

Influence of Governance Structure on the Financial Performance of Microfinance Banks in Kenya

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ABSTRACT

The study evaluated the influence of governance structure on the financial performance of microfinance banks in Kenya. The theory that ran the research was the agency theory. The study adopted a causal research design that explored cause-and-effect relationships. The study targeted all 14 microfinance banks in Kenya. The census approach was used as the sampling method. Secondary data from Central Bank of Kenya (CBK) and the bank's website for the period 2018–2022 was used. The data was analysed using descriptive and inferential statistics. Descriptive statistical analysis was used to summarise data using frequencies, skewness, kurtosis, percentages, means, and standard deviations. The analysed data were presented in the form of tables and models for ease of comparison and inference. From the findings, the estimated coefficient of governance structure was significantly not equal to zero ($\beta = 0.639906$, $t = 2.30$, $p\text{-value} = 0.034$), implying that a unit increase in governance structure would cause the levels of financial performance to increase by 0.639906 units. Governance structure accounted for 16.08% (overall $R^2 = 0.1608$) of the variation in financial performance of microfinance banks in Kenya. The suggestions derived from these data suggest that throughout the process of board member selection, shareholders should prioritise the inclusion of individuals from varied professional backgrounds. This approach is anticipated to yield a broader range of perspectives on various topics.

Keywords: Board Composition, Financial Due Diligence, Financial Performance, Governance Structure, Microfinance Banks

1. INTRODUCTION

Scholars and practitioners in the field of financial management have continuously focused on financial due diligence and its overall contribution to firm performance. Before making any decisions, it is important to conduct a thorough financial due diligence investigation into the state of the microfinance bank and to examine its financial statements for the most recent and prior years. Particular attention should be paid to any out-of-the-ordinary income or expenditures, any unusual trends or deviations, and the quality of the bank's internal system of control (Neumann, 2020).

In the United States, high-profile companies like Enron and WorldCom have reportedly failed or been embroiled in controversy (Iraya et al., 2015). This is because little financial due diligence was performed, namely on the businesses' liquidity levels. As a result, many businesses' operations were hindered since so much capital was stuck in idle current assets (Sultan & Mohamed, 2022). Financial institutions in Japan have reportedly been doing better recently. Strong due diligence in recent decades has resulted in fewer company debts, which has contributed to the better performance. In addition, Japanese businesses depend on their own resources and large cash reserves to keep their leverage low. From 2001 to now, Japanese companies' average leverage has decreased from 27.49% to 19.34%, as stated by Khoo and Durand (2017). Strong financial due diligence, as reported by Matzen (2018), has led to a spectacular growth in the assets of listed corporations, which in turn has contributed to increased performance.

Sub-Saharan African businesses mirror the region's rich cultural diversity. This variety is also reflected in the financial systems, but financial due diligence varies from nation to nation based on factors including financial development, the strength of institutions, and the regulatory and policy climate (Franssen, 2020). According to the findings of an empirical study on financial due diligence in emerging countries (Kinyua, 2020), financial institutions in Africa carry an average of 18% long-term debt. Kusuma and Siregar (2021) claim that tangibility, financial due

diligence, development potential, and starting leverage are all factors of financial due diligence that contribute to financial success in emerging nations. Financial institutions in South Africa have been doing poorly. Firms in South Africa have been shown to perform worse when their debt levels are higher in both the long and short term (Abata et al., 2017). Ugandan financial institutions are now doing financial due diligence under the watchful eye of mandatory regulations. The most recent updated set of rules, for instance, came out in February of 2010. These rules are based on the idea that the board of directors should serve as a moral compass for the company as a whole. Director involvement in banks' financial due diligence is an integral part of good corporate governance. Taking this class will provide you with the information and training you need to succeed. The Bank of Uganda is also bolstering its monitoring abilities by adopting risk-based supervisory approaches (Nkuutu et al., 2021).

Using return on assets as a metric, Mahfoudh (2013) looked for a correlation between several business characteristics and financial success. These criteria were company size, leverage, age, liquidity, and board size. Liquidity and board size were shown to be the only two factors with statistical significance, whereas company size, leverage, and age all failed to reach statistical significance. According to Lwaminah (2017), there is no connection between a bank's financial due diligence and its return on equity. It was shown to be statistically significant in the analysis of variance. Financial performance at commercial banks was favourably correlated with capital adequacy, return on investment and bank size and negatively correlated with loan quality and liquidity. Loan quality and capital sufficiency were not as important as liquidity, bank size, and return on investment.

According to the Central Bank of Kenya (2023), acquirers are seldom satisfied if they do not conduct financial due diligence to ensure that the company's books are in order, its underlying profit is legitimate, and its balance sheet has not been tampered with. A total of Kshs. 935.1 million was reported as a loss by Kenya's microfinance institutions as of the end of June 2018, up from a loss of Kshs. 171.4 million as of the end of June 2017. According to the Central Bank of Kenya (2019), customer deposits fell by 5%. Microfinance institutions in Kenya must comply with Central Bank of Kenya laws concerning liquidity, credit risk, capital adequacy, and financial leverage (Central Bank of Kenya [CBK], 2020). Lack of financial due diligence by microfinance banks would result in decreased revenues in a nation where commercial banks monopolise the financial system.

Although microfinance banks have played a vital role in the Kenyan economy, they have faced significant equal-measure challenges (Aswani, 2019). Some of the fundamental challenges include competition and rapid business environment changes, financial instability, uncontrolled growth, management challenges, credit rating issues, and political and economic instability. This makes it hard for them to sustain their success in the future. Therefore, they need to operate with effectiveness and efficiency (Nyawira, 2021).

1.1 Statement of the Problem

As a pillar of the banking system, microfinance institutions are crucial to the growth of a country's economy. Microfinance institutions in Kenya have helped 63% of the population in some way, according to the Central Bank of Kenya (2020). Return on assets in the microfinance industry fell from 3% in 2020 to 1% in 2021, a decrease of 2.0%. There was also a reduction of 18% in the return on shareholders' funds from 28% to 10%. As of December 31, 2021, total assets were Ksh. 73.9 billion, down from Ksh. 74.9 billion at the end of the previous year. As of the end of 2021, the industry as a whole had a loss of Ksh.877 million before taxes (CBK, 2021), down from a loss of Ksh.2.2 billion a year earlier. Only four establishments showed a profit, while 10 others posted losses. Losses before taxes of Ksh. 522 million, Ksh. 178 million, and Ksh. 153 million were recorded by Faulu Microfinance Bank Limited, Maisha Microfinance Bank Limited, and Rafiki Microfinance Bank Limited, respectively, and were the primary contributors to the loss situation.

According to Onywera (2022), financial due diligence has improved the financial performance of commercial banks, but studies from other countries have not confirmed this finding. According to Mwangi (2017), banks' increased activity has resulted in better financial outcomes. Herbert and Agwor (2021) looked at the connection between financial due diligence in the form of risk management and the success of commercial banks listed on the Nigerian Stock Exchange (NSE). The impact of risk management on the profitability of Kenya's commercial banks was the subject of research by Mutuku (2016). Both Herbert and Agwor (2021) as well as Mutuku (2016) argued that further research was needed on MFIs and other financial due diligence techniques. Because of this discrepancy, this study set out to determine how much of an impact financial due diligence had on the productivity of Kenya's microfinance institutions.

1.2 Research Objective

To examine the influence of governance structure on the financial performance of microfinance banks in Kenya.

1.3 Research Hypothesis

H₀: Governance structure has no significant influence on financial performance of microfinance banks in Kenya.

II. LITERATURE REVIEW

2.1 Theoretical Review

The authors (Jensen & Meckling, 1976; Fama & Jensen, 1983) put forward the concept of agency theory. Its goal is to alleviate the tension that exists between company management and its investors. Since managers have more knowledge than owners do, an agency connection develops between them. Morris (1987) contends that disagreements, a cost of agency that might harm both enterprises' equity and debt, would arise if managers looked out just for their own interests to the prejudice of the owners. When managers are seen to be acting in their own self-interest, the value of a company's shares falls, a phenomenon known as the "agency cost of equity." The price of keeping an eye on things to safeguard property owners' interests will rise as a result. According to agency theory, in order to prevent managers from making value-reducing decisions on behalf of the firm, principals must incentivize or bond agents and bear the remainder of the losses. A big board of directors is proposed as a solution to the resource issue by Husaini et al. (2020), who cite agency theory and the theory of resource dependence. For the sake of the organisation's continued existence, it is crucial to actively monitor and enhance performance via ERM implementation. The larger a company's Board of Directors, the better its financial success.

2.2 Conceptual Framework

According to Mugenda (2008), the term "conceptual framework" refers to a "hypothesised model" that lays out the model being investigated and the connection between the two. The financial health of microfinance institutions was the determining factor, and governance structure was the independent variable in this research, as seen in Figure 1.

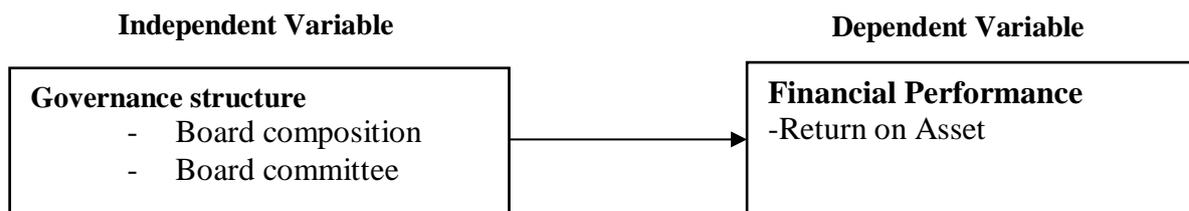


Figure 1
Conceptual Framework

2.3 Empirical Studies

Microfinance organizations in Nairobi County were studied by Sheikh et al. (2021) to ascertain the effect of board composition on financial outcomes. Participants were 351 directors, CEOs, and auditors from 25 microfinance institutions (MFIs) in Nairobi County. A total of 187 participants were randomly selected using the Yamane algorithm to supply the study's main data. Secondary data was gathered via financial newsletters and published financial statements among the 25 MFIs in Nairobi County, while primary data was gathered using the drop-and-pick techniques of a questionnaire among the respondents. The research found that the financial performance of MFIs in Nairobi County was positively and significantly impacted by the membership of their boards. According to the findings, there is an optimum number of board members that is both cost-effective and efficient. Besides, the study recommended a good mix of directors, both executive and non-executive, gender inclusiveness, and also a good mix of professionals and experienced members to ensure the better financial performance of MFIs in Nairobi County.

The impact of corporate board features on the performance of Nigerian microfinance banks was studied by Ehugbo (2021). The purpose of this research is to learn more about the role that boards of directors play in improving the operations of microfinance banks in Nigeria. The impact of board autonomy and diversity in gender on asset appreciation and liquidity is analysed in detail. The researchers used a longitudinal methodology. The sampling method utilised is a basic selection at random, and the final sample size of 284 was calculated using Taro Yamane's algorithm. Secondary information was collected by analysing the financial health of certain Nigerian-regulated microfinance institutions between 2015 and 2019. To ensure the accuracy of the measurement tool, a pilot study was conducted. The results of the hypothesis tests show that board independence is positively associated with microfinance banks' return on assets. Microfinance institutions' return on assets is significantly and negatively impacted by gender diversity. Liquidity is positively and significantly related to board autonomy, diversity in gender, and microfinance bank liquidity. Nonetheless, the research shows that there is still a severe lack of female participation on the management teams of microfinance institutions.

Microfinance banks in Nigeria had their corporate structure and financial results examined by Oyebanji (2022). 133 participants were surveyed from a random sample of ten licenced MFBs in Lagos State to provide data for the research. These microfinance institutions were selected because their histories and operations have been verified as legitimate by the relevant authorities at both the state of Lagos and the Central Bank of Nigeria (CBN). The correlation between organisational structure and economic outcomes was investigated using descriptive data and regression modeling. According to the results, the organisational makeup is a crucial factor in the profitability of MFBs. This confirmed the existence of a correlation between ROA and organisational structure, with a coefficient value of 0.777. Consequently, this suggested that MFB's economic success was affected by CG. Corporate structure, the research found, is a powerful instrument for boosting performance, guaranteeing survival, and making MFBs suitable. Therefore, the research suggests that MFBs prioritise the grouping of their boards of directors, placing more emphasis on competence and ability than eligibility, in order to guarantee the delivery of excellent service.

III. METHODOLOGY

The study was conducted among 14 microfinance banks in Kenya. Cause-and-effect correlations were investigated using a causal research strategy, which was used in this study. The correlation between the two types of variables is evident in this study's design. The study targeted all fourteen microfinance institutions in Kenya. All microfinance banks were used as the sample size using the census sampling technique. The study relied mainly on secondary data, which was qualitative in nature. The researcher used CBK reports in gathering the required data and a website where various variables were collected for a 5-year period, 2018–2022. To provide information, the data was processed using quantitative techniques in the context of STATA software. Descriptive statistical analysis was used to summarise data using frequencies, skewness, kurtosis, percentages, means, and standard deviations. The analysed data was presented in the form of tables, charts, and graphs for ease of comparison and inference. For inferential analysis, Pearson correlation and regression analysis were used. A unit root test was undertaken to eliminate the issue of spurious data. The augmented Dickey-Fuller test and Levin-Lin-Chu were used for inferential correlation. The Hausman test was undertaken to determine whether fixed-effect or random-effect regression

IV. RESULTS

4.1 Descriptive Analysis

The results are as shown in Table 1.0

Table 1

Descriptive Statistics

Stats	Board Composition	Number of Board Audit Committee Members	ROA
N	65	65	65
Min	0.166667	2	-0.5838
Max	0.6	7	0.03904
Mean	0.352106	4.430769	-0.0905
Sd	0.13233	1.310644	0.14415

Governance structure was measured using board composition and a board committee. Board composition was determined using the ratio of executive directors to non-executive directors, while the number of members of the board audit committee was determined. From Table 1, board composition (ratio of executive to non-executive) averaged 0.352 and had an acceptable variation of 0.132, with values ranging from 0.167 to 0.6. There was a wide variation in the size of the audit committee for the board of directors, with the average being four individuals and the norm's variation being 1. Returns on assets were used to measure the economic performance of the variable of interest. The economic performance between 2018 and 2022 varied from -0.584 to 0.039, with an average of -0.090 and an acceptable variance of 0.144, according to the summary statistics in Table 1.0, which were derived from the data from the panel.

4.2 Inferential Analysis

Internal audit risk planning techniques were hypothesised to have no impact on the financial results of Saccos in Western Kenya. Regression and the Pearson Correlation Coefficient were used to get this conclusion. The study's hypothesised results were put to the test as follows:

H₀: Internal audit risk planning practices has no significant influence on financial performance of Saccos in Western Region, Kenya

4.2.1 Pearson Correlation

The investigation used the measure of correlation to check for a connection between the answer variable financial results and the predicator parameters of the governance framework and for interdependence between the explanatory factors. Table 2 provides a summary of the relevant findings. The financial results of Kenya's microfinance institutions are somewhat positively and significantly impacted by the institution's governance framework. ($r = 0.4010$, $P = 0.0030$).

Table 2

Correlation Analysis

		Financial Performance
Governance structure	Pearson Correlation	0.401
	Sig. (2-tailed)	0.003
	N	65

4.2.2 Unit Root Test

In panels that combine data from the time series scale and the cross-sectional scale, Phillips-Perron and enhanced Dickey-Fuller were used to look for unit roots. This reduces the number of time samples needed for the test's power. The p-values in Table 3 show statistical significance.

Table 3

Unit Root Test

Variable	Phillips-Perron tests	Augmented Dickey-Fuller Tests
Financial Performance	3.6024 (0.0002)	3.602 (0.0002)
Governance structure	15.0001 (0.0000)	15.0001 (0.0000)

The existence of unit roots is indicated by a p-value greater than 0.05 for both the Phillips-Perron test and the enhanced Dickey-Fuller test, while the absence of unit roots is indicated by a p-value less than 0.05 for both tests. No unit root was found to exist for any of the investigated variables. This proved that all of the variables are stationary, that the unit root test was successful, and that the data is ready for statistical analysis.

4.2.3 Hausman Test

Researchers looked at the pros and cons of using a model with fixed effects versus a model with random effects for analysing panel data. Random effects are assumed in the null hypothesis, whereas fixed effects are considered in the alternative. A p-value less than 5% indicated that FEM should be chosen, whereas a p-value greater than 5% indicated that REM should be chosen. Table 4 shows the outcomes.

Table 4

Hausman Test

	(b) Fixed	(B) Random	(b-B) Difference	$\sqrt{\text{diag}(V_b - V_B)} \text{S.E.}$
Governance structure	0.639906	0.22553	0.414376	0.088956
Prob>chi2 = 0.0034				

Table 4 shows that the prob>chi2 value is 0.0034, which is less than the essential P value at the 0.05 level of significance, indicating that the model with a random effect is not the best option. For this reason, the analysis used a regression model with a fixed effect.

4.2.4 Regression Analysis

The intention of this investigation was to figure out whether or not Kenyan microfinance banks' governance arrangements affected their financial standing. H₀: There is no relationship between microfinance banks' governance structures and their financial results in Kenya. The outcomes are shown in Table 5.



Table 5
Linear Regression Analysis

Financial Performance	Coef.	Std. Err.	T	P>t	[95% Conf. Interval]	
Governance Structure	0.639906	0.279039	2.30	0.034	0.42256	0.802375
_cons	6.24262	0.836106	7.47	0.000	4.564067	7.921174
R-sq: overall = 0.1608			Number of obs =		65	
F(1,51) =			5.22		Number of groups =	
Prob > chi2 =			0.0343		13	

In this bivariate analysis, the study demonstrates that the panels were quite evenly distributed in terms of events. Fixed effect model results showed that governance structure was responsible for 16.08% of the variance in financial performance across Kenya's microfinance institutions (overall R square = 0.1608). The analysis of variance statistics evaluates the overall efficacy of the model. The model's F-statistic of 5.22 is more than zero, suggesting that the parameter estimates are not all in the range of zero. This suggests that Kenya's microfinance banks' financial results are affected by their governance structure. This effect is statistically significant ($P < 0.05$).

With a p-value of 0.034, the calculated coefficient of the system of governance is substantially different from zero ($= 0.639906$, $t = 2.30$). Given that the likelihood ratio is less than 0.05, the predicted coefficient is statistically significant at the 5% level. Increasing the system of governance by one unit is expected to boost financial results by 0.639906 units, as shown by the calculated coefficient related to the governance architecture. The significance of the term that constitutes a constant is shown by a p-value of less than 0.05. Below is a representation of the regression model.

$$\text{Financial performance} = 6.24262 + 0.639906 \text{ Government Structure (GS)}$$

Consequently, the research concluded that there is an impact of the governance framework on the financial results of microfinance banks in Kenya, thereby rejecting the null assumption. This suggests that better management of Kenya's microfinance institutions will improve their bottom line.

Sheikh et al. (2021), who studied the implications of the board's makeup on the profitability of microfinance institutions in Nairobi County, corroborate these findings. The research found that the financial health of MFIs in Nairobi County had a substantial beneficial effect on the makeup of their boards. Ehugbo (2021) studied how different corporate board qualities impacted the success of Nigeria's microfinance institutions. The results of the hypothesis tests show that executive autonomy has a beneficial connection with microfinance banks' investment return on assets. The effect of the corporate framework on the financial results of Nigerian microfinance banks was studied by Oyebanji (2022). Corporate framework, the research found, is a powerful instrument for boosting performance and assuring the continuing existence and adaptability of MFBs.

V. CONCLUSIONS & RECOMMENDATIONS

5.1 Conclusions

Board composition (ratio of executive to non-executive) had a mean of 0.352, while the number of board audit committee members had a mean of 4 members. Numbers from a Panel The financial health of Kenya's microfinance banks was shown to have a moderately significant advantageous link with the banks' governance structures, as determined by a Pearson correlation test. According to a fixed-effects regression model investigation, the governance structure of microfinance institutions in Kenya accounts for 16.08% of the variance in their financial outcomes. A unit change in governance structure would result in a significant change in financial performance in the same direction. The results of the investigation illustrate that the structure of governance has a good impact on financial results. Boosting the governance architecture would considerably enhance financial results. The null hypothesis was not supported.

5.2 Recommendations

These outcomes suggest that shareholders ought to prioritise a board with members from a variety of industries and backgrounds in order to benefit from new perspectives. Additionally, Kenyan microfinance institutions should work to improve the quality of their board of directors by routinely performing induction and reviewing the directors' roles. Regardless of the type of governance structure, it is important to review and update it regularly to ensure that it is still effective and meets the needs of the organisation.

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