board effectiveness to FP measured by market share. The study found a significant positive relationship between CG compliance and FP, highlighting the importance of adhering to governance principles. In Eastern Europe, Aluchna and Kuszewski (2020) studied 155 firms in Poland, examining CG compliance with board practices and its impact on corporate value using Tobin's Q and ROA. Their findings suggested an inverse correlation between CG and FP, indicating challenges in addressing governance issues in economies transitioning from hierarchical controls. The study underscored the need to contextualize findings within specific institutional environments to understand the impact of CG practices on FP.

Shifting to India, Khatib et al. (2021) focused on 41 entities over five years, investigating variables such as CEO duality and board characteristics in relation to FP indicators like ROA and ROE. Their research highlighted the significant role of CG practices in enhancing firm value. Finally, Hasan et al. (2023) examined 59 firms in Bangladesh, assessing various CG indices' effects on FP metrics such as EPS, ROE, and ROA. Their study emphasized the positive influence of board independence on FP, while other aspects like audit committee and board effectiveness showed no significant correlations.

Conceptual Framework

The study examined how CG influences the FP of deposit-taking SACCOs in Kenya. Figure 1 depicts the conceptual model illustrating the connections between the variables under investigation.

Fig.1. Conceptual Model

Research Hypothesis

H₀₁: There is no significant relationship between corporate governance and financial performance of deposit taking Sacco's in Kenya.

Research Methodology

The study employed a descriptive research design to systematically analyze the relationship between corporate governance (CG) practices and financial performance (FP) among deposit-taking SACCOs in Kenya. This design was selected to thoroughly explore CG mechanisms and their impact on FP metrics, offering an extensive overview of trends within the SACCO sector. Through this approach, researchers collected quantitative data from financial statements obtained from the Sacco Societies Regulatory Authority (SASRA), establishing a solid basis for analysis.

Panel data utilized in the study comprised a sample of 163 firms chosen from the total population of 172 deposit-taking SACCOs in Kenya. This sample was strategically selected to represent a diverse cross-section of the SACCO sector, enabling broader generalizability of findings. The data extracted from SASRA's financial statements provided comprehensive insights into CG practices, including aspects like board size, board financial expertise, board activity, board diversity as well as board independence, alongside FP indicators such as return on assets (ROA).

Data and Variable Description

The study utilized balanced panel data sourced from SASRA reports spanning from 2018 to 2022, focusing on corporate governance (CG) and financial performance (FP) within deposit-taking SACCOs in Kenya. Corporate governance was operationalized across several critical dimensions: Board Size, reflecting the number of directors on the SACCO's board; Board Financial Expertise, assessing the financial knowledge and qualifications of board members; Board Activity, quantifying the level of engagement in overseeing operations and strategic decisions; Board Diversity, encompassing skills, experience, and demographic variety among board members; and Board Independence, evaluating the extent of autonomy from conflicts of interest and external influences. These dimensions were measured using data extracted from SACCO financial statements reported to SASRA.

Financial performance (FP) was evaluated primarily through Return on Assets (ROA), which measures the SACCO's efficiency in generating earnings from its assets. ROA is calculated as net income divided by average total assets, providing insights into how effectively SACCOs utilize their resources to generate profits. By examining these variables over a balanced panel dataset across five years, the study aimed to comprehensively analyze the impact of various CG practices on FP within the SACCO sector in Kenya. This approach ensures robustness in assessing the relationship between governance mechanisms and financial outcomes, contributing valuable insights into the dynamics of SACCO management and performance over time.

Empirical Strategy

The econometric model employed in this study to estimate the relationship between CG and FP among deposit-taking SACCOs in Kenya is a panel regression model. Panel regression is well-suited for this research as it allows for the analysis of both cross-sectional and time-series data simultaneously, capturing individual SACCO characteristics (cross-sectional variation) and changes in these characteristics over time (time-series variation). Specifically, the panel regression model incorporates fixed effects or random effects to account for unobserved heterogeneity across SACCOs and time-invariant factors that may influence both CG practices and FP outcomes. To test the mediation process, the following general linear models were employed as specified below;

$$\mathbf{FP_{it} = \beta_0 + \beta_1 CG_{it} + \varepsilon_{it}} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \mathbf{3.1}$$

Where: $\boldsymbol{FP_{it}}$*= Financial performance of deposit taking Sacco's i at time t;* $\boldsymbol{CG_{it}}$*= Corporate governance of deposit taking Sacco's i at time t;* $\boldsymbol{\beta_0}$ *= constant;* $\boldsymbol{\beta_1}$ *= Coefficients;* $\boldsymbol{\varepsilon_{it}}$ *= Error term deposit taking Sacco's i at time t.*

Estimation Results

The estimation results are presented in the form of descriptive statistics, correlation analysis, and panel regression analysis. Descriptive statistics summarize the data, highlighting the central tendencies and variability of the key variables. Correlation analysis explores the relationships between different CG practices and FP indicators, identifying the strength and direction of these associations. Panel regression analysis further investigates the impact of various CG dimensions on FP over the five-year period.

Descriptive Statistics

The descriptive statistics for CG and FP are outlined in Table 1.

Table 1: Descriptive Statistics

Variable	Mean	Standard Deviation
Corporate Governance	1.42	0.07
Financial Performance	0.02	0.05

Table 1 presents the descriptive statistics for the variables examined in the study. The average value for CG is 1.42, with a standard deviation of 0.07. This suggests that CG practices among the SACCOs in the sample are fairly uniform, showing minimal variation around the average. In terms of FP, the mean is 0.02 with a standard deviation of 0.05, indicating that these SACCOs have generally low FP with some degree of variability.

Correlation Analysis

The correlation between CG and FP was assessed using the Pearson correlation coefficient. This statistical measure determines the strength and direction of the linear relationship between the two variables. The findings are highlighted in Table 2.

Table 2: Correlation Analysis Results

Variable	Corporate Governance	Financial Performance
Corporate Governance	1	
Financial Performance	0.81*	1

Table 2 displays the outcomes of the correlation analysis between CG and FP. The Pearson correlation coefficient of 0.81 between CG and FP signifies a strong positive relationship. This indicates that enhancements in CG practices are linked to higher FP among the deposit taking Sacco's in Kenya.

Estimation Results and Discussion

To test the relationship between corporate governance and financial performance, the null hypothesis is specified below was tested.

> *H_{01}: There is no significant relationship between corporate governance and financial performance of deposit taking Sacco's in Kenya.*

Table 3: Empirical Findings of Corporate Governance and Financial Performance

Model:	Fixed Effect Model			
Time:	2018 to 2022			
R^2	within	= 0.856		
	between	= 0.335		
	overall	= 0.657		
F (1, 651)	= 3,861.14			
Prob > F	= 0.00			
FP	**β**	**SE**	**t**	**P**
Constant	0.31	0.003	91.36	0.00
CG	0.75	0.11	62.14	0.00

Table 3 illustrates the empirical findings on the relationship between CG and FP using a fixed effect model, based on data from 2018 to 2022. The model shows a strong explanatory power within the sample, with an overall R^2 value of 0.856, indicating that 85.6% of the variability in FP among SACCOs is explained by CG practices. The F-statistic {$F (1, 651) = 3,861.14$} is highly significant ($p < 0.05$), confirming the model's statistical significance and the non-random nature of the CG-FP relationship. The coefficient for CG ($\beta = 0.75$, SE = 0.11, t = 62.14, $p < 0.05$) is positive and significant, indicating that a unit increase in CG is associated with a 0.75 unit increase in FP. These findings underscore the strong positive impact of CG on FP in deposit-taking SACCOs in Kenya.

The findings of the current study align with several empirical investigations conducted across diverse regions, demonstrating a positive and significant association between CG and FP in various settings. For example, Farooq et al. (2021) in Pakistan concluded that enhancements in CG quality, particularly through improvements in board committees and ownership structure, positively impacted Tobin's Q, indicating improved market valuation. Similarly, Bui and Krajcsak (2023) in Vietnam identified a positive correlation between effective CG practices and FP metrics such as Tobin’s Q and ROA.

Moreover, studies by Mansour (2022) in Jordan and Khatib et al. (2021) in India underscored the significant role of CG in enhancing firm value, albeit within different institutional contexts. Mansour's (2022) research linked CG compliance with shareholder rights and board effectiveness to increased market share, reaffirming the positive connection between governance quality and FP. Conversely, Hasan et al. (2023) in Bangladesh emphasized the specific impact of board independence on FP metrics such as EPS, ROE, and ROA, further supporting the idea that distinct elements of CG can uniquely affect FP. However, findings from Aluchna and Kuszewski (2020) in Eastern Europe, which suggested an inverse relationship between CG compliance and FP of Polish firms.

Conclusions, Limitations and Areas for Further Research

The significant and positive relationship between CG and FP observed in deposit-taking SACCOs in Kenya underscores the critical role of governance practices in driving organizational success. These findings suggest that SACCOs with stronger governance frameworks tend to exhibit higher levels of financial health and efficiency. Effective CG mechanisms, such as transparent decision-making processes, strong board oversight, and adherence to ethical standards, contribute to improved operational management and strategic direction. This, in turn, enhances SACCOs' ability to optimize resource allocation, mitigate risks effectively, and capitalize on growth opportunities, thereby bolstering their financial performance metrics.

Moreover, the robust CG-FP relationship highlights broader implications for stakeholders within the SACCO sector. Members, investors, and regulatory bodies alike benefit from enhanced governance practices, which foster greater accountability and trust. Transparent governance not only safeguards member interests but also attracts investment and enhances SACCOs' reputation in the financial market. For policymakers and regulators, these findings emphasize the importance of promoting and enforcing governance standards that support sustainable growth and resilience across SACCOs. By nurturing an environment conducive to sound governance practices, regulators can facilitate a more stable and competitive financial sector, ultimately contributing to broader economic development goals.

The study's limitations primarily stem from its exclusive focus on deposit-taking SACCOs, which restricts the generalizability of its findings to other types of SACCOs, such as non-deposit-taking or agricultural SACCOs. This narrow scope may overlook important differences in governance practices that significantly impact FP and the applicability of CG practices. Additionally, the study's short timeframe of five years limits its ability to capture long-term trends and dynamics in the relationship between CG and FP. Despite employing a longitudinal approach, this timeframe may not adequately account for critical shifts and fluctuations that unfold over more extended periods in deposit-taking SACCOs.

Future research could explore several areas to build upon the findings of this study. Firstly, investigating the comparative impact of CG practices on FP across different types of SACCOs, including non-deposit-taking and agricultural SACCOs, would provide insights into how varying regulatory environments and operational structures influence CG-FP dynamics. Secondly, longitudinal studies extending beyond five years could track the evolving relationships between CG and FP over longer periods, capturing broader trends and adaptations in SACCO governance and financial strategies. Lastly, comparative analyses across diverse financial institutions, including microfinance institutions and commercial banks, would enrich understanding of sector-specific challenges and opportunities in enhancing CG practices and FP.

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