

Does the Corporate Governance Practice Support the Corporate Financial Performance of Banking Industries in Ethiopia? Panel Data Analysis

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ABSTRACT

The high-profile corporate collapses and failures in early 2000s changed the image of accounting, auditing, and regulatory environments. As a result, the need for implementing effective corporate governance practice (CGP) in corporate financial institutions has gained significant attention worldwide. Effective CGP paves the way for access to finance, lower cost of capital, better corporate financial performance (CFP), and favourable treatment by all stakeholders. This study examines the relationship between corporate governance variables and financial performance in the Ethiopian banking industry. The board size, independence, educational level of board and audit committee characteristics were employed as measures of corporate and return on assets (ROA) and return on equity (ROE) as financial performance metrics. The study involves a census of all major financial institutions supervised by the National Bank of Ethiopia (NBE) for six years, 2015-2020. The main finding of this study revealed that the existence of board independence, the presence of an audit committee, the financial leverage ratio and financial institution size have a positive significant influence on CFP. Therefore, this study offers an important implication for developing corporate governance and capital structure to support underdeveloped financial institutions. This makes a significant contribution to the existing literature by addressing the specific context of Ethiopian banking industries, filling a gap in knowledge regarding the relationship between corporate governance and financial performance in this sector.

Keywords: Corporate governance practice, Ethiopian banks, Board characteristics, and corporate financial performance.

JEL Code: C33, G01, G21, and G30

1. INTRODUCTION

Since the global economic crises, scandals, and failure of many high-profile corporate entities worldwide, the issues of corporate governance practice (CGP) have been a debatable topic in the financial administration of modern corporations (Amoateng, et al., 2017, p. 54). This raises doubts about whether the corporate management system and effective disclosures of accounting information of business are accountable, transparent, and reasonable. The necessity of implementing an effective CGP in modern corporations arises from the separation of ownership and control. This separation of ownership and control triggers conflicts of interest, creating more agency costs (Le et al., 2021). Therefore, an effective board of directors is responsible for acting in the best interest of shareholders. If the shareholders' interests align with the board's decision-making, it would reduce conflicts between managers and shareholders, leading to better corporate financial performance (CFP).

In addition to CGP, capital structure choice and allocation strategies remain equally critical factors affecting firms, from CFP to the strategic financial decision. According to Aman (2019), the most private and fragmented financial institutions own more private financial reserves than global firms due to the difficulty and cost of seeking contemporary external finance. This issue is particularly true in developing countries like Ethiopia, where the financial market is inefficient and has high information asymmetry. This results in financial institutions facing severe problems of adverse selection. That is why access to formal finance is usually difficult for financial institutions. According to Kule et al. (2020) the effective process of capital allocation strategies is crucial to dynamic economies, which promotes productivity, encourages innovations, and supplies an efficient and liquid market for buying and selling securities.

However, the Ethiopian financial sectors have not been directly affected by the failure of high-profile corporations in many countries. According to the African Development Bank Group (DDBG) 2020 report, Ethiopia's financial sector remains shallow as it offers a limited range of products and services. In addition, the Ethiopian financial industry remains suspended due to foreign participation, and a capital market is lacking. An indicator of financial deepening, the ratio of the monetary base (M2) to Gross Domestic Product (GDP) is still constant at around 0.28 percent; the domestic credit as a percentage of GDP makes up 31.1 percent, and the credit to private sectors as the percentage of GDP remain only 9.3 percent during 2016 to 2020 (Chekole et al., 2020). Ethiopia is also ranked 116th out of 144 in 2015/16 based on the Global Competitiveness Report due to its low ranking in financial sector development. The value of required collateral compared to the loan amount is more immense in Ethiopia (234%) compared to the rest of the continents (160%) and least industrialised countries (164%). Developing and alleviating poverty in Ethiopia requires more influential financial institutions that generate and enhance employment opportunities, produce goods and services, and generate profits for investors. This requires a continuous investment in the issues of the source of capital and management expertise and consumers' satisfaction with national confidence in the financial institutions.

The Ethiopian financial institutions play a crucial role in the country's economic development; hence, assessing the relationship between corporate governance and corporate financial performance is essential. The well-functioning financial sector is vital for financial stability since business is crucial to a country's economic health (Peihani, 2015). Therefore, this study examines the relationship between corporate governance practices and financial performance of Ethiopian banking institutions. These firms in Ethiopia operate in a unique economic and regulatory environment, facing specific challenges and opportunities. Studies examining the relationship between corporate governance and financial performance have focused on other countries, creating a gap in the Ethiopian banking industry literature. This research contributes to the literature by providing insights into the specific dynamics and implications of corporate governance practices in the Ethiopian banking sector.

2. LITERATURE REVIEW

2.1 Theoretical Framework

Recently, corporate governance issues have become the most interesting areas of research among scholars and practitioners from various disciplines. The empirical research associated with the issues of CGP has been conducted based on three corporate governance theories: agency theory, stewardship theory, and stakeholder theory. Therefore, this study is conducted through the lens of agency theory, which originated from the issues in principal and agent relationships. In this relationship, the corporate managers are called agents that oversee a corporation's day-to-day activities. In contrast, principals are referred to as the shareholders represented by board of directors. Agency theorists argue that the corporate management problem is an agency problem because the CGP arises as the result of an agent's conflict of interest between different parties in the management of the corporations (Madsen and Bingham, 2014). The divergence of self-interest between management and owners results in agency problems and occasions agency costs, including resultant costs of residual loss, bonding costs, and monitoring costs (Connelly et al., 2012).

To minimise agency costs and alleviate the conflict of interests, agency theorists (Jensen and Meckling, 1976; Fama and Jensen, 1983; Jensen, 1994) prescribed various governance mechanisms and practices to control agents' actions and protect the shareholders' wealth expropriations. Therefore, one can conclude from the earlier reviews that the board of directors, as a governance mechanism, watches the management and can improve the overall corporate management performance through their controls. The key role of the board of directors would be to minimise the agency costs and maximise the shareholders' wealth.

2.2 Corporate Governance and Financial Performance

A considerable amount of empirical evidence stresses that effective CGP has a direct and significant impact on the CFP in various countries. For instance, Kule et al. (2020), Arora and Sharma (2016), Abubakar (2017), Bhagat and Bolton (2019) and Xu et al. (2022) support the view that effective corporate governance practice improves corporate financial performance. Their view was that effective CGP improves the CFP by enhancing expected cash flows to investors and reducing the cost of capital, which reduces monitoring and audit costs. In contrast, if the financial institutions have ineffective CGP, it will lead to misallocation of the company resources, expose the systems to fraud risk, and constitute opportunities for managers to commit fraud that leads to substandard CFP, resulting in corporate entities' failures. Therefore, in improving the financial sector, corporate governance principles play a significant role in fostering better disclosure in business reporting that can help market liquidity and capital formation in the emerging economy.

Anis et al. (2017) recognized the impact of board characteristics on financial performance of 70 Egyptian listed companies for the period of 2005-2010. Their study reported that board size effectiveness has significant positive impacts on financial performance. The study recommended mandatory implementation of corporate code because the absence of board of directors is not effective in implementing proper governance. However, the study presents a contextual gap since this study focused on Egyptian-listed companies that cannot be generalised to the Ethiopian context. Similarly, Raed (2021) examined the effects of board characteristics on corporate performance in 85 Jordanian industrial and service companies with 425 observations. The board characteristics were measured by managerial ownership, CEO duality, board independence, gender diversity, advanced education, board meeting, board size, corporate age and age, and nationality identity. ROA and ROE measured the financial performance. The result revealed that the study variables had significant positive effects on financial performance, while corporate age and educational level of board members had negative effects.

Muhamat et al. (2021) also claimed the various scandals and failure of corporate governance problems linked with corporate performance. Similarly, Ullah et al. (2021) demonstrated the impact of board structure, financial reporting and, disclosure and transparency on the success of family business in Pakistan. The finding of this study revealed that the corporate governance practice had a significant positive monitoring impact on the success of the family business. According to Assenga et al. (2018) and Chukwuma et al. (2017), who investigated the effects of board qualities on the financial performance of firms in Tanzanian and Nigeria, respectively. The findings of these studies support that the separation of CEO role and gender diversity has a significant positive impact on performance. However, the result of the study did not support the outside directors, board size, and academic qualifications linked to the financial performance.

The preceding discussion demonstrates that a relationship between CGP and CFP can be established. Thus, this study proposed to test the following research hypothesis based on the above empirical literature.

H1: There is a positive relationship between the board size and CFP.

H2: There is a positive relationship between independent directors and CFP.

H3: There is a positive relationship between the education level of the board of directors and CFP.

H4: There is a positive relationship between the number of audit committee and CFP.

H5: There is a positive relationship between Audit committee accounting experience and CFP.

Furthermore, banking size and age are the control variable in addition to the above independent variable based on various earlier empirical literature (Arora & Sharma, 2016; Hung, Pham & Ha, 2018; Dang and Nguyen, 2021). The proposed hypothesis is as follows:

H6: There is a positive relationship between bank size and CFP.

H7: There is a positive relationship between bank age and CFP.

3. RESEARCH METHODS AND MATERIALS

The research strategy for this study is a quantitative research design since the primary aim of this study is to investigate the extent of the existing relationship between CGP and CFP of major financial institutions in Ethiopia. The quantitative research design is best suited for examining the relationship between the variables, and the results can be used to form generalised conclusions about business-related issues (McCusker and Gunaydin, 2015, p. 537). All the necessary data for this study was collected from the published financial statements extracted from the following websites of NBE and the individual financial institutions. The CGP variables were collected from individual financial institutions' financial statements containing information on the board of directors' characteristics, income statements, financial positions, principal activities, risk management system, operational procedures, and explanatory notes. Table 1 below describes the data type, source, and data analysis methods.

Table 1. Data type, source, and methods of data analysis.

Type of data	Secondary data	It has a greater capacity to capture complex behaviours than data sets with only a temporal or a cross-sectional
Number of banks	All 18 commercial banks	All 18 commercial banks that are under the supervision of National Bank of Ethiopians (NBE) directives were selected.
Time span	2015-2020	Considered based on the availability of the necessary data on the national banks' official website and the issuance of corporate governance code
Observations	6-years average	To overcome the cyclical effect and measurement error
Data Source	NBE websites and annual reports of individual firms	To keep its consistency and to avoid biases.
Analysis Method	Inferential method	Panel data multiple regression analysis
Estimation Method	Pooled OLS	To overcome endogeneity and collinearity of regressors as well as econometric problems such as cross-sectional dependence and multi-correlation

3.1. Measurements of the Variables

This study incorporated five independent variables, two dependent and two control variables. The measurements and data source for each study variable are shown in the following Table 2. In addition to the above independent variables, this study employed financial institution size and age as control variables based on earlier research (Arora and Sharma, 2016; Dang and Nguyen, 2021). The firm size adopted in this study shows that large firms have resources to engage in research and development, attract and keep the experienced board and negotiate with suppliers and government agencies that contribute to improving performance.

The dependent variable of this research is CFP, and two indicators, ROA and ROE, are employed

to measure CFP. ROA shows the ability of corporate management to earn a return on a firm's resources and decide the organisations' growth over the study period, while ROE is used to find the comparability of an organisation's profitability with others for the same study period.

Table 2. Measurements and the sources of data for each study variable

Study Variables	Encode	Measurements	apriori
Return on asset	ROA	Net profit after tax divided by total asset	
Return on equity	ROE	Net profit after tax divided by total equity	
Board size	BOSIZE	Total number of board members.	+
Independent Board	INDE	Number of independent board members divided by total number of board members	+
Board educational level	BEDU	Number of members holding a master's or doctorate degree divided by the total number of board members.	+
Number of the audit committee	AD-C	The total number of audit committee members	+
Audit committee accounting experience	AD-AEDU	Total number of years as an accounting expert in financial institutions	+
Firm age	FSIZE	Natural log of the banks' total assets to measure firm size	+
Firm size	FAGE	Number of years of the banks to measure the firm age.	+

3.2. Method of Data Analysis Techniques

The data was analysed using descriptive and inferential statistics. This study employed panel data multiple regression to test the relationship between dependent, independent, and control variables. Panel data multiple regression models were used to establish if the components of CGP are related to CFP. The general econometric model used in this study to test the overall impact of corporate governance and financial performance is stated in EQ 1.

$$CFP_{it} = \beta_0 + \beta_1(BOSIZE_{it}) + \beta_2(INDE_{it}) + \beta_3(BEDU_{it}) + \beta_4(AD - C_{it}) + \beta_5(AD - AEDU_{it}) + \beta_6(BSIZE_{it}) + \beta_7(BAGE_{it}) + \epsilon_{it} \dots \dots \dots \text{EQ (1)}$$

Where CFP = Corporate Financial performance, which is measured by its indicators such as ROA and ROE based on earlier empirical literature; $\beta_1 \dots \beta_7$ = Regression Coefficient of 7 variables; β_0 = Intercept of coefficients; BOSIZE = Board size; INDE = independent board; BEDU = Board educational level; and AD-C = Number of the audit committee. In addition, AD-AEDU = Audit committee accounting experience; BSIZE = bank age; BAGE = bank size; and ϵ_{it} = Error Term. Similarly, i denotes financial institutions (cross-sectional dimension and t donates years ranging from 2015-2020 (time-series dimensions). The other models used to test the association between each component of the dependent variables are stated in EQ 2 and EQ 3 below.

$$ROA_{it} = \beta_0 + \beta_1(BOSIZE_{it}) + \beta_2(INDE_{it}) + \beta_3(BEDU_{it}) + \beta_4(AD - C_{it}) + \beta_5(AD - AEDU_{it}) + \beta_6(FSIZE_{it}) + \beta_7(FAGE_{it}) + \epsilon_{it} \dots \dots \dots \text{EQ (2)}$$

$$ROE_{it} = \beta_0 + \beta_1(BOSIZE_{it}) + \beta_2(INDE_{it}) + \beta_3(BEDU_{it}) + \beta_4(AD - C_{it}) + \beta_5(AD - AEDU_{it}) + \beta_6(FSIZE_{it}) + \beta_7(FAGE_{it}) + \epsilon_{it} \dots \dots \dots \text{EQ (3)}$$

4. EMPIRICAL RESULTS AND DISCUSSION

4.1. Descriptive Statistics

Table 3 presents the descriptive statistics of the study variables. The mean value of ROA for all commercial banks in Ethiopia is 2.77%. The mean values of 2.77 for ROA revealed that the financial institutions operating in Ethiopia during the study periods generated 2.77 percent average return on the total assets. Conversely, the mean value of ROE for all commercial banks in Ethiopia during the study period was 20.16%. The value of 20.16 percent for ROE shows that the banking sector in Ethiopia generated 20.16% of average profit margin on invested total capital. The board size ranges from 20 to 7.

Table 3. The descriptive statistics of the study variables

Variables	Obs.	Mean	Std. Dev.	Max	Min
ROA	108	2.77	1.01	5.10	-2.01
ROE	108	20.16	17.56	132.6	-73.4
BOSIZE	108	10.13	2.01	20.0	7.00
INDE	108	0.17	0.41	1.75	0.00
BEDU	108	0.28	0.22	0.80	0.00
AD-C	108	2.99	0.99	4.00	0.00
ADA-EDU	108	9.02	7.27	30	0.00
BSIZE	108	10.27	0.54	11.99	9.05
AGE	108	27.51	25.81	119	7.00

4.2. Correlation matrix of the study variables

The correlation coefficient between INDE and BSIZE indicates a moderate positive relationship between board size and the presence of independent directors. However, multicollinearity is not a concern as this correlation is not very high. BEDU has a negative correlation (-0.20) with BSIZE, suggesting a weak negative relationship between board size and the educational level of board members. Again, the correlation is not vital to raise concerns about multicollinearity. In addition, ADC has a positive correlation coefficient (0.07, 0.05, 0.04) with BSIZE, INDE, and BEDU, respectively, indicating a weak positive relationship. While these correlations exist, they are not at a level that would lead to significant multicollinearity issues. Similarly, there is a weak positive correlation among the other variables. In addition, all the VIF results are less than the acceptable threshold of 10. Overall, the multicollinearity results suggest that the correlations between the variables are not at a level that would significantly impact the interpretation of the regression results.

Table 4. The Correlation Matrix of the Study Variables

Variables	BSIZE	INDE	BEDU	ADC	ADAEDU	FSIZE	AGE	VIF
BSIZE	1.000							1.57
INDE	0.30**	1.000						1.37
BEDU	-0.20***	-0.05	1.000					2.65
ADC	0.07	0.05	0.04	1.000				2.84
ADAEDU	0.08	-0.23	0.08	0.26***	1.000			2.65
FSIZE	0.04	0.05	-0.14	0.20***	-0.09	1.000		3.08
FAGE	-0.13	0.10	-0.23	-0.56*	-0.31**	0.60*	1.000	4.72

level at *=5%, **=10%, and ***=1% respectively.

4.3. Panel Data Regression Analysis and Hypothesis Testing

Table 6 presents the results regarding the relationship between corporate governance factors and the Ethiopian banking firms' financial performance (ROA and ROE). The results present several intriguing discoveries. The positive coefficient of 0.07 for board size indicates a significant relationship between board size and ROA. However, a greater board size is linked to a decline in ROE, as seen by the results, which demonstrate that board size has a negative coefficient of -0.75. The positive coefficient for ROA shows that a larger board's effect on company profitability is significant. This study's overall findings contradict those of other researchers (Almaqtari et al., 2021; Arora & Sharma, 2016; Bekele & Dănescu et al., 2021). However, the negative coefficient of ROE suggests that bigger boards are linked with lower returns on equity. This variation may result from various decision-making procedures and levels of coordination among larger boards, which may affect profitability differently than shareholder returns. This finding conflicts with the research of (Arora & Sharma, 2016) while being compatible with studies such as those conducted by Raed (2021), Assenga, Aly and Hussainey (2018) and Chukwuma et al. (2017).

The results demonstrate an insignificant negative relationship between board independence and ROA and ROE. The negative coefficients of the independent board variable show that having an independent board has a negative impact on both ROA and ROE. This study calls into question whether independent boards are truly successful at increasing financial performance. To fully understand the underlying causes of independent boards' effects on financial performance it may indicate the need for additional research into the make-up and dynamics of independent boards. The findings also show that the educational level of the board has a positive and significant coefficient in both models, indicating that better board education is linked to higher ROA and ROE. The positive board educational level coefficients imply that board members with better educational backgrounds benefit from ROA and ROE. This suggests that a more knowledgeable board contributes significant skills and knowledge, which enhances firms' financial performance. This result implies that businesses could prioritize board seats based on educational credentials to improve financial results.

The results also show a positive relationship between the audit committee size and ROA and ROE. Since the number of audit committee members has an insignificant positive coefficient, it suggests that an increase in size would have little effect on ROA and ROE. According to the coefficients for the audit committee's size, it is insignificant ($p > 0.05$), suggesting very little impact on both ROA and ROE. This shows that merely raising the audit committee membership might not significantly impact financial performance. It is crucial to realise that other aspects of the audit committee's performance and calibre may still be relevant.

On the other hand, the negative coefficients for audit committee accounting experience suggest that having more accounting expertise within the audit committee is linked to a decline in both ROA and ROE. This result is somewhat unexpected because one would anticipate that the firms' financial performance would improve with more accounting expertise. Exploring the causes of this surprising link, such as potential conflicts of interest or restrictions on the audit committee's functioning, will require further investigation. The coefficient of the company size is negative, implying that larger firms often have greater ROE and lower ROA. The increased bureaucracy and complexity in larger firms, which can impede efficiency and profitability, may be one explanation for this finding.

The findings have significant ramifications for corporate governance procedures and their effect on financial performance. Given that the influence of various governance variables differs depending on the financial performance metric examined, the findings suggest that a one-size-fits-all strategy for corporate governance may not be acceptable. Firms should carefully evaluate the ideal board size that strikes a balance between efficient decision-making and coordination when deciding on the size of their boards. The detrimental effect on ROE demonstrates the necessity for a strategic approach to board composition and suggests that an overly large board could reduce shareholder returns.

The inverse association between independent board and financial performance raises concerns regarding the effectiveness of independent directors. This shows that businesses should concentrate on boosting these directors' independence and knowledge in order to ensure they have a beneficial impact on financial performance. On the other hand, the strong correlation between board members' educational level and financial performance highlights the need to recruit board members from various academic specialities. Companies should give board positions based on educational qualifications because they can provide significant expertise and insights into decision-making processes. Although it seems the number of audit committees has little effect, companies must concentrate on the calibre and performance of the committee. The ability of audit committee members to conduct thorough supervision and guarantee financial integrity can be improved by increasing their competence and independence.

Table 6. Regression Estimates Test Results

Variables	Pooled OLS Coefficient	
	ROA	ROE
Board size	0.07** (2.07)	-0.75** (1.98)
Independent Board	-0.20 (1.03)	-1.63* (1.75)
Board Educational Level	0.53** (3.96)	3.71*** (4.28)
Number of the Audit Committee Members	0.02* (1.85)	0.60* (1.93)
Audit committee accounting experience	-0.05 (1.03)	-0.12 (1.21)
Firm size	-0.61 (1.17)	14.60 (0.76)
Firm age	-0.01 (1.35)	-0.29* (1.73)
Constant	7.79** (2.18)	-115.93*** (4.52)
F- statistics	27.23	2.82
p-value of F- statistics	0.00	0.01
R2	0.784	0.766
Adjusted R2	0.768	0.719
observations	108	108

level at *=5%, **=10%, and *** =1% respectively.

5. CONCLUSIONS

This study investigated the relationship between the components of CGP and CFP of the 18 banking industries from 2015 to 2020. All 18 financial institutions in Ethiopia were used for the study. The data were manually collected from the annual reports of the firms. The study employed five CGP indicators, including board size, board independence, board educational qualification, audit committee size, and audit committee accounting experience independent variables. On the other hand, ROA and ROE were used as measures of CFP. The study introduced firm size and firm age as control variables. The study's findings provide interesting insights into the relationship between corporate governance practices and financial performance in the Ethiopian banking industry.

The results demonstrate that board size, independence, educational level, audit committee factors, firm size, and age had varying impacts on ROA and ROE. The findings of the study highlight the significance of considering the specific context and characteristics of firms when developing corporate governance for firms. It emphasises the need for a strategic approach to board composition, the establishment of independent directors' effectiveness, and the focus on the quality and expertise of the audit committee members. The result further suggests that banks, particularly larger and older ones, should prioritize strategies that foster innovation and adaptation to overcome potential challenges associated with size and age. The implication of the results is that the continuous monitoring and evaluation of corporate governance practices is essential to ensure that they are aligned with a firm's objectives. The findings suggest that Ethiopia's banks should carefully consider the optimal board size and composition to provide a balance between effective decision-making and coordination. This includes attracting board members with diverse educational backgrounds and expertise to bring valuable insights to the organization. The study's limitation is its inability to consider the macroeconomic factors that may affect the financial performance of the firms. Therefore, other studies should extend this study to assess the impact of macroeconomic factors on the financial performance of the firms in Ethiopia and other developing countries. In addition, further research is necessary because of the unexpectedly unfavourable link between financial performance and audit committee accounting experience. To identify potential areas for development and ensure that the committee's job aligns with the organization's goals, firms should assess the makeup and skills of their audit committees.

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