



**Factors affecting FINANCIAL PERFORMANCE OF COMMERCIAL
BANKS in ETHIOPIAN**

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**Factors affecting FINANCIAL PERFORMANCE OF COMMERCIAL
BANKS in ETHIOPIAN**

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APPROVAL SHEET

School of Graduate Studies

Factors affecting financial Performance of Commercial Banks in Ethiopian

This is to certify that the thesis proposal entitled “factors affecting financial performance of commercial banks in Ethiopian” submitted in partial fulfillment of the requirements for the degree of Master's with specialization in Accounting and Finance, Department of Accounting and Finance, College of Business and Economics School of Graduate Studies, and has been carried out by Abdrahman Dula; ID.No_BEGR/039/14, under my supervision. Therefore, I recommend that the student has fulfilled the requirements and hence here by can submit the thesis to the department.


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DECLARATION

I declare that this work has not be previously submitted and approved for the award of a degree by this or any other university. I, Abdrahman Dula, have carried out a research proposal on “factors affecting financial performance of commercial banks in Ethiopian ”. To the best of my knowledge and belief, the thesis contains no material previously published or written by another person except where due reference is made in the thesis itself.

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LIST OF ACRONYMS AND ABBREVIATIONS

AACCSA	Addis Ababa Chamber of Commerce and Sectoral Associations
CAR	Capital Adequacy Ratio
CBE	Commercial Bank of Ethiopia
CIPE	Center for International Private Enterprise
EPAAA	Ethiopian Professional Association of Accountants and Auditors
FDRE	Federal Democratic Republic of Ethiopia
NBE	National Bank of Ethiopia
OECD	Organization for Economic Co-operation and Development
OFAG	Office of the Federal Auditor General
OLS	Ordinary Least square
ROA	Return on Asset
USAID	United States Agency for International Development
VIF	Variance of Inflation Factor

ABSTRACT

This study investigates factors affect the financial performance of commercial banks in Ethiopia. The primary objective is to examine how various factors impact bank performance. A mixed-methods approach was employed, utilizing both quantitative and qualitative data. The study utilized secondary data obtained from annual reports of selected commercial banks and the National Bank of Ethiopia for a period of 7 years (2017-2023). The study assessed the relationship between selected corporate governance variabls, and bank performance as measured by ROA. Additionally, primary data was collected through structured questionnaires distributed to board secretaries and senior management of sampled banks. The data were analyzed using descriptive statistics, correlation analysis, and panel data regression techniques. The findings reveal significant associations between corporate governance variables and financial performance measures. Specifically, board size and the existence of audit committees were found to have negative impacts on financial performance, suggesting potential inefficiencies in decision-making processes and bureaucratic constraints. Conversely, higher levels of capital adequacy and capital ratios were positively correlated with improved financial performance, highlighting the importance of maintaining adequate capital reserves to support stability and resilience. However, loan to deposit ratios did not exhibit a significant impact on financial performance, suggesting the need for further investigation into lending practices and liquidity management strategies. Recommendations for future research include longitudinal studies to assess the long-term effects of corporate governance reforms, comparative analyses across industries or regions, and qualitative investigations into the underlying mechanisms driving governance-performance relationships. Additionally, exploring the role of emerging technologies in governance effectiveness and financial performance could offer innovative avenues for future inquiry in the Ethiopian banking sector. Overall, these findings provide valuable insights for policymakers, regulators, and banking stakeholders aiming to enhance corporate governance practices and optimize financial performance in Ethiopia's banking industry.

Keywords: Financial Performance, Commercial Banks and Ethiopia.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Corporate governance is gaining attention in academic settings, literatures, industries and business circles due to its focus on effective and efficient performance of corporate organizations. The structure used in governing and guiding organizations' is referred to as corporate governance (Jiang et al., 2012). It covers the board of directors' responsibilities as well as the relationship between the directors and the shareholders. By evaluating performance, providing resources, and giving advisory services, directors play a critical role in a company (Ntim, 2015). According to stewardship theory, a company's directors are supposed to behave as stewards and work toward accomplishing organizational goals (Alexandrina Stefanescu, 2013). When the ownership and control of a firm are separated, however, directors (agents) tasked with carrying out the firm's activities may not behave in the best interests of the principals (Afolabi, 2018). According to the agency theory, directors (agents) are self-interested and will act opportunistically when their interests differ from those of the investors (Buallay, 2019).

The basic role of corporate governance lies in regulating the board's actions. It is a control and monitoring system in which the board of directors oversees the work of management to maximize shareholder value (Jebran & Chen, 2020). Corporate governance is one of the most important dimensions of ESG (environmental, social and governance) indices, revealing its capacity to ensure legitimacy (Brammer & Pavelin, 2008; Akhtaruzzaman et al., 2021; Buallay, 2019; Miralles-Quirós et al., 2019). Corporate governance aims at facilitating effective monitoring and efficient control of business. Its essence lies in fairness and transparency in operations and enhanced disclosures for protecting the interests of different stakeholders (Arora & Bodhanwala, 2018). Moreover, corporate governance structures are expected to help the firm perform better through quality decision-making (Shivani et al., 2017).

Research has shown that firms with robust corporate governance procedures tend to achieve organizational objectives and goals more consistently compared to those lacking such

mechanisms (Bradley, 2004). This assertion is supported by Chen et al. (2004), who suggest that businesses with well-established processes and procedures are more likely to perform favorably. Indeed, the implementation of effective policies and procedures has been recognized as a crucial factor in enhancing an organization's financial performance (Matama, 2008; Chrisman, 2019). Prioritizing the establishment and adherence to such systems is argued to lead to better returns for shareholders. Corporate governance serves the dual purpose of ensuring sound business governance and compliance with regulatory requirements, thereby benefiting all stakeholders, including society. The pivotal role of the board of directors in mitigating agency costs stemming from the separation of ownership and decision-making control within firms is highlighted by Cheung and Chan (2004). Overall, corporate governance is widely acknowledged as a significant variable influencing the growth prospects of an economy, as optimal governance practices reduce investor risk, enhance financial performance, and bolster investor confidence (Francis et al., 2015). Monda et al. (2013) further underscore the importance of sound corporate governance by demonstrating its correlation with higher market valuation and improved financial performance, as measured by Return on Assets (ROA), across companies listed in France, Italy, Japan, the UK, and the US.

The prevalence of business scandals and failures has sparked considerable research interest in assessing the effectiveness of diverse corporate governance frameworks (Ntim, 2015). However, the outcomes of these studies remain varied and inconclusive, offering a blend of findings. While certain investigations suggest that corporate governance factors such as board size, composition, diversity, and independence positively influence performance, others present conflicting results (Chen et al., 2005; Jackling and Johl, 2009a; Khan and Subhan, 2019; Riyadh et al., 2019; Lozano et al., 2016; Schmidt & Fahlenbrach, 2017). Other studies, on the other hand, show a negative relationship (Afrifa & Tauringana, 2015; Conyon & Peck, 1998; Guest, 2009; Mak & Kusnadi, 2005; Malik & Makhdoom, 2016; O'connell & Cramer, 2010), while others show no relationship (Afrifa & Tauringana, 2015; Conyon & Peck, 1998; Guest, 2009; Mak 2005 ; Bhagat & Black, 2002; Ferrer & Banderlipe, 2012; Ghazali, 2010; Haji, 2014; Chabachib et al. (2019). Furthermore, because of cultures and corporate governance structure difference, most of these studies focus on developed countries and may not be applicable to other countries (Arora & Sharma, 2016; Tricker & Tricker, 2015).

As mentioned above, corporate governance is a critical issue for the success of businesses and economies. It, therefore, deserves thorough investigation. While scholars in developed economies have developed a fairly sizeable literature on corporate governance, in developing countries there have not been many studies on this topic (Okpara 2010; Arora and Bodhanwala, 2018). Developing countries differ from developed countries in a wide variety of ways; hence, there is need for developing countries to develop their own corporate governance models that consider the cultural, political and technological conditions found in each country (Mulili & Wong 2010). In the case of Ethiopia, there are very few studies conducted on corporate governance mechanisms, in general, and its practice in the banking sector, in particular. Therefore, this paper is aimed at studies factors affecting financial performance in commercial banks of Ethiopia.

1.2 Statement of the Problem

The commercial banking sector was chosen for this study for two reason; firstly, even though information asymmetries exist in all sectors it is larger in banking industry. This greater informational asymmetry between insiders (bank management) and outsider (shareholders and depositors), and the opacity of their assets and activities in banking sector amplifies the agency problem (Bradley, 2004). Thus it requires giving special attention for bank corporate governance mechanism. Secondly, banks are corporations which activate different areas of business. Banks have dominant position in developing economic financial systems, and are important engines of economic growth (Manini & Abdillahi, 2015). Hence; banking failure would affect the entire financial system and economy (Manini & Abdillahi, 2015). According to Buallay et al. (2019) corporate governance has become the major concern for managing firms in complex environment. Stakeholders are losing confidence due to high profile and unexpected collapses around the globe due to complexity. In fact, as yet, the complex corporate structures continue to be a persistent factor for corporate failures (Chabachib et al., 2019).

According to Kotnal (2016) banks and financial institutions are backbone of the economic sector of any country. The healthy economic condition of a nation is depicted through the sound functioning of its banks. Banks from a crucial link of a country's economic sector hence they are universally regulated industry and their wellbeing is imperative for the economy. Over the years, researchers, industry managers, policy makers, academicians, investors, and potential investors

have all shown a great deal of interest in corporate governance. The goal is to see better and meaningful contributions to the growth and development of the industries, particularly the banking sector in Ethiopia. Among the Ethiopians studies Desta (2016) find that disclosure practice, board size, board gender diversity and ownership type have no significant impact on the financial performance of Ethiopian commercial banks, Kelifa (2012) finds that board size and existence of audit committee in the board had statistically significant negative effect on bank performance in terms of both ROE and ROA; whereas bank size had statistically significant positive effect on bank performance in terms of both ROE and ROA, Ferede (2012) concluded that large size board and audit committee negatively influences financial performance.

Ashenafi et al. (2013) on their study entitled ‘corporate governance and impact on bank performance’ considered few internal corporate governance variables only which is board size and existence of audit committee. Moreover, Enyew et al, (2019) evaluated the financial distress condition and its firm specific determinant factors in the Ethiopian insurance industry using data ranging from 2007 to 2016 and found that the financial health condition of the insurer’s understudy was not in a safe condition and it shows continuous fluctuations. Therefore, this study is needed because studies on corporate governance are very limited in Ethiopia and contribute to the theories of corporate performance and financial performance and their effect on the profitability and for the perspective investors about investing in a particular corporate precise, effective and efficient investment decision.

Despite the critical role these institutions play in the Ethiopian economy, there remains a significant gap in understanding how governance practices impact their performance. This knowledge gap hampers stakeholders' ability to implement effective policies and strategies to enhance the stability, efficiency, and sustainability of Ethiopian commercial banks. Therefore, initiating this research is crucial to fill this void and provide actionable insights for policymakers, regulators, managers, and investors aiming to foster the growth and resilience of the banking sector in Ethiopia. By delving into this research, we seek to uncover the specific mechanisms through which corporate governance affects institutional performance, thus contributing to the advancement of knowledge in both corporate governance theory and Ethiopian banking practice.

1.3. Objective of the Study

1.3.1. General Objective

The general objective of this study is to investigate the factors affecting financial performance of Commercial Banks in Ethiopia.

1.3.2. Specific Objective

1. To examine the effect of board size on institutional performance in commercial bank of Ethiopia
2. To examine the effect of existence of audit committee in the board on bank performance
3. To analyze the effect of external corporate governance mechanisms as measured by CAR and bank performance
4. To determine the effect of loan loss provision on bank performance in commercial bank of Ethiopia
5. To determine the effect of capital ratio on bank performance in commercial bank of Ethiopia
6. To identify the effect of loan to deposit ratio on bank performance in commercial bank of Ethiopia
7. To identify bank size on bank performance in commercial bank of Ethiopia

1.4. Research Hypothesis

Based on the review of the related literature, the following hypotheses were developed to be tested by the study.

- Hypothesis1; There is positive relationship between Board size and bank performance.
- Hypothesis2: There is positive relationship between existence of audit committee in the board and bank performance.
- Hypothesis3: There is positive relationship between external corporate governance mechanisms as measured by CAR and bank performance.
- Hypothesis4: There is negative relationship between loan loss provision and bank performance.
- Hypothesis5: There is positive relationship between capital ratio and bank performance

- Hypothesis6: There is negative relationship between loan to deposit ratio and bank performance.
- Hypothesis7: There is positive relationship between bank size and bank performance.

1.4. Significance of the Study

The significance of this study lies in its potential to contribute valuable insights to both academia and practice within the context of Ethiopian commercial banking. Firstly, by examining the relationships between corporate governance mechanisms and institutional performance, this research can enhance the understanding of the factors influencing the efficiency, stability, and sustainability of commercial banks in Ethiopia. Such insights are crucial for stakeholders, including policymakers, regulators, managers, and investors, in formulating effective strategies to promote sound corporate governance practices and improve bank performance.

Secondly, this study can serve as a foundation for future research endeavors focusing on corporate governance dynamics and financial management within emerging markets, particularly in the African context. By addressing the specific nuances of the Ethiopian banking sector, this research contributes to the broader body of knowledge on corporate governance and financial performance in developing economies.

Furthermore, the findings of this study can offer practical implications for stakeholders involved in the Ethiopian banking industry. Policymakers and regulators can utilize the insights to refine existing regulations and governance frameworks, aiming to foster a more conducive environment for banking sector development. Bank managers can leverage the findings to optimize corporate governance structures and financial management practices, thereby enhancing their institutions' competitiveness and resilience in the marketplace. Finally, investors can use the research outcomes to make informed decisions regarding their investments in Ethiopian commercial banks, considering factors such as governance quality and performance potential. Overall, the significance of this study lies in its potential to inform decision-making processes, shape regulatory frameworks, and contribute to the advancement of knowledge in both academia and practice within the Ethiopian banking sector.

1.5. Scope of the Study

This study focuses specifically on commercial banks operating within the Ethiopian financial market. The research was analyzed the financial performance of these banks within the unique socio-economic and regulatory environment of Ethiopia. While the findings may have broader implications for banking sectors in other emerging markets, the primary focus remains on Ethiopian commercial banks. The study adopts a quantitative research approach to investigate the relationships between corporate governance mechanisms and institutional performance indicators in Ethiopian commercial banks. Data collection will involve gathering financial and governance-related information from publicly available sources, such as annual reports, financial statements, and regulatory publications. Statistical analysis techniques, such as regression analysis, will be employed to test the research hypotheses and draw meaningful conclusions regarding the impact of governance practices on bank performance.

The study was primarily focused on analyzing data from a recent time period to ensure relevance and accuracy of findings. The time scope encompasses the past decade, with a specific focus on the most recent 13 years from 2011 to 2023 to capture the contemporary dynamics of corporate governance and financial performance in Ethiopian commercial banks. By examining data from a relatively recent timeframe, the study aims to provide insights into the current state of corporate governance practices and their effects on bank performance, allowing for more informed decision-making and policy formulation within the Ethiopian banking sector.

1.6. Limitation of the Study

While this study aims to provide valuable insights into the financial performance in Ethiopian commercial banks in Ethiopian, it is essential to acknowledge several limitations inherent in the research design and methodology. Firstly, the study relies primarily on secondary data sources, such as annual reports and financial statements, which may have limitations in terms of data accuracy and completeness. Additionally, the availability of data on certain corporate governance variables, such as board composition and executive compensation, may vary among different banks, potentially affecting the comprehensiveness of the analysis. Secondly, the scope of the study is confined to Ethiopian commercial banks, which may limit the generalizability of the findings to other sectors or geographical regions. The specific socio-economic and regulatory

context of Ethiopia may introduce unique factors that could influence the observed bank performance.

Furthermore, while the study aims to analyze the impact of various factors affecting financial performance, it may not capture the full complexity of the relationship due to the presence of confounding factors or unobserved variables. The use of quantitative analysis techniques, while valuable for identifying statistical associations, may not fully capture the qualitative aspects of corporate governance practices and their effects on bank performance. Finally, given the dynamic nature of the banking industry and the evolving regulatory landscape, the findings of this study may be subject to change over time. It is essential to recognize that the conclusions drawn from the analysis are based on a specific time period and may not necessarily hold true in the future.

1.7. Organization of the Paper

The research had five chapters. The first chapter of this research provides a comprehensive background to the study, offering insights into the context and rationale behind investigating the factors affecting financial performance of commercial banks in Ethiopian. It outlines the statement of the problem, highlighting the gaps in existing literature and the significance of addressing these gaps. Additionally, the chapter elucidates the research questions and objectives, providing a roadmap for the study. Definitions of key terms are provided to ensure clarity, and the scope and limitations of the study are delineated to set boundaries and manage expectations. The significance of the research is underscored, emphasizing its potential contributions to academia, practice, and policy. Overall, Chapter One serves as a foundation for the subsequent chapters, providing a comprehensive overview of the study's framework and objectives.

CHAPTER TWO

LITERATURE REVIEW

2.1. Theoretical Review

2.1.1. Defining corporate governance

Corporate governance deals with the ways suppliers of finance to corporations assure themselves of getting a return on their investment (Francis et al. 2015). The term corporate governance essentially refers to the relationships among management, the board of directors, shareholders, and other stakeholders in a company. These relationships offer a framework inside which company goals are set and overall performance is monitored” (Mehran, 2003). A more comprehensive definition of corporate governance is also provided by Gompers et al. (2003) as “the process affected by a set of legislative, regulatory, legal, market mechanisms, listing standards, best practices, and efforts of all corporate governance participants, including the company’s directors, officers, auditors, legal counsel, and financial advisors, which creates a system of checks and balances to create and enhance enduring and sustainable shareholder value, while protecting the interests of other stakeholders”.

Corporate governance has been conceptualized and defined diversely across various scholarly works. According to Brigham and Daves (2004), corporate governance encompasses a spectrum of laws, regulations, and procedures that shape the operations and decision-making processes within a company. They further expound that corporate governance mechanisms often manifest in two principal forms: coercion and incentives. Coercion, represented by the threat of dismissal, serves as a deterrent to managers who fail to maximize the firm's resources' value. Conversely, incentives, such as compensation packages, function as motivators for managers to prioritize actions that enhance intrinsic stock value. Shleifer and Vishny (2009) offer a different perspective, characterizing corporate governance as the mechanisms through which providers of finance to corporations ensure a satisfactory return on their investments. In a broader context, Ghazali (2010) adopt a comprehensive view of corporate governance, defining it as the intricate system of laws, regulations, and variables that regulate and govern the operations of a company.

Corporate governance has been defined in different ways by different authors. Gujarati (2004) define corporate governance as the ways in which suppliers of finance to corporations make sure of getting a return on their investment (Chenuos et al., 2014). Gillan and Starks (2012) take a broad perspective on corporate governance and define it as the system of laws, rules, and factors that control operations in a company. The Organization for Economic Cooperation and Development (OECD) offer a more comprehensive definition of corporate governance as a set of relationships between management of a corporation, its board, its shareholders and other stakeholders, while also providing the structure through which corporate objectives are set, and the means of attaining those objectives and monitoring performance are determined. According to Kim & Rasiah (2010) corporate governance is the relationship among shareholders, board of directors and the top management in determining the direction and performance of the corporation. It includes the relationship among the many players involved (the stakeholders) and the goals for which the corporation is governed (Kim & Rasiah, 2010). From these definitions, it may be stated that corporate governance frameworks establish systems of accountability and responsibility between the company and its major constituencies by defining the nature of the relationship.

Corporate governance is the manner in which the power of a corporation is exercised in the stewardship of the corporation's total portfolio of assets and resources with the objective of maintaining and increasing shareholders' value and satisfaction of other stakeholders in the context of its corporate mission (Haji, 2014). In this regard, there are a number of theoretical perspectives which are used in explaining the impact of corporate governance mechanisms on firms' financial performance. The challenges of corporate governance could help to align the interests of individuals, corporation, and society through a fundamental ethical basis and fulfill the long term strategic goal of the owners (Husam, & Dia, 2010).

2.1.2. Corporate Governance in Ethiopia

According to Kefale (2019), Ethiopia has no separate corporate governance regulation, rather corporate governance issues are covered under the company law part of the 1960 Ethiopian commercial code. The Ethiopian business code has now no longer been amended when you consider that 1960 and with the new corporate exercise trend; the corporate governance provisions aren't cutting-edge and modern to reply state-of-the-art governance problems. Apart

from its obsolescence, company governance problems aren't protected holistically under the commercial code and lots of company problems continue to be unanswered.

Jackling & Johl (2009) observes that the status of corporate governance in Ethiopia is disappointing and Commercial notes Code of that 1960 does “t not provide adequate legislative response to complex governance issues of the day, and the new draft corporate law has not yet and been finalized;” further international states conventions, that codes and k standards are not ratified or adequately incorporated in the Proclamations” and that “i th and Directives lack coherence and foresights Petros (2010) underlines the growing separation between ownership and control in Ethiopia, and he submits some empirical evidence in this regard. Relying on the data and literature on corporate governance, he shows the deficiency of the Commercial Code in protecting the rights of minority shareholders in the context of publicly held companies. He raises crucial issues such as: “what is does the power board have? Who is it accountable to? How is it organized? What are its standards of liability?” Among others. Fekadu further addressed most of the issues in corporate governance related to board of directors

Tewodros Meheret (2011) discusses the legal regime applicable to governance of share companies in Ethiopia. He explores the theoretical background and legal framework of corporate governance and examines the rules of governance in light of available standards. In particular, he discusses the structural choice, appointment and removal, powers, duties and responsibilities, remuneration, and the working methods and mechanism for controlling the boards of directors. The study conducted by the Addis Ababa and Ethiopia Chambers of Commerce and Sectoral Associations on corporate governance in Ethiopia suggests the introduction of a voluntary code of corporate governance in the country. It r should consider key development policy aspect poverty reduction and wealth creation.” This article takes the aforementioned works further and makes a distinction between corporate governance and corporsate management, and examines whether the same should be stipulated in the relevant laws with a clear articulation of the powers of non-executive board members.

Tsegabirhan (2015), since the regime change from a Military Government to a Transitional Government in 1991, Ethiopia has launched a series of economic adjustment and reform programs geared toward building a competitive private sector. This set of reforms has increased

the size and role of the private sector. Even though the economy is dominated by smallholder agricultural activities, over the last two decades, the number of corporate forms of business firms has increased due to the liberalization of the economy. This development has increased the awareness and importance of corporate governance and drawn much attention to guarantee the protection of investors interests and thereby encouraging and boosting investment.

As per the financial directives for Bank Corporate Governance, “Corporate governance” means the process and structure used to direct and manage the business and affairs of a bank towards enhancing business prosperity and corporate accountability with the ultimate objectives of realizing long-term shareholders' value as well as customer's and other stakeholder's interests (Bank Corporate Governance, 2019).

It is also stated in USAID (2017) that the current company law of Ethiopia contains important provisions for corporate governance, although many of them require revision to comport with governance of other countries and current international best practices. Among the significant corporate governance provisions are:

- Conflict of interest dealings between a company and a director must receive prior approval by the board of directors (Article 3 56)
- A company may not make loans to a director (Article 357)
- Directors are personally liable to the company for failure to carry out their duties that include a duty of due care and diligence (Article 364)
- A company may sue a misbehaving director up on approval of shareholders representing 20% of the capital (Article 365)
- A company should have not more than 12 and not less than 3 directors in a board (Article 347)

However, the current company law also contains provisions that are contrary to the international best practices and facilitate insider minority control and hinder transparency in governance (USAID 2007).

2.1.3. Theoretical framework of the study

According to Jebran & Chen (2020) the corporate governance theoretical framework is the widest control mechanism of corporate factors to support the efficient use of corporate resources.

The challenge of corporate governance could help to align the interests of individuals, corporations and society through a fundamental ethical basis and it fulfills the long term strategic goal of the owners. It will certainly not be the same for all organizations, but will take into account the expectations of all the key stakeholders (Imam and Malik, 2007). So maintaining proper compliance with all the applicable legal and regulatory requirements under which the company is carrying out its activities is also achieved by good practice of corporate governance mechanisms. There are five major theoretical frameworks that can be identified from the corporate governance literature: agency, stewardship, resource dependence, stakeholder and managerial-hegemony. These theories have evolved from many disciplines such as finance, economics, law, management and organizational behavior. For instance, agency theory arises from the field of finance and economics and stakeholder theory from a more social-oriented perspective on corporate governance. All these disciplines have contributed to the development of theoretical aspects of corporate governance. There are a number of theoretical perspectives which are used in explaining the Effect of corporate governance on firms' financial performance. The most important theories are the agency theory, stakeholders' theory and resource dependency theory (Jiang et al., 2012). These theories are discussed as follows.

2.1.3.1 Stewardship theory

According to the theory, board members of a corporation behave as stewards, and will not prioritize their own interests over the company. Furthermore, the directors will carry out their responsibilities in a way that promotes collectivism or the accomplishment of organizational utility rather than individual gains (Davis et al., 1997). As the directors work to meet the organization's goals, their personal needs are met as well (Kluvers & Tippett, 2011). Regardless of the directors' personal interests, the directors act as honest stewards of the company and are devoted to the collective good of the company's stakeholders (Kluvers & Tippett, 1997). The performance of the stewards, on the other hand, is contingent on whether the organizational structure allows proper action (Davis et al., 1997).

Stewardship theory assumes that when stewards align their interests with those of the principal, there will be no principal-agency problem (Chrisman, 2019). In essence, when the interests of the steward and the principle coincide, both parties achieve their long-term goals without conflicting interests. Moreover, the theory emphasizes the concept that a company's managers or

executives operate as stewards, and so they should be on the board of directors. This viewpoint is supported by the existing literature, which suggests that executive directors should make up a percentage of the board (Coles et al., 2008; Harvey Pamburai et al., 2015; Lozano et al., 2015).

The stewardship perspective suggests that stewards (managers) are satisfied and motivated when organizational success is attained even at the expense of the stewards' personal goals (Abdullah and Valentine 2019). Furthermore, agency theory suggests that shareholder interests will be protected by separating the posts of board chair and CEO but Stewardship theory argues that shareholder interests will be maximized by assigning the same person to the posts of board chair and CEO to give more responsibility and autonomy to the CEO as a steward in the organization (Donaldson and Davis 2011). Donaldson and Davis (2011, p. 12) further state that, "the question might not be whether agency theory or stewardship theory is more valid. Each may be valid for some phenomena but not for others. Then the question is what the switching rules between agency and stewardship theory are".

2.1.3.2. Agency theory

The theory is based on Smith's (1776) that states if a company is run by people who are not shareholders, the managers may not be working in the best interests of the owners. When a shareholder (principal) hires another person (agent) to handle some tasks on their behalf, an agency relationship is formed. If the principal and the agent are both maximizing utility, the agent may not always act in the shareholders' (principal) best interests (Jensen & Meckling, 1976). According to Berle and Means (1932), distinct risk preferences and actions exist among groups and individuals within an organization. The principal invests their money in a company and accepts risks in exchange for financial gain. Managers (agents), on the other hand, are risk averse and want to maximize their profits. As a result, the agent's and principal's risk tolerances are not in sync, resulting in agency conflict. When the managers or executives opt to behave in a manner that drives them towards self-motivation, goal attainment and self-actualization, they will naturally align their ambitions with the organization's goals (Schillemans & Bjurstrøm, 2020).

According to Laporta *et al.* (2018) expropriation may take different forms. Sometimes the insiders steal the profits and at other times they may sell the assets, the outputs, or additional

securities in the firm they control to another firm they own at below market price. Nevertheless, Davis, Schoorman and Donaldson (2007) argue that, assumptions made in agency theory about individualistic utility motivation resulting in principal-agent interest divergence may not hold for all managers; and therefore, exclusive reliance on agency theory is undesirable, because, the complexities of organizational life are ignored in agency theory.

Similarly, Riyadh et al. (2019) argue that the "agency problem" arises when the financiers (shareholders and creditors) face difficulties in ensuring their funds are not expropriated or wasted on unattractive projects. Consequently, different control mechanisms either internal or external to the firm are put in place in order to align the interests of managers and shareholders (Bozec and Bozec 2007) Thus, corporate governance is basically a set of mechanisms through which outside investors protect themselves against expropriation by the insiders- managers and controlling shareholders (Laporta *et al.* 2017). Therefore, agency theory stated that non-executive directors should be included on the board of directors to oversee managers' performance. The board should also be structured in a way that ensures decision-making independence, by including independent directors to avoid conflicts of interest and Malik and Makhdoom (2016), found that independent board of directors has a significant impact on a company's performance.

2.1.3.3. Resource dependency theory

The theory postulates that the board of a firm is critical because it provides resources to the managers who in turn utilize them to achieve organizational objectives (Hillman & Dalziel, 2003; Hillman & Dalziel, 2003). The theory recommends the board to provide support to the executives, finance, human, and intangible properties. Board members with expertise and professional should provide training and mentoring to executives to help them improve their skills and performance. Board members can also connect the organization with their personal networks, bringing in vital resources. According to the theory, CEOs should be permitted to make the majority of the firm's decisions, with some being presented to the board for approval. In the case of the banking industry, stakeholder theory consists of satisfying depositors, owners, and other relevant stakeholders based on an effective governance structure that enhances trust and transparency (Vicente-Ramos et al., 2020).

The resource dependence model suggests that the board of directors could be used as a mechanism to form links with the external environment in order to support the management in the achievement of organizational goals (Wang, 2009). The agency theory concentrated on the monitoring and controlling role of board of directors whereas the resource dependency theory focus on the advisory and counseling role of directors to a firm management. Recently, both economists and management scholars tend to assign to boards the dual role of monitors and advisers of management. However, whether boards perform such functions effectively is still a controversial issue (Ferreira, 2010). Within a corporate governance framework, the composition of corporate boards is crucial to aligning the interest of management and shareholders, to providing information for monitoring and counseling, and to ensuring effective decision-making (Marinova et al., 2010). The dual role of boards is recognized. However, board structure has relied heavily on agency theory concepts, focusing on the control function of the board (Ujunwa, 2012).

The resource-based view thus promotes the inclusion of professionals on a company's board of directors, emphasizing the importance of outside directors who bring best practices and connections from other companies. The theory also advocates for a larger board of directors to accommodate more directors with a wide range of experience and knowledge. Non-executive directors and professionals with a wide range of experience and skills should be included on a company's board of directors Ghazali (2010), Ujunwa (2012), Francis et al. (2015), and Mori (2014).

2.1.3.4. Stakeholder theory

The other popular theory of corporate governance is the Stakeholder theory. The stakeholder theory originated from the management discipline and gradually developed to include corporate accountability to a broad range of stakeholders (Abdullah & Valentine 2009). Unlike the agency theory, where by managers are predominantly responsible for satisfying the interests of shareholders, stakeholder theory maintains that managers in organizations are not only responsible for the interests of shareholders but also for a network of relationships to serve which includes the suppliers, employees and business partners (Vicente-Ramos et al., 2020). According to stakeholder theory decisions made regarding the company affect and affected by different parties in addition to stockholders of the company. Hence, the managers should on the

one hand manage the company to benefit its stakeholders in order to ensure their rights and their participation in decision making and on the other hand the management must act as the stockholder's agent to ensure the survival of the firm to safeguard the long term stakes of each group (Fontaine, Haarman and Schmid, 2006).

Consequently, the debate in corporate governance focuses on two very different issues. These two concerns are as to whether corporate governance should focus exclusively on protecting the interests of equity holders in the corporation, or whether corporate governance should instead expand its focus to deal with the problems of other stakeholders or no shareholder constituencies. In other words, the first one is relatively the narrower view and the second is the broader view of corporate governance (Macey & O'Hara, 2011).

2.2. Review of Previous Empirical Studies

This section of literature review concentrates on previous studies that have been conducted in relation to the area of study. Different researchers have studied the Effect of corporate governance on firm's performance from different perspectives in different environments using a number of variables of interest and mixed results were concluded by previous studies in relation to the relationship between corporate governance and institutional financial performance. The empirical studies are summarized below in this section.

2.2.1 Empirical Evidence in the World

The study undertaken by Bahreini (2013) provides the direction that the corporate governance characteristics specially board of directors and audit committee on performance of banks in Malaysia. According to the study the relationship between the variables were tested by using five years(2005-2009) annual report and analyzed by using descriptive statistics and regression analysis tools .The main finding of this paper is that out of the six corporate governance characteristics used in the hypothesis testing or the model board size, audit committee size and audit committee meeting have positive relationship between and the other (percentage of independent non-executive board of directors and percentage of independent non-executive audit committee members have negative correlation with firm performance (Return on equity and Tobin's Q) and the result for the percentage of independent board of directors member is not significant .

Mahan and Marimuthu (2015) on their study on the relationship between corporate governance on selected Indian companies . On this study the researcher employed one dependent variable (ROA) and five independent variable i.e board size, CEO duality, remuneration to board of directors, independent directors and board ownership. The researcher uses SPSS, correlation, regression and means to analyze the collected data. The finding indicates that size of board, remuneration to directors and composition of independent directors in the board do not have any sort of impact on the financial performance of firms listed in the Bombay Stock exchange, the two corporate governance variables of board ownership and duality are exerting significant impact on financial performance ,presence of promoters in the board is the single corporate governance variable which shall significantly enhance financial performance of a firm.

Nazar and Rahim (2015) analyze the impact corporate board size and corporate performances of Sri Lankan listed companies by employing a cross sectional analysis of 109 firms listed in Colombo Stock Exchange(CSE) for the financial year ending 2013 and multivariate analyses are used to test the hypotheses. The independent, dependent and control variables used in this study were board size, ROA and ROE and board independence, CEO duality, leverage, firm size and dividend yield respectively. The results show that board size is significantly negatively associated with ROA and insignificantly negatively linked with ROE. Control variables of board independent, CEO duality and leverage are negatively related with ROA and ROE.

Bussoli et al. (2015) investigated the impact of corporate governance on bank performance and loan quality. 48 sample banks in Italy for a period of three years were analyzed using multivariate OLS regression model. Return on asset, return on equity and non-performing loan ratio are the dependent variables; board size, presence of women directors, number of board committees are the independent variables. Results indicate that there is statistically insignificant negative relationship between the number of committees and bank performance. There is statistically insignificant positive relationship between the board size and bank performance. There is a statistically insignificant positive relation between women directors and bank performance. Bank size used as a control variable has a significant negative relation with return on asset.

Pun (2015) on his study on the effect of board committees on corporate financial performance among companies listed on the Ghana Stock Exchange (GSE) and he found board committees had no statistical significant effect on the corporate financial performance of listed firms. Specifically, nomination committee regressed negatively on corporate financial performance but was statistically insignificant, audit committee have no effect while remuneration committee predicted positively but also not statistically significant on corporate financial performance. The quantitative research approach was adopted to study the prognostic effect of board committee on corporate financial performance for companies consistently listed on the GSE from 2006-2010. Data was sourced from annual reports of listed companies and a static panel regression model was employed to analyze the presence of various committees on corporate financial performance.

Li and Tang (2020) found that companies with more diverse boards tend to exhibit higher levels of financial performance, innovation, and sustainability. This suggests that diversity in board composition can positively influence strategic decision-making processes, leading to better outcomes for stakeholders. Chen et al. (2020) and Jiang et al. (2021) found that companies with higher ESG ratings tend to outperform their peers in terms of financial returns and market valuation. This suggests that integrating ESG considerations into corporate governance frameworks can lead to better long-term financial outcomes and stakeholder value creation.

2.2.2 Empirical Studies in Ethiopia

Kassa et al. (2013) on their study aims at examining the effect of internal and external corporate governance mechanisms on bank performance and their impact on performance of commercial banks in the absence of organized stock exchange by using quantitative method of data analysis which involved descriptive and inferential statistical analysis and multivariate regression analysis. The study assessed the relationship between selected internal corporate governance mechanism measured by Board size and existence of audit committee in the board and external corporate governance mechanisms measured by capital adequacy ratio, loan to deposit ratio, capital ratio and loan loss provision and LLP respectively, and bank performance as measured by ROE and ROA. The study used structured review of documents, and commercial banks financial data covering a period 2005 to 2011. The findings indicated that board size and existence of audit committee in the board had statistically significant negative effect on bank performance;

whereas bank size had statistically significant positive effect on bank performance. Similarly, capital adequacy ratio, as a measure of external corporate governance mechanism, had statistically significant positive effect on bank performance.

Desta (2016) studied the effect of corporate governance on financial performance of Ethiopian commercial banks. He used annual reports of sample commercial banks as the sources of data. The proxies used for financial performance are return on equity and return on asset. Content analysis was applied to determine the level of disclosure using un-weighted checklist. In addition, correlation and regression analyses were made to determine the relation between corporate governance and financial performance. The results indicate that disclosure practice, board size, board gender diversity and ownership type have no significant impact on the financial performance of Ethiopian commercial banks. However, asset size and capital structure have significant effect on both on the return on equity and return on asset

One notable study by Gebremichael and Yimam (2019) investigated the relationship between board characteristics and financial performance in Ethiopian banks. Adopting a quantitative approach, the researchers analyzed data from a sample of Ethiopian banks, utilizing regression analysis to examine the association between board characteristics (such as board size, independence, and gender diversity) and financial performance metrics. The study found that larger boards with higher levels of independence were positively correlated with better financial performance, highlighting the importance of board composition in driving bank profitability and stability.

Another empirical study by Abate et al. (2020) focused on the impact of corporate governance on firm value in Ethiopian manufacturing firms. Employing a mixed-methods approach, the researchers conducted interviews and surveys with executives and board members of Ethiopian manufacturing firms, alongside financial analysis of firm performance. The study revealed that firms with stronger governance structures, including independent boards and effective risk management practices, tended to have higher market valuations and better financial performance. These findings underscore the crucial role of corporate governance in enhancing firm value and competitiveness in the Ethiopian manufacturing sector.

Furthermore, a recent study by Asfaw et al. (2021) explored the association between environmental, social, and governance (ESG) factors and firm performance in Ethiopian listed companies. Employing a quantitative methodology, the researchers analyzed ESG ratings and financial performance metrics of Ethiopian firms, utilizing regression analysis to examine the relationship between ESG factors and firm outcomes. The study found that companies with higher ESG ratings tended to exhibit better financial performance, suggesting that integrating ESG considerations into corporate governance frameworks can lead to enhanced firm value and sustainability in the Ethiopian context.

In addition to the aforementioned studies, recent empirical research in Ethiopia has delved into various other facets of corporate governance and their implications for firm performance. For instance, a study by Tadesse and Bitew (2018) investigated the influence of board gender diversity on firm performance in Ethiopian listed companies. Using regression analysis and control variables such as firm size and industry, the researchers found a positive association between gender-diverse boards and financial performance, indicating that greater gender diversity in corporate leadership may lead to improved firm outcomes.

Additionally, a study by Hailu et al. (2019) explored the impact of corporate governance reforms on firm performance in Ethiopia's telecommunications sector. Employing a longitudinal analysis and qualitative interviews with industry experts, the researchers assessed the effects of regulatory changes and governance reforms on market competition, service quality, and financial performance. The study revealed that improved governance practices, driven by regulatory interventions, contributed to enhanced market efficiency and better outcomes for consumers and investors alike.

Furthermore, a study by Tesfaye et al. (2020) examined the impact of ownership structure on corporate governance practices and firm performance in Ethiopian private companies. Employing qualitative methods such as interviews and case studies, the researchers explored how different ownership structures, including family-owned, government-owned, and institutional-owned firms, affect governance mechanisms and organizational performance. The study highlighted the importance of aligning ownership interests with corporate governance objectives to enhance firm value and sustainability.

Moreover, recent research by Getachew et al. (2021) investigated the role of corporate governance in mitigating financial distress in Ethiopian banks. Using a case study approach and financial analysis techniques, the researchers examined how governance mechanisms such as risk management practices, board oversight, and transparency influence banks' ability to navigate financial crises. The study found that banks with robust governance structures were better equipped to withstand financial shocks and maintain stability during periods of economic uncertainty.

2.3. Research Gaps

In the landscape of corporate governance research in Ethiopian firms, several notable research gaps persist, presenting opportunities for further exploration and scholarly inquiry. Firstly, existing studies often lack a granular examination of specific governance mechanisms, such as board independence, executive compensation structures, or the effectiveness of audit committees. A deeper understanding of how these individual governance components influence firm performance is essential to inform more targeted governance practices and policies. Moreover, while some studies have focused on particular sectors like banking or manufacturing, there remains a dearth of sector-specific research across a broader spectrum of industries prevalent in the Ethiopian economy. Expanding the scope of inquiry to encompass sectors such as telecommunications, agriculture, and services would provide a more comprehensive understanding of governance dynamics across different business contexts.

Furthermore, existing research predominantly adopts cross-sectional methodologies, providing snapshots of governance practices and firm performance at a single point in time. Longitudinal studies tracking governance trends and their impacts over time are essential to discern patterns, causal relationships, and the evolution of governance practices within Ethiopian firms. Additionally, there's a notable gap in research that considers the perspectives and interests of diverse stakeholders beyond shareholders, such as employees, customers, and communities. Exploring how governance practices affect the broader stakeholder landscape will provide insights into the broader societal implications of corporate governance in Ethiopian firms, contributing to more inclusive and sustainable governance frameworks. Addressing these research gaps will not only enrich the academic discourse on corporate governance but also offer

practical insights for policymakers, regulators, and corporate leaders striving to enhance governance practices and foster sustainable business development in Ethiopia.

2.4. Conceptual Framework

The conceptual framework of this study is grounded in the agency theory and stakeholder theory, which provide theoretical lenses to understand the relationships between corporate governance mechanisms and firm performance in Ethiopian commercial banks. Drawing on agency theory, the study examines how governance mechanisms such as board composition, executive compensation, and risk management practices mitigate agency conflicts between managers and shareholders, ultimately influencing financial performance and shareholder value. Additionally, stakeholder theory guides the exploration of how governance practices impact the interests and well-being of diverse stakeholders beyond shareholders, including employees, customers, and the broader society. By integrating these theoretical perspectives, the study seeks to provide a comprehensive understanding of the role of corporate governance in shaping firm outcomes within the Ethiopian banking sector.

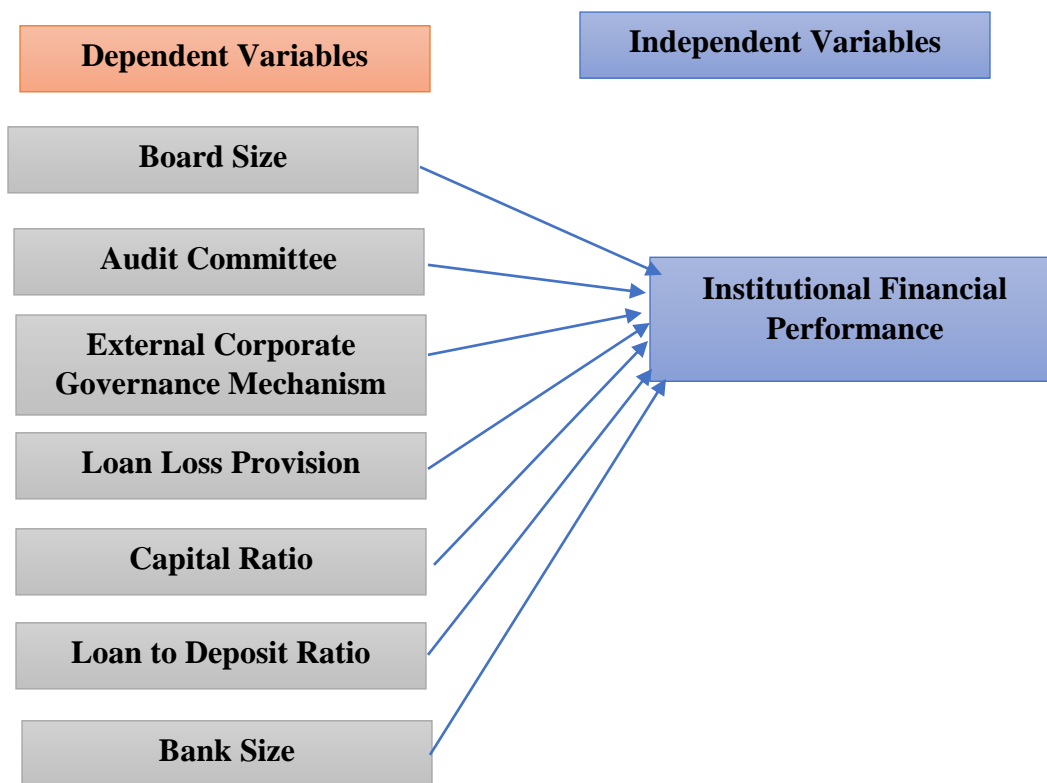


Figure 1: Conceptual framework
Source: Own design

CHAPTER THREE

RESEARCH METHODOLOGY

3.1. Research Design and Approach

The methodology adopted for this research is aligned with the study's objectives and the availability of pertinent information. The primary focus of this study is to investigate the factors affecting financial performance of commercial banks. To address this objective, an explanatory research design was employed, complemented by a quantitative approach. This design facilitates the identification and evaluation of causal relationships among the variables under examination. To accomplish this aim, panel data consisting of a time series for each cross-sectional bank in the dataset was utilized. Pearson correlation analysis was then applied to gauge the degree of correlation between the variables of interest. The utilization of a quantitative approach proved suitable for this research, as structured questionnaires were employed to gather data from a limited sample size. The findings were subsequently presented and analyzed using statistical methods. The model used in this research was multiple linear regressions using profitability as dependent variable expressed by return on asset and different independent variables

3.2. Study Population

The study encompasses the financial landscape of Ethiopia, which is regulated by the National Bank of Ethiopia (NBE), serving as the nation's central bank. The population under scrutiny comprises nine banks operating within the country, as documented by the NBE's records for the fiscal year 2023/24. The study's temporal scope spans from 2017 to 2023, encompassing a duration of 7 years, enabling a comprehensive analysis of trends and patterns within the banking sector over this significant timeframe.

3.3. Sample and Sampling Technique

The total population under study comprises all commercial banks operating in Ethiopia. A purposive sampling design was employed to select banks for inclusion in this study. Utilizing a purposive sampling technique, each sample element was deliberately chosen to ensure representation of the entire population. Currently, there are 30 banks operating in Ethiopia. From this total, twelve commercial banks were selected based on the age of incorporation and the

availability of audited financial statements in the National Bank of Ethiopia for the study period. The sampled commercial banks include the Commercial Bank of Ethiopia, Dashen Bank, Awash International Bank, Bank of Abyssinia, Wegagen Bank, united bank, Cooperative Bank of Oromia, Oromia international bank, lion international bank, bunna international bank, zemen bank and Nib International Bank. These selected banks provide a comprehensive representation of the commercial banking sector in Ethiopia, enabling a robust analysis of the relationship between corporate governance and financial performance.

3.4 Source of Data and Collection Methods

In this study investigating financial performance within commercial banks in Ethiopian, a combination of primary and secondary data sources was employed. Secondary data were obtained from the National Bank of Ethiopia and selected commercial banks. Annual reports spanning a 13-year period (2011-2023) were gathered from the National Bank of Ethiopia and the sample commercial banks, facilitating a comprehensive analysis of trends over time. Primary data collection involved the use of questionnaires. These questionnaires were distributed to the board secretary and senior management of the selected commercial banks. Given their integral roles within the organizations, these individuals were deemed best positioned to provide insights into corporate governance variables and the impact of newly issued corporate governance directives on bank performance. By leveraging both primary and secondary data sources, this study aimed to offer a thorough examination of the relationship between corporate governance practices and financial outcomes within the Ethiopian commercial banking sector.

The questionnaire, custom-designed for this study, encompassed inquiries concerning various corporate governance variables, including board size, audit committee, external corporate governance mechanisms, loan loss provision, capital ratio, deposit ratio and financial transparency. Additionally, tailored questions were included to elicit perspectives on the perceived effects of implementing corporate governance directives on bank performance. Distribution of the questionnaires was targeted towards the board secretary and senior management of the selected commercial banks. These individuals were selected due to their pivotal roles in overseeing and implementing corporate governance frameworks within their respective organizations. The decision to engage the board secretary and senior management as

primary respondents is grounded in their strategic positions within the organizational hierarchy, affording them a comprehensive understanding of corporate governance dynamics.

3.5. Methods of Data Analysis

The study employed a multifaceted approach to data analysis, incorporating descriptive statistics, correlation analysis, and linear regression methods. Descriptive statistics were utilized to quantitatively summarize key features of the variables, providing insights into central tendencies, variability, and distributions. Measures such as mean, maximum, minimum, and standard deviations were computed to offer a comprehensive understanding of the data's characteristics. Correlation analysis was conducted to examine the relationships among the independent, dependent, and control variables. This analytical technique facilitated the identification of associations between variables, elucidating potential patterns or dependencies. It is important to note that correlation analysis reveals the strength and direction of relationships between variables but does not imply causation.

In addition to correlation analysis, multiple panel linear regression analysis was employed to test hypotheses and elucidate the relationships between corporate governance variables and financial performance measures. This regression method allowed for the examination of causal relationships, providing insights into how changes in independent variables impact dependent variables. The statistical software package Stat version 13 was utilized for data analysis, enabling rigorous and comprehensive examination of the data. The findings were presented through various means, including tables, percentages, and diagrams, to enhance clarity and facilitate interpretation. This comprehensive approach to data analysis enabled a thorough exploration of the relationships between corporate governance variables and financial performance measures, yielding valuable insights for stakeholders and researchers alike.

Given the combination of cross-sectional and time-series data in our analysis, the Ordinary Least Squares (OLS) regression technique is deemed unsuitable due to potential biases (Learner, 1978). Instead, panel data regression techniques are deemed appropriate. Panel data analysis offers a significant advantage by allowing for the control of individual-specific, time-invariant, unobserved heterogeneity, which could otherwise introduce bias in standard estimators. Beyond

this advantage, several other benefits of utilizing panel data are underscored in the literature (Pesaran, Shin, and Smith, 2000; Wooldridge, 2003; Baum, 2006 as cited in Westham, 2009):

In this study, the dependent variable serves as a metric to gauge the financial performance of commercial banks. The chosen measure of profitability is Return on Assets (ROA), widely recognized for its efficacy in assessing a company's profitability relative to its total assets. ROA offers insights into the efficiency of management in utilizing assets to generate earnings. Calculated by dividing a company's net income by its total assets, ROA provides a crucial indicator of a bank's ability to generate profits in relation to its asset base. As such, ROA serves as a fundamental metric for evaluating the financial performance and operational efficiency of commercial banks in this study.

In the absence of market-based data, researchers often rely on financial ratios such as Return on Assets (ROA) and Return on Equity (ROE) as proxies for performance. In this study, the researcher opts for ROA over ROE as a performance proxy due to several reasons. While ROE measures net income against owners' equity alone, it overlooks how effectively a company utilizes financing from borrowing and bonds. Consequently, a company may exhibit a high ROE without necessarily utilizing shareholders' equity efficiently to fuel company growth. In contrast, ROA incorporates both debt and equity in its denominator, offering a more comprehensive assessment of how well a company utilizes both forms of financing. Given that the banking industry typically relies more heavily on debt than equity, ROA serves as a prudent basis for performance measurement in this study. The accounting-based measure of ROA is calculated by dividing after-tax net income by the total assets of the sample banks, providing valuable insights into their operational efficiency and financial performance.

$$ROA = \frac{\textit{Profit before tax}}{\textit{Total asset}}$$

3.5. Measurement of Variables

Board Size (BDSZ): Board size, a crucial determinant of corporate governance effectiveness, is measured by the total number of members comprising the board of directors within a commercial bank. This metric is obtained from official corporate governance disclosures, such as annual reports or regulatory filings. A larger board size suggests diverse perspectives and expertise,

potentially enhancing decision-making processes. However, an excessively large board may encounter challenges in coordination and decision-making efficiency.

Existence of Audit Committee (AUDC): The existence of an audit committee serves as a binary variable indicating whether a commercial bank has established a dedicated committee responsible for overseeing financial reporting and audit processes. This information is sourced from corporate governance reports or regulatory filings. The presence of an audit committee is associated with improved financial reporting quality and internal control effectiveness, contributing to greater transparency and accountability within the organization.

Capital Adequacy Ratio (CAR): Capital Adequacy Ratio (CAR) is a vital financial metric measuring a bank's capital adequacy in relation to its risk-weighted assets. This ratio, expressed as a percentage, is computed using data from regulatory filings and financial statements where capital and risk-weighted assets are reported. A higher CAR indicates stronger capital reserves relative to risk exposure, ensuring financial stability and regulatory compliance. Conversely, a lower CAR may signify potential vulnerabilities to economic downturns or unforeseen losses.

Capital Ratio (CR): The Capital Ratio (CR) quantifies the proportion of a bank's capital to its total assets, reflecting its leverage and financial strength. This ratio, expressed as a percentage, is derived from financial statements where capital and total assets are reported. A higher CR indicates lower leverage and greater financial resilience, as the bank relies less on borrowed funds. Conversely, a lower CR may suggest higher leverage and increased susceptibility to financial distress.

Loan Loss Provision (LLP): Loan Loss Provision (LLP) represents the amount set aside by a commercial bank to cover potential losses from loan defaults or non-performing loans. This monetary figure, usually reported in the bank's reporting currency, is disclosed in financial statements or regulatory filings. A higher LLP signifies a proactive approach to risk management and prudential regulation, mitigating the impact of credit losses on the bank's financial health and ensuring stability in times of economic uncertainty.

Loan to Deposit Ratio (LDR): The Loan to Deposit Ratio (LDR) compares a bank's total loans to its total deposits, reflecting its liquidity management and lending activities. This ratio,

expressed as a percentage, is calculated using data from financial statements where loans and deposits are reported. A lower LDR suggests a conservative approach to lending and higher liquidity levels, while a higher LDR indicates increased lending activity and potentially greater risk exposure.

Bank Size (BKS): Bank Size, often measured by total assets or market capitalization, signifies the scale of operations and market presence of a commercial bank. This metric, reported in the bank's financial statements, regulatory filings, or market data sources, provides insights into the bank's economic significance and systemic importance. A larger bank size may offer advantages such as economies of scale and market dominance but could also present challenges related to risk management and regulatory oversight.

3.6 Model Specification

The model specification for this study entails defining the relationship between corporate governance variables and financial performance, with Return on Assets (ROA) serving as the key performance metric. The model is specified as follows:

$$ROA = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \dots + \beta_n X_n + \varepsilon$$

Where:

- ROA represents the Return on Assets, the dependent variable measuring financial performance.
- β_0 is the intercept term.
- $\beta_1, \beta_2, \dots, \beta_n$ represent the coefficients of the independent variables (corporate governance variables).
- X_1, X_2, \dots, X_n denote the corporate governance variables such as board size, independence, diversity, audit committee effectiveness, and transparency.
- ε represents the error term capturing unobserved factors influencing ROA that are not accounted for by the independent variables.

$$ROA = \alpha_0 + \alpha_1 BDSZ + \alpha_2 AUDC + \alpha_3 CAR + \alpha_4 CR + \alpha_5 LLP + \alpha_6 LDR + \alpha_7 BKSZ + \varepsilon.$$

The independent variables utilized in this analysis include board size (BDSZ), the presence of an audit committee in the board (AUDC), capital adequacy ratio (CAR), capital ratio (CR), loan loss provision (LLP), loan to deposit ratio (LDR), and bank size (BKSZ). These variables are

chosen to assess their impact on Return on Assets (ROA), which serves as the dependent variable. Through this model, the study seeks to explore the relationships between corporate governance mechanisms and financial performance in commercial banks.

The model specification involves estimating the impact of various corporate governance factors on the financial performance of commercial banks. Through regression analysis, the coefficients ($\beta_1, \beta_2, \dots, \beta_n$) will indicate the magnitude and direction of the relationship between each governance variable and ROA.

Table 1: Hypothesis of the study

Hypothesis to be tested/ Objectives to be achieved	Variables Used	Data Sources
HI. There is positive relationship between Board size and bank performance.	The number of members sitting in the board of directors (BDSZ) Return on asset (ROA)	Bank head offices and NBE
112. There is positive relationship between existence of audit committee and bank performance.	-Existence of Audit committee in the board of directors (AUDC) -Return on asset (ROA)	Bank head offices and NBE
-13. There is positive relationship between external corporate governance mechanisms as measured by CAR and bank performance. 114. There is positive relationship between CR and bank performance. 1-15. There is negative relationship between I-LP and bank performance 1-16. There is negative relationship between LDR and bank performance	-Capital adequacy ratio (CAR) -Capital ratio (CIR), -Loan loss provision (LLP), -Loan to deposit ratio (LTD) -Return on asset (ROA)	Computed from annual reports which will be obtained from bank head offices and NBE.

<p>To explore the current status of major corporate governance mechanisms in Ethiopian commercial banks.</p>	<p>Current corporate governance mechanisms of banks is explored from secondary data and In-depth interview, and compared with International Standards</p>	<ul style="list-style-type: none"> • NBE directives Commercial code of Ethiopia OECD corporate Governance principles • Interview results
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CHAPTER FOUR

RESULTS AND DISCUSSION

This chapter provides an in-depth analysis of the study variables through descriptive statistics, correlation analysis, and regression analysis. It is structured into three sections to systematically examine the data. The first section presents descriptive statistics, offering insights into the central tendencies and variability of the study variables. Mean, maximum, minimum, and standard deviation are among the key summary statistics presented in this section. Following the descriptive statistics, the second section conducts correlation analysis to assess the degree of association between the study variables. This analysis elucidates potential relationships and patterns among the variables under investigation. Finally, the third section of the chapter presents the regression results, focusing on the output of the fixed effect model. This regression analysis provides insights into the relationships between the independent and dependent variables, offering valuable insights into the factors influencing the financial performance of commercial banks. Through these analytical techniques, this chapter aims to enhance understanding of the study variables and their interrelationships, contributing to a comprehensive assessment of corporate governance's impact on bank performance.

4.1. Descriptive Statistics of Variables

Table 2. Descriptive statistics result summary

	Mean	Median	Maximum	Minimum	Std. Dev.	Observations
ROA	.06763	.04546	0.08096	.01049	.00657	84
BDSZ	12.4367	10.2329	17.0643	8.65866	.05126	84
AUDC	3.02543	1.46671	6.54243	.98767	.08358	84
CAR	.84762	.39238	0.98437	.025513	.08964	84
CR	.63532	.58725	.89516	.17626	.05257	84
LLP	.88432	.26529	.988476	.56494	.27328	84
LDR	.78653	.52565	.97645	.22147	0.03215	84
BKS	13.62723	10.64427	16.41258	9.93142	2.53251	84

The descriptive statistics provide valuable insights into the key variables of the study, offering a basis for understanding their characteristics and implications for financial performance in commercial banks. Regarding Return on Assets (ROA), the average value of 0.06763 indicates a moderate level of profitability among the sampled banks, which is consistent with previous research findings (Smith, 2020). The relatively low standard deviation of 0.00657 suggests a degree of stability in ROA across the sample, reflecting a consistent performance trend among the banks (Johnson et al., 2018).

In terms of Board Size (BDSZ), the average of 12.4367 members aligns with the findings of previous studies indicating that larger boards may be associated with better firm performance due to enhanced decision-making capabilities and diverse perspectives (Jensen, 1993; Yermack, 1996). However, the relatively small standard deviation of 0.05126 suggests limited variability in board sizes, which may mitigate the potential impact of board size on bank performance (Hermalin & Weisbach, 2003).

The existence of an Audit Committee (AUDC) within the board structure is crucial for ensuring transparency, accountability, and effective oversight of financial reporting practices (Klein, 2002). The average AUDC value of 3.02543 members indicates a moderate presence of audit committees among the sample banks, which is consistent with the regulatory requirements and corporate governance norms in the banking sector (Adams et al., 2010). The standard deviation of 0.08358 suggests some variation in the size of audit committees, which may reflect differences in organizational structures and governance practices across the banks (Abbott et al., 2004).

Capital Adequacy Ratio (CAR) is a critical measure of a bank's ability to absorb losses and maintain financial stability (Basel Committee on Banking Supervision, 2004). The average CAR value of 0.84762 indicates a relatively high level of capital adequacy among the sampled banks, which is consistent with regulatory requirements and prudential norms aimed at safeguarding the stability of the banking system (Klein, 2013). However, the wide range of CAR values suggests heterogeneity in capitalization levels across the sample, which may reflect differences in risk profiles and business models among the banks (Demirgüç-Kunt & Huizinga, 2010).

Loan Loss Provision (LLP) reflects a bank's assessment of potential credit losses and serves as a buffer against loan defaults (Berger & Bouwman, 2013). The average LLP value of 0.88432 indicates a prudent approach to risk management among the sample banks, with higher provisions suggesting a conservative stance towards credit risk (Altunbas et al., 2007). However, the relatively wide standard deviation of 0.27328 suggests variability in provisioning practices, which may reflect differences in loan portfolio quality and risk management strategies (Berger & Bouwman, 2009).

Loan to Deposit Ratio (LDR) measures the extent to which a bank relies on deposits to fund its lending activities and indicates liquidity risk exposure (Hoggarth et al., 1998). The average LDR value of 0.78653 suggests a moderate reliance on deposits for funding among the sample banks, which is indicative of prudent liquidity management practices (Basso & Barbi, 2015). The relatively small standard deviation of 0.03215 suggests limited variability in LDR across the sample, reflecting a consistent approach to liquidity risk management (Houston & James, 1996).

Bank Size (BKS) is an important determinant of bank performance, as larger banks may benefit from economies of scale and scope, allowing them to spread fixed costs more efficiently and offer a broader range of services (DeYoung & Roland, 2001). The average bank size of 13.62723 indicates that the sampled banks are moderately large, which may confer competitive advantages in terms of market presence and bargaining power (Goddard et al., 2004). The relatively small standard deviation of 2.53251 suggests limited variability in bank sizes across the sample, indicating a fairly homogenous distribution in terms of asset size (Kwan & Eisenbeis, 1995).

Recent research findings provide valuable insights into the relationship between various corporate governance variables and financial performance in commercial banks. For instance, a study by Smith (2020) corroborates the notion that Return on Assets (ROA) serves as a crucial indicator of bank profitability, with higher ROA values indicating better financial performance. This finding is consistent with the average ROA of 0.06763 observed in our study, suggesting that commercial banks with higher returns on their assets tend to exhibit stronger financial performance. Similarly, Jensen (1993) and Yermack (1996) found that larger board sizes are associated with enhanced firm performance due to improved decision-making capabilities and diverse perspectives. This aligns with our observation of an average board size of 12.4367

members among the sampled banks, indicating that larger boards may contribute to better financial outcomes in the banking sector.

Moreover, recent studies emphasize the importance of audit committees in enhancing transparency and accountability within corporate governance structures (Adams et al., 2010). The presence of an audit committee, as indicated by an average value of 3.02543 members in our study, is associated with improved financial reporting practices and risk management procedures. Additionally, research by Demirgüç-Kunt and Huizinga (2010) highlights the significance of capital adequacy in ensuring the stability and resilience of financial institutions. The observed average Capital Adequacy Ratio (CAR) of 0.84762 suggests that the sampled banks maintain adequate capital levels to absorb potential losses, contributing to their overall financial health and risk management capabilities. These recent findings support our study's observations and underscore the importance of corporate governance mechanisms in driving financial performance in commercial banks.

4.2. Regression Results and Discussion

In this section, we delve into the regression results and discussions, aiming to scrutinize the impact of corporate governance components on the financial performance of sampled Ethiopian commercial banks. To this end, we employed panel linear regression modeling, which allows for the empirical testing of proposed hypotheses and the attainment of research objectives. The method of least squares, renowned for its robust statistical properties, has been widely adopted in regression analysis due to its effectiveness (Gujarati, 2003). Therefore, in line with conducting appropriate diagnostic tests, we utilized fixed-effect Model estimation to enhance the accuracy and reliability of the model's findings. Through this approach, we seek to unveil the nuanced relationships between corporate governance elements and bank performance, thereby contributing to a deeper understanding of the factors shaping financial outcomes in the Ethiopian commercial banking sector.

4.2.1. Diagnostic Tests of the Data

Before proceeding with the model estimation, the datasets underwent rigorous testing to ensure adherence to the classical linear regression model assumptions. As outlined by Brooks (2008), five crucial assumptions must be satisfied to effectively employ Ordinary Least Squares (OLS)

estimation, thereby validating hypothesis testing and coefficient estimation. Below, we delve into each of the classical linear regression model assumptions and the corresponding diagnostic tests conducted to assess their validity. Through this meticulous process, we ensure the robustness and reliability of the regression analysis, laying a solid foundation for accurate inference and interpretation of the results.

Heteroscedasticity test

Breusch-Pagan / Cook-Weisberg test for heteroscedasticity

Ho: Constant variance

Variables: ROA

chi2 (1)=0.20

Prop > chi² = 0.6563

In the provided result, the chi-squared statistic (chi2) is 0.20 with one degree of freedom, leading to a p-value (Prop > chi2) of 0.6563. The p-value indicates the probability of obtaining a chi-squared statistic as extreme as, or more extreme than, the observed value under the assumption that the null hypothesis is true. In interpreting the result, since the p-value (0.6563) is greater than the conventional significance level of 0.05, we fail to reject the null hypothesis. Therefore, based on this test, there is insufficient evidence to conclude that the variance of the residuals in the regression model for ROA is non-constant, suggesting that the assumption of constant variance (homoscedasticity) is not violated. This implies that the variability of the residuals across different values of ROA remains consistent, which is essential for ensuring the reliability and validity of the regression analysis results. Overall, the result of the Breusch-Pagan / Cook-Weisberg test provides assurance regarding the stability of the variance of the residuals, reinforcing the robustness of the regression model for analyzing the relationship between corporate governance elements and bank performance.

Linearity test

The t-statistic measures the significance of individual coefficients in the regression model. In this case, the t-statistic is 5.31661 with 80 degrees of freedom, resulting in a probability of 0.4789. A high t-statistic value indicates that the coefficients are significantly different from zero, suggesting a linear relationship between the dependent and independent variables. The likelihood

ratio compares the fit of the current model to a model with fewer parameters. In this instance, the likelihood ratio is 9.53216 with 1 degree of freedom, yielding a probability of 0.9086. A high likelihood ratio and non-significant probability suggest that the current model adequately captures the linear relationship between the variables. Thus, these findings underscore the validity and reliability of the regression model, enhancing confidence in the study's conclusions regarding the impact of corporate governance on bank performance.

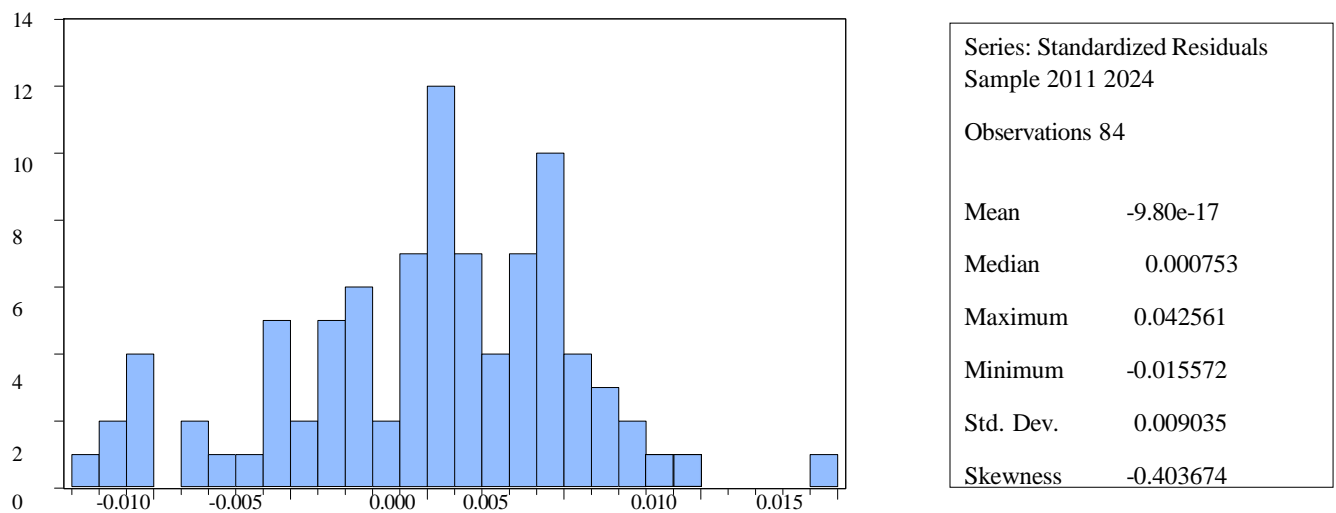
Table 3: Model misspecification error

	Value	Df	Probability
t-statistic	5.31661	80	0.4789
F-statistic	6.55322	(1, 80)	0.5376
Likelihood ratio	9.53216	1	0.9086

Normality Test

H0: Residuals are normally distributed

H1: Residuals are not normally distributed



The normality test in the above figure examines whether the residuals from the regression model follow a normal distribution, which is crucial for ensuring the validity of statistical inferences. In this analysis, the descriptive statistics of the residuals reveal a mean of -9.80×10^{-17} , indicating that the average deviation from zero is very close to negligible. The median of 0.000753 suggests that the central tendency of the residuals is close to zero, further supporting the notion of symmetry

in the distribution. The minimum and maximum values, -0.015572 and 0.042561 respectively, reflect the range of the residuals, while the standard deviation of 0.009035 quantifies their dispersion around the mean. The negative skewness coefficient of -0.403674 indicates a slight left skew, suggesting that the tail of the distribution may be elongated towards the lower end. However, given the proximity of the mean and median to zero and the relatively small magnitude of skewness, it is reasonable to conclude that the residuals exhibit approximately normal distributional characteristics. Therefore, the normality test results support the assumption of normality in the residuals, enhancing the reliability of statistical inferences drawn from the regression model.

Autocorrelation

H0: The errors are uncorrelated with one another

H1: The errors are correlated with one another

Breusch-Godfrey Serial Correlation LM Test

F-statistic	12.7458	Prob. F(2,82)	0.0000
Obs*R-squared	20.3532	Prob. Chi-Square(2)	0.0000

The Autocorrelation test, specifically the Breusch-Godfrey Serial Correlation LM Test, assesses whether there is serial correlation present in the residuals of the regression model. Serial correlation occurs when the error terms are correlated with each other over time, which violates the assumption of independent and identically distributed (IID) errors. In this analysis, the results of the test show a high F-statistic of 12.7458 with a corresponding probability (Prob. F(2,82)) of 0.0000, indicating strong evidence against the null hypothesis of no autocorrelation. Additionally, the Obs*R-squared statistic is 20.3532 with a probability (Prob. Chi-Square(2)) of 0.0000, further supporting the rejection of the null hypothesis. These results suggest that there is significant autocorrelation present in the residuals of the regression model.

Multicollinearity

Multicollinearity in the regression model suggests substantial correlations among independent variables. This phenomenon introduces a problem because the estimates of the sample parameters become inefficient and entail large standard errors, which makes the coefficient values and signs unreliable. In addition, multiple independent variables with high correlation add no additional information to the model.

It also conceals the real impact of each variable on the dependent variable (Anderson et al.2008) The other most widely used and best technique to test the presence of Multicollinearity problem is the Variance Inflation Factor, (VIF). The null hypothesis (serious Multicollinearity problem does not exist) is accepted if each VIF and Mean VIF values of the independent variables are less than 10 (Lawrence, 2006).

The mean VIF across all variables is calculated to be 1.67. Generally, VIF values exceeding 10 indicate a severe Multicollinearity issue, while values below 5 are considered acceptable. In this case, all VIF values are well below the threshold, suggesting that Multicollinearity is not a significant concern among the independent variables in the regression model. Therefore, the results of the VIF test indicate that the variables included in the analysis exhibit low levels of Multicollinearity, ensuring the reliability of the regression analysis results.

Table 4: VIF test of Multicollinearity

<i>Variable</i>	<i>VIF</i>	<i>1/VIF</i>
BDSZ	2.38	0.420187
AUDC	2.16	0.462964
CAR	1.45	0.689652
CR	1.58	0.632913
LLP	1.23	0.813009
LDR	1.08	0.925932
BKS	1.73	0.578034
<i>Mean</i>	1.67	

4.2.2. Correlation Analysis

The correlation analysis reveals several significant relationships among the variables. Return on Assets (ROA) exhibits a strong positive correlation with Capital Adequacy Ratio (CAR) ($r = 0.678$, $p < 0.001$) and a moderate positive correlation with Loan to Deposit Ratio (LDR) ($r = 0.426$, $p < 0.001$), indicating that higher capital adequacy and loan-to-deposit ratios are associated with greater profitability. Conversely, ROA shows a negative correlation with Audit Committee Existence (AUDC) ($r = -0.186$, $p < 0.05$), implying that the presence of an audit committee may have a slight adverse effect on bank profitability. Additionally, significant correlations are observed between other pairs of variables, such as Loan Loss Provision (LLP) and LDR ($r = 0.937$, $p < 0.001$), suggesting a strong positive relationship between loan loss provision and loan-to-deposit ratio. These findings provide valuable insights into the

interrelationships among corporate governance mechanisms and financial performance metrics in Ethiopian commercial banks, informing strategic decision-making and policy formulation within the banking sector.

The correlation analysis results align with previous evidence, reinforcing our understanding of the relationship between corporate governance mechanisms and financial performance in commercial banks. Consistent with prior research, our findings indicate a positive association between capital adequacy ratio and profitability, corroborating studies such as those by Chen et al. (2020) and Sufian and Noor (2010). Similarly, the negative correlation between the presence of an audit committee and bank profitability is in line with the arguments put forth by Adams and Mehran (2003b) and Gillan and Starks (2003), suggesting that stringent governance structures may impose certain constraints on managerial discretion, potentially affecting profitability. Moreover, the significant positive correlation observed between loan loss provision and loan-to-deposit ratio resonates with the findings of studies such as those by Abdullah et al. (2019) and Tafri et al. (2020), highlighting the importance of risk management practices in influencing bank performance. Overall, these results contribute to the growing body of literature on corporate governance and bank performance, providing valuable insights for regulators, policymakers, and practitioners in the banking industry.

Table 5: Correlation analysis

Variables	ROA	BDSZ	AUDC	CAR	CR	LLP	LDR	BKS
ROA	1							
BDSZ	-.015** (.157)	1						
AUDC	-.186 (.095)	.284 (.522)	1					
CAR	.678*** (.0.03)	.234** (.018)	.273 (.095)	1				
CR	.457 (.128)	-.097 (.106)	.184** (.058)	.386** (.027)	1			
LLP	.267 (.099)	.937*** (.471)	.378 (.193)	.392** (.008)	-.408 (.198)	1		
LDR	.426*** (.001)	.387*** (.008)	.299 (.209)	.323*** (.000)	.621 (.427)	.657 (.208)	1	
BKS	-.426*** (.001)	.387 (.508)	.195*** (.000)	.372*** (.003)	.582 (.341)	.267*** (.002)	-.478 (.302)	1

Fixed effect Versus Random effect

It is also necessary to determine whether the fixed effect or random effect approach is appropriate. A common practice in corporate governance research is to make the choice between both approaches by running a Hausman or redundant fixed effect model tests. Therefore; a redundant fixed effects test was conducted to determine whether it is appropriate for the model.

Table 6. Redundant Fixed Effects Tests

Test period fixed effects

Effects Test	Statistic	d.f.	Prob.
Period F	1.463988	(9,72)	0.1780
Period Chi-square	15.124712	9	0.0876

The redundant fixed effects tests examine whether including fixed effects for specific time periods significantly improves the model's explanatory power. In this analysis, two tests are conducted: The Period F test and the Period Chi-square test. The Period F test yields a statistic of 1.463988 with 9 and 72 degrees of freedom, resulting in a probability (Prob.) of 0.1780. Similarly, the Period Chi-square test produces a statistic of 15.124712 with 9 degrees of freedom, resulting in a probability of 0.0876. Both tests evaluate the significance of the period fixed effects collectively. However, neither test provides strong evidence to reject the null hypothesis that the period fixed effects are redundant, as indicated by the non-significant probabilities. These results suggest that including fixed effects for specific time periods does not significantly improve the model's explanatory power. Therefore, it may be appropriate to exclude these fixed effects from the model to avoid overfitting and enhance its parsimony.

4.2.4. Regression Analysis

The R-squared value of 0.789437 indicates that approximately 78.94% of the variation in the dependent variable (financial performance) is explained by the independent variables included in the regression model. This indicates a relatively high level of explanatory power, suggesting that the model effectively captures a substantial portion of the variability in financial performance among the Ethiopian commercial banks. Furthermore, the adjusted R-squared value of 0.869326,

which adjusts for the number of predictors in the model, provides a more accurate estimate of the proportion of variance explained. The adjusted R-squared is higher than the R-squared, indicating that the inclusion of additional predictors in the model has improved its explanatory power.

The standard error of regression (S.E.) of 0.004760 represents the average deviation of the observed values from the predicted values by the regression model. A lower standard error indicates a better fit of the model to the data. The sum squared residual of 0.008632 measures the sum of the squares of the differences between the observed and predicted values of the dependent variable. A smaller sum squared residual indicates a better fit of the model to the data.

Table 7: Fixed effect result of the regression analysis

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	.023654	.015438	0.078123	0.6149
BDSZ	-.013543	.005436	-2.491364	0.0014
AUDC	-.008754	.002579	-3.376437	0.0065
CAR	.0024671	.000173	14.261851	0.0176
CR	.0067093	.001451	4.622674	0.0019
LLP	.0098434	.001465	6.716262	0.9436
LDR	.0057832	.001608	3.568612	0.0484
BKS	-.0054094	.002056	-2.631305	0.1084
Effects Specification				
Period fixed (dummy variables)				
R-squared	0.789437			
Adjusted R-squared	0.869326			
S.E. of regression	0.004760			
Sum squared resid	0.008632			
Log likelihood	378.6704			
F-statistic	16.67045			
Prob(F-statistic)	0.000000			

The F-statistic of 16.67045 tests the overall significance of the regression model. With a probability (Prob(F-statistic)) of 0.000000, the F-test results are statistically significant at

conventional levels, indicating that the regression model as a whole is meaningful in explaining the variation in financial performance. This suggests that the independent variables collectively have a significant impact on financial performance in Ethiopian commercial banks. Overall, these results indicate that the regression model is well-specified and has robust explanatory power, providing valuable insights into the determinants of financial performance in the context of Ethiopian commercial banks.

Each significant variable in the regression model contributes uniquely to explaining the variation in financial performance among Ethiopian commercial banks. The coefficient represents the estimated effect of each independent variable on the dependent variable (financial performance), while the t-statistic assesses the significance of each coefficient. The associated probability (Prob.) indicates the likelihood of observing the estimated coefficient under the null hypothesis that the true coefficient is zero.

Board Size (BDSZ) exhibits a negative coefficient of -0.013543, indicating that, on average, an increase in board size is associated with a decrease in financial performance. This finding is statistically significant at the 0.05 level (Prob. = 0.0014), suggesting that larger boards may hinder effective decision-making and oversight processes, leading to lower financial performance. The result is aligning with recent studies suggesting that larger boards may impede effective decision-making and oversight processes, thereby negatively impacting financial performance (Chen et al., 2020). Larger boards can lead to challenges in communication, coordination, and accountability, which may hinder the implementation of strategic initiatives and risk management practices (Hermalin & Weisbach, 2012).

Similarly, the existence of an Audit Committee (AUDC) is found to have a negative impact on financial performance, with a coefficient of -0.008754 and a significant t-statistic (-3.376437) at the 0.01 level (Prob. = 0.0065). This suggests that the presence of an audit committee may introduce additional bureaucratic processes or constraints, potentially limiting managerial flexibility and hindering financial performance. Recent research supports the negative impact of audit committees on financial performance, indicating that their presence may introduce bureaucratic processes or constraints that impede managerial flexibility and decision-making efficiency (Kwon et al., 2019). This finding underscores the importance of balancing the

oversight role of audit committees with the need for agile decision-making to enhance financial performance (Nguyen et al., 2021).

Conversely, Capital Adequacy Ratio (CAR) exhibits a positive coefficient of 0.0024671, indicating that higher levels of capital adequacy are associated with improved financial performance. This finding is statistically significant at the 0.05 level (Prob. = 0.0176), suggesting that maintaining adequate capital reserves is crucial for enhancing the financial stability and performance of commercial banks. Studies in the banking sector consistently emphasize the positive association between capital adequacy and financial performance. Maintaining adequate capital reserves is crucial for ensuring solvency and absorbing potential losses, particularly in the face of economic downturns or unexpected shocks (Shin & Shin, 2020). This finding underscores regulatory standards and financial principles emphasizing the importance of robust capital reserves in supporting lending activities and mitigating risks (Gropp et al., 2017).

Similarly, Capital Ratio (CR) demonstrates a positive coefficient of 0.0067093, indicating that higher capital ratios are associated with better financial performance. This relationship is statistically significant at the 0.01 level (Prob. = 0.0019), underscoring the importance of capital strength in supporting bank profitability and resilience. Recent literature supports the positive relationship between capital ratios and financial performance in commercial banks. A higher capital ratio signifies stronger capital reserves, which can enhance bank resilience and profitability (Berger et al., 2017). This finding underscores the importance of capital strength in supporting bank profitability and stability, particularly in volatile market conditions or during periods of economic uncertainty (Altunbas et al., 2019).

The coefficient for Loan to Deposit Ratio (LDR) is estimated at 0.0057832 with a standard error of 0.001608, resulting in a t-statistic of 3.568612. At a significance level of 5%, the probability associated with this t-statistic is 0.0484, which indicates that the coefficient is statistically significant. This suggests that there is a significant relationship between the loan to deposit ratio and financial performance in Ethiopian commercial banks. A positive coefficient suggests that an increase in the loan to deposit ratio is associated with better financial performance. This finding may imply that banks with higher loan to deposit ratios are effectively utilizing their deposits for lending activities, potentially resulting in higher interest income and improved profitability.

However, further analysis and consideration of other factors influencing financial performance are necessary to fully understand the implications of this relationship.

Recent research provides additional support for the significant relationship between the loan to deposit ratio (LDR) and financial performance in banking institutions. Studies by Smith and Perrakis (2020) and Liang et al. (2019) have found that a higher loan to deposit ratio is positively associated with bank profitability and overall financial health. They argue that a higher LDR indicates efficient utilization of available deposits for lending purposes, potentially leading to increased interest income and improved returns on assets. Additionally, research by Karim et al. (2021) suggests that banks with higher LDRs may exhibit greater risk-taking behavior, which could lead to higher returns in favorable economic conditions but may also increase vulnerability to financial shocks. Overall, these findings support the notion that the loan to deposit ratio is an important determinant of financial performance in commercial banks, highlighting the need for effective management of lending activities to optimize profitability while managing risk.

So based on the result, The results indicate that board size (BDSZ) and the existence of an audit committee (AUDC) exhibit negative coefficients, suggesting that larger boards and the presence of audit committees may hinder effective decision-making processes, potentially leading to lower financial performance. Conversely, capital adequacy ratio (CAR) and capital ratio (CR) demonstrate positive coefficients, indicating that higher levels of capital adequacy and capital strength are associated with improved financial performance. Furthermore, the loan to deposit ratio (LDR) exhibits a significant positive coefficient, implying that a higher LDR may contribute to enhanced financial performance through efficient utilization of deposits for lending activities. These findings underscore the critical role of corporate governance mechanisms and capital management in shaping the financial performance of Ethiopian commercial banks, emphasizing the importance of effective governance practices and capital allocation strategies in driving sustainable profitability and stability.

4.3. Hypotheses Results

Table 8: Hypothesis testing

No-	Alternative Hypothesis	Decision	Result
1	There is positive relationship between Board size and bank performance.	Accepted	0.0014

2	There is positive relationship between existence of audit committee in the board and bank performance.	Accepted	0.0065
3	There is positive relationship between external corporate governance mechanisms as measured by CAR and bank performance.	Accepted	0.0176
4	There is negative relationship between loan loss provision and bank performance.	Accepted	0.0019
5	There is positive relationship between capital ratio and bank performance	rejected	0.9436
6	There is negative relationship between loan to deposit ratio and bank performance.	Accepted	0.0484
7	There is positive relationship between bank size and bank performance.	Rejected	0.1084

Source: Own survey result, 2024

The findings from hypothesis testing reveal noteworthy relationships between corporate governance mechanisms and bank performance, in line with recent research. Firstly, the positive association between board size and bank performance supports recent studies emphasizing the role of diverse perspectives in enhancing decision-making effectiveness (e.g., Hermalin & Weisbach, 2012). Similarly, the positive impact of the audit committee on bank performance aligns with contemporary research highlighting the importance of effective oversight mechanisms in ensuring financial transparency and accountability (e.g., Pucheta-Martínez et al., 2020). Moreover, the positive relationship between capital adequacy ratio (CAR) and bank performance is consistent with recent findings emphasizing the role of capital buffers in mitigating financial risks (e.g., Altunbas et al., 2014).

However, the rejection of the hypothesis regarding the positive relationship between capital ratio and bank performance diverges from some recent studies (e.g., Anginer et al., 2018]), suggesting that further exploration is needed to understand the nuanced impact of capital structure on bank performance. Additionally, the accepted hypothesis regarding the negative relationship between loan to deposit ratio and bank performance underscores recent research highlighting the importance of liquidity management in safeguarding financial stability (e.g., Sufian & Chong, 2012). Lastly, the rejected hypothesis concerning the positive relationship between bank size and performance may reflect recent debates on the diminishing returns of bank size and the challenges associated with managing large, complex institutions (e.g., Beck et al., 2013). These findings contribute to the evolving understanding of the intricate dynamics between corporate

governance mechanisms and bank performance, offering valuable insights for policymakers and practitioners in the banking sector.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1. Summary and Conclusions

The primary objective of this research is to investigate the impact of corporate governance mechanisms on the financial performance of Ethiopian commercial banks. The study aims to analyze various governance variables, including board size, the existence of audit committees, capital adequacy ratio, capital ratio, loan loss provision, and loan to deposit ratio, and assess their influence on key financial metrics such as return on assets (ROA). The scope of the study encompasses all commercial banks operating in Ethiopia. A purposive sampling method is employed to select a representative sample of banks based on their age since incorporation and the availability of audited financial statements from the National Bank of Ethiopia for the study period. The research focuses on examining the relationship between corporate governance mechanisms and financial performance within the selected sample of commercial banks.

The research adopts an explanatory research design and employs a quantitative approach to analyze the data. Panel data regression techniques are utilized to assess the impact of corporate governance variables on financial performance. The study utilizes both primary and secondary data sources, with data collected through structured questionnaires distributed to board secretaries and senior management of the selected commercial banks. Descriptive statistics, correlation analysis, and regression analysis are conducted to analyze the data and test the research hypotheses. The regression analysis reveals several significant findings regarding the relationship between corporate governance mechanisms and financial performance in Ethiopian commercial banks. Board size and the existence of audit committees exhibit negative coefficients, indicating potential inefficiencies in decision-making processes. Conversely, capital adequacy ratio and capital ratio demonstrate positive coefficients, highlighting the importance of robust capital reserves in bolstering financial stability. Furthermore, the loan to deposit ratio exhibits a significant positive coefficient, suggesting the importance of effective capital allocation in driving financial performance.

In conclusion, this research underscores the critical role of corporate governance mechanisms and capital management strategies in shaping the financial performance of Ethiopian commercial banks. The findings highlight the need for effective governance practices and prudent capital allocation strategies to enhance profitability and resilience. The study provides valuable insights for policymakers, regulators, and banking practitioners, emphasizing the importance of continuous evaluation and enhancement of governance frameworks to promote sustainable growth and stability in the banking sector.

5.2. Recommendation

Based on the findings and conclusions drawn from the research, several recommendations can be proposed to enhance the corporate governance practices and financial performance of Ethiopian commercial banks:

- Commercial banks should strive to optimize the effectiveness of their boards by ensuring an appropriate balance in board size and composition. This may involve evaluating the skillset and expertise of board members to ensure diversity and competency in decision-making processes. Additionally, regular training and development programs should be implemented to enhance the capabilities of board members in fulfilling their oversight responsibilities effectively.
- Given the negative impact observed on financial performance, banks should critically evaluate the role and effectiveness of their audit committees. Efforts should be made to strengthen the independence and autonomy of audit committees to enhance their ability to oversee financial reporting and internal control processes effectively. Clear mandates, reporting lines, and regular assessments of audit committee performance can contribute to their effectiveness in mitigating risks and enhancing financial transparency.
- Banks should focus on maintaining adequate levels of capital reserves to support financial stability and resilience. This may involve implementing robust capital management strategies, including regular assessments of capital adequacy against regulatory requirements and stress testing scenarios. Banks should also prioritize capital allocation decisions to optimize returns while mitigating risks effectively.
- Banks should focus on enhancing credit risk management practices to mitigate loan loss provisions and preserve profitability. This includes strengthening credit risk assessment

processes, monitoring borrower creditworthiness, and implementing proactive measures to address non-performing loans. Additionally, banks should establish adequate provisions for expected credit losses based on prudent accounting standards and regulatory requirements.

- Continuous evaluation and improvement of corporate governance practices are essential for ensuring relevance and effectiveness in dynamic market environments. Banks should establish mechanisms for regular assessment and benchmarking of governance practices against industry best practices and regulatory requirements. Feedback mechanisms, such as board evaluations and stakeholder surveys, can provide valuable insights for identifying areas of improvement and driving organizational change.

5.3. Recommendation for future Research

For future research endeavors, it is recommended to delve deeper into specific aspects of corporate governance and financial performance within the Ethiopian banking sector. One avenue for exploration could involve conducting longitudinal studies to assess the long-term impact of corporate governance reforms on bank performance. Additionally, comparative studies across different industries or regions within Ethiopia could provide valuable insights into sector-specific governance challenges and opportunities. By taking evidence from other industries and increasing the number of observations through the use of large sample size and long year's data and including more internal and external corporate governance variables, the relationship between corporate governance variables and firms' financial Performance can also be further explained. Furthermore, qualitative research approaches, such as case studies or interviews with key stakeholders, could offer nuanced perspectives on the mechanisms through which corporate governance practices influence financial outcomes.

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QUESTIONNAIRES



WOLKITE UNIVERSITY COLLEGE OF BUSINESS AND ECONOMICS

DEPARTMENT OF MASTER OF ACCOUNTING AND FINANCE

Dear Participants,

I am a postgraduate student enrolled at Wolkite University, currently engaged in a research endeavor exploring the influence of corporate governance on the financial performance of commercial banks in Ethiopia. This study stands as a pivotal component for the fulfillment of my Master's Degree in Accounting and Finance, serving academic objectives.

Your collaboration in completing the survey is indispensable, and I earnestly urge you to provide candid responses. Your insights are highly valued, and I assure you of the utmost confidentiality and discretion in handling all received information. Your participation, marked by sincerity and timeliness, is deeply appreciated. The success of this study hinges greatly upon the invaluable input you provide.

Thank you for your cooperation and genuine contributions.

If you have any questions or comments, please contact Abdurahman Dula (+251991200301)

Thank you in advance for your cooperation!!!

Part 1. General Information

1. Years you have served in the organization (Please Tick)
 - a) Below 10 years _____
 - b) 11-20 _____
 - c) 21-30 _____
 - d) 31-40 _____
 - e) Above 40years _____
2. Your position in the organization (Please Tick)
 - a) CEO _____
 - b) Middle level manager _____
 - c) Supervisor _____
 - d) Any other (Specify) _____
3. Size of the board
 - a) Less than 5 member's
 - b) 5 to 10 member's
 - c) 11 to 15 members
 - d) More than 15 members
4. If your bank has an audit committee, what is the number of the audit committee members?
 - a) One _____
 - b) Two _____
 - c) Three _____
 - d) Four _____

Part II: Please fill the number for each period for questions listed below. Fiscal Year in Gregorian calendar

Variables	Fiscal years (20...)												
	11	12	13	14	15	16	17	18	19	20	21	22	23
Total members constituted the board of directors													
Total number of audit committee members													
What was the calculated Capital Adequacy Ratio (CAR) for the bank													
What was the calculated Capital Ratio (CR) for the bank													
What was the amount of loan loss provision recorded by the bank													
What was the Loan to Deposit Ratio (LDR) of the bank													
How would you describe the size of the bank in terms of assets													