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Corporate Governance and Financial Performance of Deposit Taking Micro Finance Institutions in Kenya

Kiruja Kagwiria Doreen, MBA[1] Margaret Kosgei, PhD[2]
1. *MBA Student, Kenyatta University: P.O Box 43844, 00100 Nairobi, Kenya.*
2. *School of Business, Kenyatta University: P.O Box 43844, 00100 Nairobi, Kenya.*

Abstract
Although deposit taking micro finance institutions in Kenya have shown wide outreach in recent years, as per Central Bank of Kenya statistics their financial performance have shown a downward trend, Return on equity declined from year 2015 to the year 2017, this may be well connected to how they are governed. The financial performance of DTMFIs are very important in achieving poverty reduction mission and sustainability goal. The key aim of this study therefore was to inquire into the effect of corporate governance on financial performance of DTMFIs in Kenya. Particular objectives were to evaluate the influence of board diversity, size and Committees on financial performance of DTMFIs in Kenya. The study was directed by Stakeholders, Agency and Stewardship theory. Panel regression model to study the relationship between corporate governance variables and financial performance was used. From the regression analysis, board diversity, board size and board committees had p-values of 0.02,0.00 and 0.01 respectively an indication that they had significant effect on the financial performance of DTMFIs in Kenya consequently all the null hypotheses were rejected. Therefore, the study concluded that corporate governance affects the financial performance of the DTMFIs in Kenya. The study recommends the management of DTMFIs in Kenya should seek to have a diversified board composition of different ages as they poses a variety of experience, leadership styles and skills that may improve the financial performance. The study also recommends the Government of Kenya in putting up laws and legislation to guide the management of deposit taking microfinance institutions in Kenya to have an optimum board size. This can be achieved by incorporating in the existing laws or regulations on the maximum and minimum number of board size at any given time.

Key words: *Board committees, board size, corporate governance, deposit taking microfinance institution, financial performance and return on equity.*

List of acronyms
DTMFI : Deposit Taking Microfinance Institution
ROE : Return on Equity

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I. Introduction and Background

Accessibility to financial services are critical to the development of any enterprise. Microfinance institutions therefore create an avenue through which ultimate savers and investors interact for their common good, they provide accessibity to financial and other support services thereby improving quality life of the needy people (Munene, 2014). Micro finance institutions plays a big role in empowering communities and especially women, they provide training to help them optimally utilize available resources to advance their enterprises and create self-employment. Micro finance institutions in addition helps in providing extra support resource to the needy e.g creating opportunities to the poor to help them learn on how to move from poverty faster thereby creating sustainable communities.

Microfinance institutions provides wage and capital allocation that is equitable in the SME's sector (Mutuku, 2017). Consequently in Kenya Microfinance Institutions Act was enacted in the year 2006 and came into play in the year 2008. With the adoption of this act, regulations and the establishment of such institutions is through licensing and supervision. There are three categories of micro finance institutions deposit, non-deposit and NGO lead institutions. Micro finance Act made it possible to accommodate public deposits. This has promoted efficiency, competition and access in the financial sector.

In many parts of the world microfinance sector is a prime instrument in eradicating poverty. Bangladesh for instant, micro finance sector has experienced growth leading to emergence of banks like gramean bank, poshika bank, and Bangladesh rural advancement. This has impacted on poverty reduction among the poor in the country. On a regional perspective Nigeria for example in 2007 established and licensed micro finance banks substituting community micro finance to help in dropping poverty level in the country. The regulation is done by central bank of Nigeria. (Tawio, *et al* 2011).

Microfinance institution performance is measured and it's reflected in traditional accounting ratios which include ROE, ROI and in earnings per share. These results come about by analyzing and measuring institutions operations and policies in monetary terms. Financial performance determines institutions outreach and depth in service provision. Financial accounting ratios expresses firm's results. The main reason for use of accounting ratios is profit since organization long term objective is purely financial. According to (Thomsen & Pedersen, 2008) additionally accounting ratios gives an entire perspective of corporation accomplishment.

Additionally corporate governance is integral in contributing to financial performance of DTMFI's. A research by (Hartarska, 2004) states that governance provides systems that ensures funds contributed by various stakeholders are put into proper investment where transparency and accountability prevails. Agency theory by ((Jensen and Meckling, 1976)), reveals that different investors and managers have varying preferences then control systems are important to ensure all stakeholders concerns are taken into account. Agency cost may arise due to conflict between investors and managers. Therefore governance mechanism help to reduce such costs. Corporate governance involves the board and thus board size, board committees, and board diversity are paramount in constituting good corporate governance

Financial scandals in the past especially economies that are developing has brought in the need to look at corporate governance. At international level, due to corporates collapsing as a results of weak systems which are brought about by poor governance then this has brought the need to put strong corporate governance to ensure success of these corporations. For examples the collapse of Enron, Parmalat and other similar cases due to poor governance has made countries to put measures to avoid repeat of similar cases by ensuring good corporate governance.

The past few decades the environs in which enterprises are operating is quickly changing. According to (Shleifer & Vishny, 1997; Dewji & Miller, 2013), key points to note in a changing environment is aligning organization strategies in line with environmental and stakeholders forces, good corporate governance and financing structure to ensure organisation success.

Good corporate governance provides systems that help organisations to operate efficiently and effectively by promoting transparency, accountability, improved access to capital and being able to mitigate risk and safeguard assets against mismanagement. Organisations becomes more acceptable to investors since they are able to responds to their needs and needs of all stakeholders in a transparent way. Access to resources, investments, economic growth and development and opportunities for jobs can also be contributed by having t good corporate governance principles. Hence, by implementing the right corporate governance helps organization to be competitive and sustainable.

In Uganda for example having good corporate governance practices has brought about the success of micro finance sector. Members are reluctant into joining MFIs, especially SACCOs, where corporate governance is not strong and no opportunities that would generate income. (Mpiira *et al,* 2007). A study by (Labie, P., & Perilluex, A. ,2008) points that having inexperience directors on board, poor management and board relationships, and limited individual influence are challenges faced by micro finance institutions.

In Kenya the Mwongozo, defines corporate governance as the foundation and guidelines, enactment and procedures in which a firm is directed, controlled and held responsible. It comprises of supremacy, responsibility, oversight, guidance, direction and control applied in organizations. It mainly entails having a balance of interests all stakeholders in the organization. Some of these stakeholders include government, financiers, customers, management among others.

The need for MFI to revolve as deposit taking micro finance institutions calls for a need to embrace good corporate governance mechanism so as to ensure sustainable performance. In Kenya most MFI get funding from donors and wholesalers which are expensive and thus they have resulted in other sources of funds such as public deposits in order to finance their activities and expansion, informing importance for good corporate governance from all stakeholders. According to a study (Journal of banking& finance Mpra paper no. 3887, Agder University Norway) on performance and corporate governance of micro finance institutions found that Board Committees, board Size and having a female on the board influences performance of the institutions

II. Research Problem

According to the Statistics by the CBK Regulator, Deposit taking micro finance institutions financial performance has been on downward trend. Annual supervisory report (CBK, 2016) the micro finance profits before tax decreased by 169% from 548 million to Ksh 372 million. This was mainly attributed to decline of 62% on financial income on investment. Governance plays a key role in steering investment in an organisation to ensure good financial performance. In the same year Return on Equity declined from 5% in year 2015 to -3.2% in year 2016. This was an earth-shattering decline that lasted for three successive financial years.

By the end of year 2017, 70% of micro finance businesses had reflected losses in their performance bottom line this raised questions on a sector which was considered to provide financial exclusion in the country. Consequently in the year 2018 there was a decline in profits, customer deposits and core capital in MFI sector in Kenya. This promoted CBK to seek amendment for the micro finance law, to push for hardy core capital and governance rules and to issue a buffer opposing potential financial downturns. These changes would create transparency, resilience and stale micro finance banking sector with capability in adapting to emerging risks, challenges and opportunities. Deposit Taking Micro Finance institution use public deposits to finance their investments and expansion thus corporate governance is of great necessity in ensuring they utilize the resources and record good financial performance.

Although some studies examined corporate governance and financial performance on micro finance institution Empirical literature on governance issue in microfinance is still scarce. A study by (Grace, 2018) on Corporate Governance, strategies and Performance of Financial Institutions in Kenya using descriptive statistics and primary data, found that when agency tensions are minimized and companies enforce good business methods that match policies with overall company goals, optimum efficiency is achieved, the researcher recommends further studies using alternative research methods or alternative source of data like secondary data.

A study by (Mashiya, 2016) looked at what determines performance of micro finance institutions in Nairobi County, researcher used descriptive research methodology and the outcome showed that corporate governance influences financial performance of MFI's however the researcher examined only board diversity as the variable.

A study by (Jackson, 2007) on the contrary, indicated that corporate governance influences firm performance. A study by (Adams & Mehran, 2011) found out that corporate governance had no correlation on financial performance. I addition (Narwal & Jindal, 2015) did a study and the outcome showed corporate governance does not significantly influence organizational performance. This indicate a gap in literature on whether corporate governance influences financial performance of a firm.

Most studies examined above have not provided a conclusive findings on whether financial performance of DTMFI's is influenced by corporate governance. Further, most empirical studies have focused only on financial firms (Adams and Mehran, 2011; Narwal & Jindal, 2015; Jackson, 2017; Kamau G, 2018), Commercial Banks (Josephine 2017; mugurwe, 2018) and Microfinance institutions in general (Mohamed, Abdi et al (2014); Waithaka, Gakure, 2012;). The literature on Deposit Taking within Microfinance tends to be ignored. It is against this base that this research focused on adding to the literature by evaluating the outcome of Corporate governance on financial performance among DTMFI`s in Kenya.

III. Objectives

The overall objective of this study aimed to investigate effect of Corporate Governance on financial performance of Kenya's DTMFIs. The study also sought to address the following specific objectives:

a) To find out influence of board diversity on performance of Deposit Taking Micro Finance Institutions in Kenya.

b) To establish influence of board size on financial performance of Deposit Taking Microfinance Institutions in Kenya.

c) To evaluate the influence of board committees on financial performance of Deposit taking microfinance institutions in Kenya

Research hypotheses were formulated for each specific objective.

IV. Review of Literature

a. Theoretical Review

The study was anchored on Agency theory, stakeholder's theory and stewardship theory. The agency theory was formulated by Jensen and Meckling (1976). This theory state that if ownership and control is separated in modern organisations it can lead to conflict arising from many sources. The theory assumes that due to incentive effect, firm's performance increases with higher levels of managerial ownership. Therefore separation of ownership from control may create a conflict between owners and management since managers do not benefit from 100% profits which arise from their professionalism and experience in managing the organisation, although they bear the costs of these activities. In such situation managers may not optimally manage the organisation and may even not promote activities aimed at growing the organisation unless they benefit them.

The applicability of this theory to the study was that financial performance can be negatively affected if there arise agency costs which can make loss of significant worth to investors. Since governance basically involves the management (agents) and stakeholders (principals) then agency problem may arise. The aim of governance mechanisms is to lower agency costs through alignment of principal-agent objectives to that of the manager-agent. The need of agency theory in this manner is to address issues emerging from separation amongst management and ownership caused by contrasting objectives and motivation amongst owners and administrators.

Stewardship theory by Davis, Schoorman, and Donaldson (1997) is rather a new notion (Karns, 2011) The assumption of the theory is that managers are agents authorized to manage the organisation and they exhibit conduct and goals same as the investors. Additionally according to this theory companies aim is to add value to people's lives by serving customers, employees and the community. Under this theory protection of stakeholders interest are vested on firms executive and they are also supposed to represent them in decisions making .Executive's main goal is to create organisation that are recording growth in their operations. Firms that embrace stewardship place governance responsibilities to board of directors, these directors should come from insiders of organisation since they are more knowledgeable about the organisation and will be deemed to be more committed.

Management makes decisions considering a group's interest rather than individual. The more group satisfaction, more wealth is created, and the greater the financial rewards. Additionally deposit taking micro finance institution provide services to stakeholders to improve their wellbeing and financial performance is seen as critical and valuable tool in helping by providing funds to meet this goal of serving its stakeholders. Hence aspects of corporate governance such as Board committees, optimal board size, and Board diversity provides stewardship towards success of the organization.

Evolved by Edward Freeman in 1984 (Emerson *et al.,* 2011) stakeholders theory assumes that business should not be operated in a vacuum but should go beyond it corporate boundaries and incorporate the needs of all its stakeholders both internal and external stakeholders. This does not imply that the organisation fails to focus on profits. Besides, the theory advocates for positive operating profits (Emerson, Alves, & Raposo, 2011). Gains are important in organisations tenability.

Stakeholder's theory was applicable in this study because it requires building relationship between the company and shareholders. These relationships help in coming up with structures in governance that upgrade coordination not only on principal and agent but also on all other stakeholders. Smallman (2004) has criticized this theory and argues that the theory has given more focus on issues of who constitutes genuine stakeholders. Additionally, protecting stakeholders' expectations can also lead to dishonesty, as it can give agents a chance to divert wealth away from owners.

b. Empirical Review

The study reviewed empirical literature so as to document the research gaps. Wanjau (2007) examined the relationship between board diversity in terms of gender diversity and the financial performance of Kenyan commercial banks. Researcher examines gender, skills of board members and leadership of board members as the independent variables. Descriptive statistics was used and the findings were that board gender diversity negatively relates to the financial performance of Kenyan commercial banks. Recommendations from the study was to apply large data in a different context. This research covered three year data year 2015-2017 on DTMFI's in Kenya.

Neema (2014) did a study on director's diversity and board performance on micro finance institutions in east Africa. The researcher surveyed 105 board directors in 63 MIF's covering Kenya, Uganda and Tanzania. The findings showed that director's age and their education level positively related to board performance. However having a female director on board did not show any evidence. These findings indicate that appointment of directors should be based on director's ability to perform. This study researched on gender, number of Board committees and Board size as the variables.

Thrikawala (2018) did a study on gender diversity and financial performance of Sri Lankan MFIs. The study was for the period 2007-2012 on 300 firms. The unbalanced panel data was analyzed using OLS regression model, random and fixed effect models. The results showed that having female director on the Board negatively relates to financial performance while having a Ceo and Chairman who is a female positively relates to the financial performance.

Kibuchi (2010) did a research on corporate governance and financial performance of companies listed in NSE. Casual research design was adopted. Multiple regression model was assumed to evaluate the relationship. Findings occurred as other facets of corporate governance displayed a favorable association and others exhibited a negative correlation. The study recommended that board size be maintained as small as possible however did not indicate the number, the study also found that financial performance decreases as board size become large. However, board size must be maintained at optimal because having small Board size can results to inefficiencies in their performance. However this study showed mixed results.

Oganda (2016) examined effect of board size on the financial performance of merged establishments using mixed methodology research design. Purposive sampling was used. The outcome of the inquiry indicated board size had a notable correlation amid financial performance of merged institutions. The study recommendations were board size of 6-8 members because this enhances effective and efficient monitoring and decision making processes and it also creates cohesion among board members. This study adopted census sampling.

Jackson (2007) investigated the influence of corporate governance in the performance of micro-finance institutions in Kenya, used survey design. The target population were all 15 MFIs registered. Questionnaires were used to gather the data needed to draw conclusion. Descriptive statistics was embraced in analyzing the data collected. This inquiry established a correlation among various corporate governance mechanisms and organization's performance. In particular board size positively related to organisations yield. It then implies that having a big board translates to rise in income. However this study did not give any recommendations on the number board size. This study looked further into investigating such recommendations, also panel data analysis yielded better results.

Puni (2015) examined committees of the board and corporate ROE in the listed companies on the GSE. Data covering year 2006 to year 2010 was gathered. Sources of this data was annual financial reports of companies under study. Static panel data analysis was done. The study assumed descriptive research design. The research results showed that board committees insignificantly affected financial performance of listed companies. Researcher recommended transparency in selection process since it will strengthen board committees.

V. Methodology

The study was quantitative in nature hence the adoption of descriptive research design. Descriptive studies are the process of the compilation and examination of quantitative data in order to explain the individual phenomena through its latest patterns, incidents and linkages at the present time. Creswell (2013) found research of a descriptive design to be effective when the results explain a situation very accurately by analyzing events very deeply and making good decisions as a result.

All the 13 DTMFI's in Kenya that were in existence, registered and licensed since the year 2015 to the year 2017 were the target population. The sample size was 12 DTMFI's this was informed by unavailability of data on one DTMFI - Maisha Microfinance bank Ltd - since it was licensed in May 2016. The study adopted census approach on 12 (twelve) DTMFI's. The data was collected from secondary sources. The source of data was Central bank of Kenya (CBK) annual supervisory reports. The analysis of data was aided by R software in respect to the panel multiple regression model structure. This data analytics happened by way of inferential and descriptive statistics to draw conclusion. The regression model adopted is indicated below:

$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \epsilon_{it}$

Where Y_{it} – Financial Performance (ROE)

β_0 - Constant

X_{1it} – Board Size for firm i at time t

X_{2it} – Board diversity for firm i at time t

X_{3it} – Board Committees for firm i at time t

$\beta_1 - \beta_3$ –slopes of regression equation.

ϵ_{it} - Random error representing any variable not included in the model.

i – Represent the institution

t – Represent (year)

VI. Results, Findings and Discussion

The section provides a summarized analysis of the data that was collected using data collection tools as stipulated in research methodology. The results are presented in form of correlation analysis, inferential and descriptive statistics. The results are compared to the results of other studies and the key findings of this study are also indicated.

a) Correlation Analysis

The Karl Pearson Correlation Coefficient was used to test the relationship between ROE and the independent variables (board diversity, size and committees). The correlation analysis was carried out with a 95% confidence level. The outcome points that board diversity by age and financial performance (ROE) are connected to each other in a constructive and meaningful way ($r= 0.625$, $p=0.000$). The results concur with Neema (2014) who concluded that there was a positive relationship between ROE and director's age of DTMFIs in Kenya. However, the relationship between board diversity by gender ROE could not be established as it was statistically insignificant.

The results also indicate that board size and financial performance (ROE) are significantly and positively related with ($r= 0.753$, $p=0.000$). The results concur with Oganda (2016) who noted that the board size enhances the effectiveness and efficiency and it also creates cohesion among board members. Correlation results indicated that board committees and financial performance (ROE) are positively related with (p=0.001, r= 0.332).

b) Diagnostic Tests

Four diagnostic tests were done prior undertaking the regression analysis. These were the autocorrelation, normality, multicollinearity, panel unit root, heteroscedasticity, and hausman tests. The study used variance inflation factors (VIF) to test for multicollinearity which indicated that there were multicollinearity issues as the VIF>10. This was resolved by eliminating board diversity by gender. Normality test was done using shapiro- Wilk test and indicated normality as the values were greater than 0.05. For heteroscedasticity test, the study used the breusch-pagan test that indicated a value of P>0.05 thus the data didn't suffer from statistically significant heteroscedasticity.

Autocorrelation test indicated that p= 0.562 which is (p>0.05) and we conclude that there is absence of serial correlation. This therefore means that the model is optimal and has attained minimum variance. For the model specification test, the value of the hausman test is 0.4163>0.05, thus the random effects are independent of the explanatory variables. Therefore, the random effect estimator is used to analyse the regression model.

c) Multiple Regression Analysis

The results indicate that all the independent variables (board diversity, board size and board committees) had positive influence on financial performance undertaken by DTMFIs. Results show that the p-values of board diversity, board size, board committees were less than 5% hence they are statistically significant. The findings indicate that a growth of 1 unit in board diversity brings about an increase of 19.831 units increase of ROE so long as the other variables are held constant. Also, a unit growth of board size leads to a growth of 24.234 units of ROE and a unit increase of board committees leads to a growth of ROE by 19.107 units. Therefore, the multiple regression model is;

$ROE_{it} = -1450.2 + 19.831X_{1it} + 24.234X_{2it} + 19.107X_{3it}$

Where: ROE_{it} – Return on equity for DTMFI at time t

X_{1it} – Board diversity for DTMFI at time t

X_{2it} – Board size for DTMFI at time t

X_{3it} – Board committees for DTMFI at time t

i – Represent the institution DTMFI

t – Represent (year)

VII. Conclusion and Recommendations

The study concluded that corporate governance affects the financial performance of the DTMFIs in Kenya. From the findings board diversity has a notable impact on financial performance of DTMFIs in Kenya. Therefore, financial performance of DTMFIs is influenced by board diversity. However, the relationship between board diversity in terms of gender and ROE could not be established as the data on gender could not meet the assumptions of classical linear regression models; that is, it had significant multicollinearity issues.

The study also concluded that board size has a significant effect on financial performance of DTMFIs in Kenya. Therefore, board size is used by the DTMFIs in Kenya so as to gain more ROE. Lastly, the study concludes that board committees have a significant effect on financial performance of Kenya's DTMFIs.

The study recommends the management of DTMFIs in Kenya should seek to have a diversified board composition of different ages as they poses a variety of experience, leadership styles and skills that may improve the financial performance. For instance, when making critical decisions pertaining the financial status of a firm, it is crucial that the board to try to foresee the future trends that may be informed by the past experiences acquired by the board members.

The study also recommends the Government of Kenya in putting up laws and legislation to guide the management of DTMFIs in Kenya to have an optimum board size. This can be achieved by incorporating in the existing laws or regulations on the maximum and minimum number of board size at any given time. The board size should not be too large to create bureaucracy nor too small to lack in experience and diversified leadership.

Additionally the study suggest that the management of DTMFIs in Kenya to have a higher number of committees. The benefit of having several committees is that it provides more insight to issues that are to be considered by the main board.

Areas for Further Studies

Notable gap was noted from the study as the relationship between board diversity in terms of gender and ROE could not be established as the data on gender could not meet the assumptions of classical linear regression models; that is, it had significant multicollinearity issues. The study recommends that a study should be done on the effects of board diversity in terms of gender on the financial performance of the DTMFIs in Kenya by increasing the size of data. This can be achieved by focusing on a longer span of data.

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