

Does Funding Structure Mediate the Relationship Between Corporate Governance and Financial Performance? Evidence from Deposit Taking Sacco's in Kenya

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Abstract

The study focused on assessing how the funding structure mediates the relationship between corporate governance (CG) and financial performance (FP) in deposit-taking Savings and Credit Cooperative Organizations (SACCOs) in Kenya from 2018 to 2022. The research covered all 172 deposit-taking SACCOs in Kenya, using longitudinal data sourced from annual financial reports and supervision reports by the Sacco Societies Regulatory Authority (SASRA). To estimate the relationships, the fixed effect model was utilized, justified by the Hausman specification test. The findings indicated that the funding structure acts as a partial mediator in the CG-FP relationship. This implies that while CG has a direct impact on FP, the funding structure also significantly influences this relationship. These findings are critical for theoretical development, as they enhance the understanding of how CG affects FP through the funding structure. Moreover, the results have significant policy implications. For regulators like SASRA, the findings provide insights into crafting policies that strengthen CG practices to improve FP within SACCOs. For SACCO management, the study offers guidance on developing strategies that align their funding structures with effective governance practices to achieve better financial outcomes.

Keywords: Corporate Governance, Funding Structure, Financial Performance; Deposit Taking SACCO's.

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1. Introduction

The nexus between corporate governance (CG) and financial performance (FP) has been extensively researched worldwide, with ongoing debates about their direct correlation still remaining elusive. Effective CG mechanisms are widely acknowledged for their potential to boost FP by promoting sustainable and inclusive growth within the corporate sector (Bawuah, 2023). It enables the boards to effectively and constantly oversee the management team's operations. Moreover, CG fosters a strong culture of ethics, core values, integrity, steadfastness, and fair dealings among entities. Companies that implement robust governance practices are believed to achieve greater operational aptitude and superior access to external resources at minimal costs, hence scaling down their overall capital expenses. These improvements are mainly due to amplified trust and confidence from stockholders, rating agencies, and clients, which are vital for financial growth (Indrawati, & Hanif, 2023). However, the costs related with instituting and maintaining these governance mechanisms within an organization often lead to questions about their overall benefit, as the financial and administrative burdens may sometimes negate the advantages. Thus, the discussion persists on whether the long-term financial gains outweigh the immediate costs of implementing rigorous CG practices, highlighting a complex and nuanced issue in corporate finance inquiries (Dwaikat, 2023).

The nexus between CG and FP is considerably influenced by the firm's funding structure. Robust CG typically contributes to a more advantageous funding structure, which in turn enhances FP. For instance, companies with strong governance frameworks often secure debt capital at lower interest rates due to reduced perceived risk, directly lowering financial costs and boosting profitability (Fatmasari & Mardiana, 2023). Moreover, exemplary governance practices increase investor confidence, facilitating the attraction of equity investments that provide the necessary capital for profitable ventures. Effective CG also enhances a firm's creditworthiness and reduces information asymmetry, making external financing more accessible and affordable. As a result, firms with strong CG are more likely to achieve an optimal capital structure, efficiently balancing debt and equity. This balance leverages the benefits of debt's tax advantages while mitigating the risks of financial distress, thus acting as a crucial channel through which effective CG translates into improved FP (Queiri, 2024).

The funding structure of deposit-taking SACCOs in Kenya consists of a diverse set of strategies aimed at maintaining the solidity, lucidity, and dependability of their financial operations. SACCOs obtain funds from various sources such as member deposits, share capital, retained earnings, and occasionally external borrowings, all of which are essential for ensuring financial strength (Mwatu & Abdul, 2018). Member deposits serve as the primary source of capital for SACCOs, supporting their lending and investment actions. Share capital, contributed by members, acts as a vital safeguard against prospective losses and helps uphold capital adequacy, thereby enhancing financial solvency and steadiness. Retained earnings enable

SACCOs to reinvest profits into their operations, promoting sustainable growth and resilience. External borrowings, although less frequent, provide additional capital during periods of increased demand or expansion but require careful management to avoid excessive debt. Effective management of these funding sources ensures SACCOs maintain sufficient liquidity to meet short-term obligations and manage risks effectively, preventing disruptions in member services (Ofoeda, 2017). Ultimately, this well-structured funding framework not only helps SACCOs achieve operational resilience and stability but also fosters an environment conducive to sustainable growth and protects the interests of stakeholders within Kenya's financial sector.

In Kenya, deposit-taking SACCOs encounter a continuum of complex challenges, including stringent regulatory compliance requirements, issues with transparency and accountability, and the need to sustain diverse stakeholder trust in a highly competitive financial landscape. Implementing robust CG practices, while essential, can be both costly and complex (Odhiambo, 2019). However, these practices are crucial for enhancing their financial stability and performance. Effective CG mechanisms allow Kenyan SACCOs to improve their reputations, facilitate easier access to external funding, and reduce their overall capital costs. Ultimately, this leads to better FP. Therefore, addressing these challenges through strong governance practices is imperative for SACCOs to achieve sustainable growth and maintain financial well-being.

1.1 Objective of the Study

To determine the mediating effect of funding structure on the relationship between corporate governance and financial performance of deposit taking Sacco's in Kenya.

1.2 Research Hypothesis

There is no statistically significant mediating effect of funding structure on the relationship between corporate governance and financial performance of deposit taking Sacco's in Kenya.

2. Literature Review

The literature review encompasses both theoretical and empirical investigations into the relationship between CG, funding structure and FP.

2.1 Theoretical Literature

The current study is anchored on the free cash flow theory. Jensen (1986) introduced the free cash flow (FCF) theory, which explores how entities with ample cash flows may face agency issues where managers prioritize their interests over shareholders'. According to the FCF theory, excessive free cash flow can entice executives to invest in low-return projects or expand for personal gain rather than maximizing shareholder value. Debt, as emphasized in the theory, imposes discipline by obligating regular interest payments, thereby constraining managerial discretion

and reducing wasteful spending risks (Tahir, 2020). This financial leverage serves as a mechanism to monitor and align managerial actions with shareholder interests, ensuring that cash flow is used efficiently to enhance firm performance.

The FCF theory underscores the importance of CG in overseeing the use of free cash flow and maintaining financial discipline. Successful CG practices, such as independent board oversight and clear reporting, play a crucial role in monitoring managerial decisions regarding funding structure, whether through debt or equity financing. Managers under pressure from debt obligations are motivated to allocate resources prudently, aiming to meet financial commitments and enhance FP (Mahrani & Soewarno, 2018). Conversely, equity financing represents a commitment to shareholders, aligning managerial incentives with maximizing shareholder value by prioritizing profitable investments over excessive cash holdings (Uzma, 2018).

In the context of SACCOs, the FCF theory suggests that funding structure comprising deposits and external borrowings mediates the relationship between CG and FP. SACCOs that rely on deposits from members demonstrate answerability through dividend payouts and transparency in financial operations, aligning managerial actions with member interests (Affes & Jarboui, 2022). Conversely, SACCOs leveraging on debt must adhere to stringent covenants and interest obligations, fostering financial discipline and ensuring funds are directed towards productive uses that enhance SACCO performance. Therefore, optimizing the funding structure under effective CG practices mitigates agency problems, supports liquidity management, and strengthens financial health, ultimately contributing to improved FP and stakeholder satisfaction.

2.2 Empirical Literature

The empirical studies reviewed explored the intricate relationships among CG, funding structure, FP. A study by Bokhari et al. (2019) on publicly traded textile companies in Pakistan found that specific dimensions of CG, such as the auditing committee, board size, and autonomy, significantly impact firms' return on assets (ROA), indicating the critical role of CG practices in FP within the textile sector. Conversely, Ferriswara et al. (2022), focusing on firms within the Jakarta Islamic Index, revealed that CG influences FP indirectly through capital structure decisions, emphasizing factors like audit committee independence and board composition. Bokhari et al. (2019) highlighted the positive effects of dividend policies and earnings per share on FP, reflecting broader financial influences alongside governance, while Ferriswara et al. (2022) emphasized the mediating role of capital structure metrics like debt ratios in linking CG to FP indicators such as return on equity (ROE) and ROA. These contrasting findings underscore how sector-specific contexts and governance practices shape the relationship between CG and FP across different markets.

In Pakistan, Shahzad and Zulfiqar (2022) focused on the sugar industry, examining how CG dimensions such as CEO duality and board size influence FP while being mediated by capital structure. Despite limitations in sample size and sector specificity, their study reveals significant links between CG practices, capital structure decisions, and financial outcomes, illustrating industry-specific aspects in governance impacts on FP. The findings of this study are consistent with those of Amed and Hossain (2019) who validated the mediating role of capital structure on the relationship between CG and FP.

Similarly, Okiro (2014) extend this inquiry to the East African region, encompassing Rwanda, Burundi, Tanzania, Kenya, and Uganda. The study integrates CG variables like board composition, transparency, and ownership structure with capital structure metrics to explore their collective impact on FP, measured through ROA. By adopting a pooled OLS approach across multiple listed firms, the outcomes highlight a positive correlation between effective CG practices, optimal capital structure management, and improved performance, emphasizing regional variations in governance dynamics and their implications for FP.

3. Methodology

The research utilized a descriptive longitudinal design to investigate how funding structure mediates the linkage between CG and FP among deposit-taking SACCOs in Kenya. The research encompassed a population of 172 licensed deposit taking SACCOs, for which a census approach was employed due to small population size. However, the final dataset was sourced from 163 deposit taking SACCOs owing to missing data from nine deposit taking SACCOs. By analyzing longitudinal data over a five-year period, the research sought to uncover patterns and relationships that highlight how CG practices influence the funding decisions of SACCOs and subsequently affect their FP.

3.1 Data

This study employed secondary data collected via data collection sheet to investigate CG attributes, funding structure and FP of 172 deposit-taking SACCOs in Kenya. CG attributes such as board activity, board size, financial expertise, independence, and gender diversity were examined, alongside funding structure in form of deposit and non-deposit funding. FP was assessed using Return on Assets (ROA). Data spanning 2018 to 2022 was extracted from SACCOs' annual financial reports and SASRA's supervision reports, enabling a longitudinal analysis of how these factors influenced SACCO performance.

3.2 Empirical Model

Panel regression was utilized in this study to estimate the parameters, providing several advantages for analyzing longitudinal data across multiple SACCOs spanning five years. This method integrates both time-series and cross-sectional variations in the dataset, which leads to more robust and efficient estimates

compared to using traditional methods that focus solely on cross-sectional or time-series data. By aggregating data from numerous SACCOs over the years, panel regression strengthens statistical power and effectively manages unobserved differences among SACCOs. This approach is particularly beneficial for this study as it allows for a thorough examination of how fluctuations in CG, funding structure, and SACCO FP consistently occur over the study period. The causal steps strategy popularized by Baron and Kenny was utilized to assess mediation as follows;

$$FP_{it} = \beta_0 + \beta_1 CG_{it} + \epsilon_{it} \quad (1)$$

$$FS_{it} = \beta_0 + \beta_1 CG_{it} + \epsilon_{it} \quad (2)$$

$$FP_{it} = \beta_0 + \beta_1 CG_{it} + \beta_2 FS_{it} + \epsilon_{it} \quad (3)$$

Where:

FP = Financial performance

CG = Corporate governance

FS = Funding structure

β_0 = Regression constant

β_1, β_2 = Regression coefficients

4. Main Results

4.1 Descriptive Statistics

The descriptive statistics for the study variables are presented in Table 1.

Table1: Descriptive Statistics

Variable	N	Mean	Standard Deviation
Corporate Governance	815	1.42	0.07
Funding Structure	815	0.67	0.11
Financial Performance	815	0.02	0.05

Table 1 present's descriptive statistics for three key variables related to deposit-taking SACCOs in Kenya, based on 815 observations. CG had a mean score of 1.42 with a standard deviation of 0.07, indicating generally strong governance practices among the SACCOs sampled. This suggests that these SACCOs tend to adhere closely to governance principles and frameworks set forth by regulatory bodies. The "funding structure reported a mean of 0.67 and a standard deviation of 0.11, highlighting moderate variability in how SACCOs structure their funding sources, including member deposits, earnings retained, and external borrowings. This variability could influence their financial viability and growth strategies. Finally, FP is represented with a mean of 0.02 and a standard deviation of 0.05, indicating relatively stable FP outcomes across the sampled SACCOs.

4.2 Correlation Analysis

The correlation analysis results based on Pearson's method is outlined in Table 2.

Table 2: Pearson's Correlations Analysis Results

Variable	Corporate Governance	Funding Structure	Financial Performance
Corporate Governance	1		
Funding Structure	0.63	1	
Financial Performance	0.81*	0.84*	1

Table 2 presents the Pearson's correlation analysis results for the study variables, focusing on the relationships among CG, funding structure, and FP of deposit-taking SACCOs in Kenya. The correlation coefficient between CG and funding structure is 0.63, indicating a moderately positive relationship, which suggests that better CG is associated with an improved funding structure. Furthermore, the correlation between CG and FP is 0.81, showing a strong positive significant relationship and signifying that enhanced CG is linked to better FP. The correlation between funding structure and FP is 0.84, also demonstrating a significant strong positive relationship, indicating that an improved funding structure is closely related to better FP.

4.3 Panel Regression Results

Table 3: Moderation Results of Funding Structure on the Relationship between Corporate Governance and Financial Performance

Variables	Step	R ²	Model Fit	β	SE	t	p
Total Effect (CG → FP)	1	0.66	F = 3,861.14, p < 0.05	0.75	0.11	62.14	0.00
Indirect Effect (CG → FS → FP)							
CG → FS	2	0.40	F = 1,604.95, p < 0.05	0.35	0.01	40.06	0.00
FS → FP	3	0.83	F = 2,770.53, p < 0.05	0.49	0.02	25.95	0.00
Direct Effect (CG → FP)	4	0.83	F = 2,770.53, p < 0.05	0.67	0.02	15.60	0.00

Table 3 displays the results of the mediation analysis examining the role of funding structure on the relationship between CG and FP of deposit-taking SACCOs in Kenya. The total effect of CG on FP shows that the model explained 66% of the variance in FP ($R^2 = 0.66$), with a significant overall model fit ($F=3,861.14$, $p < 0.05$). The standardized beta coefficient (β) for the total effect was 0.75, with a standard error (SE) of 0.11 and a t-value of 62.14 ($p < 0.05$), indicating a strong and significant total effect of CG on FP.

The mediation analysis further breaks down the indirect effect into two components. The effect of CG on funding structure shows that the model explained 40% of the variance in funding structure ($R^2 = 0.40$), with a significant model fit ($F = 1,604.95$, $p < 0.05$). The standardized beta coefficient for CG on funding structure is 0.35, with an SE of 0.01 and a t-value of 40.06 ($p < 0.05$), indicating a significant positive effect of CG on funding structure. The effect of funding structure on FP was analyzed, showing that the model explained 83% of the variance in FP ($R^2 = 0.83$), with a significant model fit ($F = 2,770.53$, $p < 0.05$). The standardized beta coefficient for funding structure on FP is 0.49, with an SE of 0.02 and a t-value of 25.95 ($p < 0.05$), demonstrating a significant positive effect of funding structure on FP.

The direct effect of CG on FP, while controlling for funding structure, revealed that the model explained 83% of the variance in FP ($R^2 = 0.83$), with a significant model fit ($F = 2,770.53$, $p < 0.05$). The standardized beta coefficient for the direct effect of CG on FP was 0.67, with an SE of 0.02 and a t-value of 15.60 ($p < 0.05$), indicating a significant direct effect of CG on FP. These results suggest that funding structure significantly mediates the relationship between CG and FP. Improvements in CG positively influence funding structure, which in turn enhances FP. However, since the direct effect of CG on FP remains significant, it indicates that while funding structure partially mediates the relationship, CG independently contributes to FP as well. This suggests that there is partial mediation in the relationship between CG and FP through funding structure.

5. Conclusions

The findings from the mediation analysis of the role of funding structure on the relationship between CG and FP of deposit-taking SACCOs in Kenya provide several important insights. To begin with, the results indicate that robust CG practices directly enhance the FP of SACCOs, highlighting the substantial impact of CG on FP. This significant relationship underscores the critical role that effective CG plays in the overall financial health and success of these entities.

Further analysis reveals that CG also positively affects funding structure, suggesting that better CG practices lead to improved funding structures within SACCOs. Improved funding structures, in turn, enhance FP, indicating that a sound funding structure is a crucial intermediary that enhances the FP of SACCOs when influenced by strong CG. Moreover, the direct effect of CG on FP, after accounting for the influence of funding structure, remains significant. This means that while funding structure mediates the relationship between CG and FP, CG still has an independent and substantial impact on FP. The partial mediation observed suggests that funding structure is an important pathway through which CG influences FP, but CG also directly affects FP beyond its impact on funding structure. This finding highlights the multifaceted role of CG in driving FP, both through its direct influence and through its effect on critical financial mechanisms such as funding structure.

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