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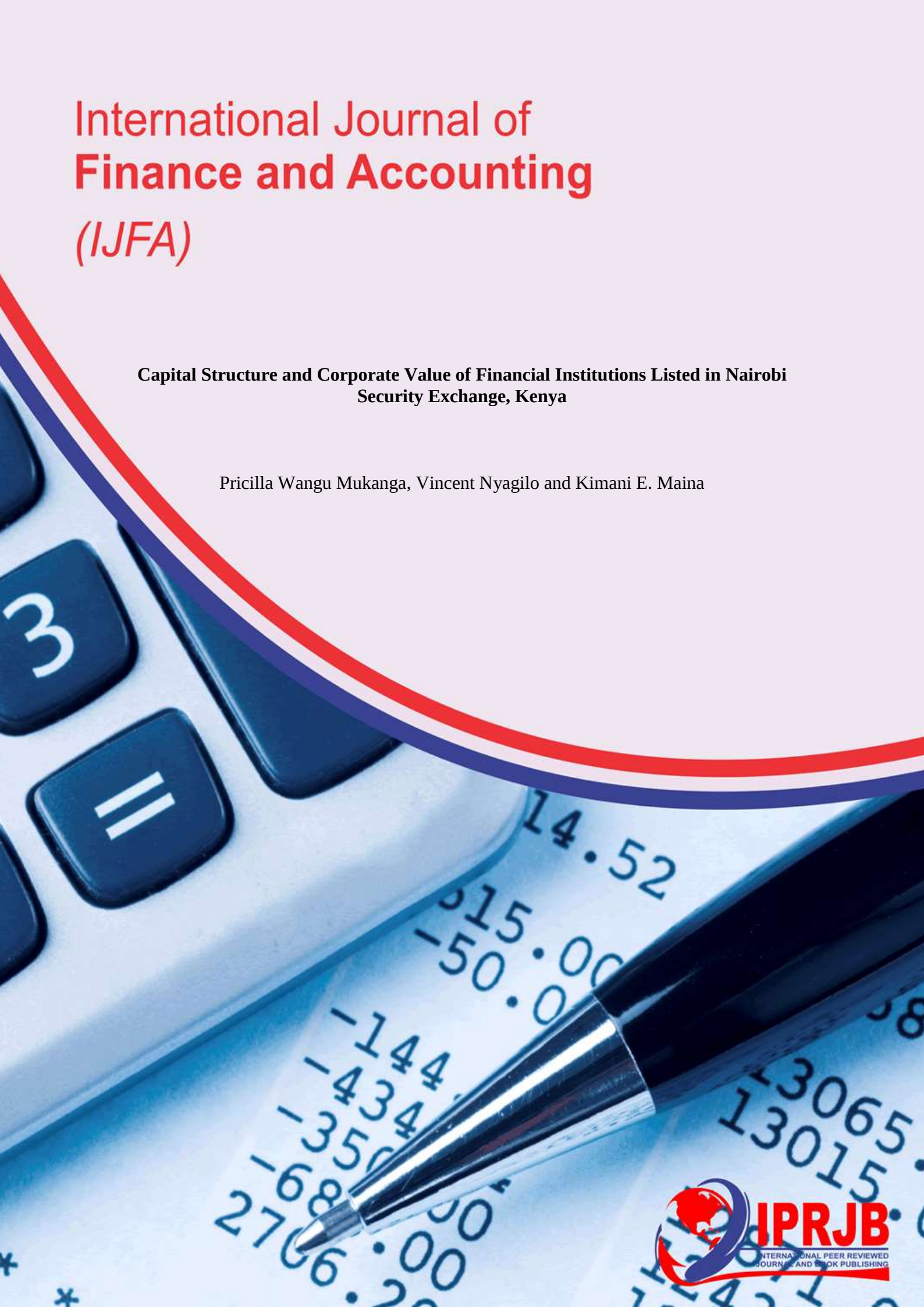
Pricilla Wangu Mukanga, Vincent Nyagilo and Kimani E. Maina



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Capital Structure and Corporate Value of Financial Institutions Listed in Nairobi Security Exchange, Kenya

[1*]Pricilla Wangu Mukanga
Master of Science, Finance School of Business and Entrepreneurship, Department of Economic, Accounting and Finance, Jomo Kenyatta University of Agriculture and Technology

[2]Vincent Nyagilo
Lecturer, Department of Economic, Accounting and Finance, School of Business and Entrepreneurship, Jomo Kenyatta University of Agriculture and Technology

[3]Kimani E. Maina
Lecturer, Department of Economic, Accounting and Finance, School of Business and Entrepreneurship, Jomo Kenyatta University of Agriculture and Technology

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Abstract

Purpose: Corporate value refers to shareholders' perceptions and is closely tied to the market price of equity shares, serving as an indicator of a firm's success, with higher stock prices reflecting greater corporate value. Recent declines in profitability in Kenya's banking and insurance sectors prompt an investigation into the role of capital structure in influencing corporate value. The general objective of this study is to determine the effect of capital structure on the firm value of listed financial institutions in Kenya.

Methodology: A descriptive longitudinal design is employed to capture the dynamic influence of capital structure over five years, from 2019 to 2023. The target population comprises 16 financial institutions listed on the Nairobi Securities Exchange in the banking and insurance sectors, and due to the small population size, a census study approach is used. Secondary panel data is collected from financial statements filed with the Capital Markets Authority and processed using STATA, ensuring that the assumptions of the classical linear regression model are met. Data analysis reveals a subtle set of findings.

Findings: The overall model explains 59.17% of the variation in corporate value. Capital structure demonstrates a strong positive influence with a coefficient of 0.53 (p-value = 0.00), underscoring its role as a significant driver of firm value. The findings underscore the importance of capital structure as a critical lever in Kenya's financial sector.

Unique Contribution to Theory, Practice and Policy: This study offers valuable insights for regulatory bodies, policymakers, and investors seeking to optimize capital structure for value maximization, providing empirical support for strategic decisions aimed at enhancing corporate value in emerging markets.

Keywords: *Capital Structure, Firm Value, Financial Institutions, Nairobi Securities Exchange*

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INTRODUCTION

Corporate value is the shareholders' perception of a firm that is associated with the market price of its shares (Fatma & Chouaibi, 2021). The primary goal of a firm is to maximise its corporate value, which day electric impacts the prosperity of its shareholders (El-Ansary & Hamza, 2022). As Suhadak and Handayani (2020) explain, the share price reflects the market value of the company, thereby enhancing shareholders' welfare. Consequently, when a company's share price rises, it augments the well-being of its shareholders. Moreover, firms make a substantial economic contribution to national development, so they must prioritize maximizing their value as the overall health of the economy relies on their performance. (Fatma & Chouaibi, 2021).

Corporate value reflects management performance in managing corporate assets. The value is mirrored in the market price of the corporation shares (Widnyana et al., 2021). The financial management of a corporation underscores that every managerial decision aligns with the primary goal of maximizing its corporate value. However, in practice, the objectives may be difficult to implement due to agency problems created by the separation of ownership from the management of the listed firms (Boachie, 2021). Furthermore, in the recent past, financial crises, volatilities in the markets caused by Covid pandemic and the fall of large corporations have seen firms endure severe losses in value (Singhania, Singh, & Aggrawal, 2022).Capital structure significantly impacts a firm's value and entails a mix of debt and equity used for financing operations and investments (Agmas, 2020; Harasheh & De Vincenzo, 2022).

Bui (2023) underscores the importance of capital structure or the proportion of debt and equity it uses to fund its operations, has a big impact on corporate value since it affects risk, cost of capital, and overall financial performance. The capital structure decisions made by a business can impact its capacity to draw in investors, gain access to financial markets, and eventually boost shareholder wealth.Common proxies for capital structure include debt-to-asset, debt-equity, and long-term debt-to-equity ratios (Mathur, Tiwari, Ramaiah, & Mathur, 2021). However, capital structure ratios vary for financial institutions due to regulatory constraints, risk factors, and specific business models (Fatma & Chouaibi, 2021). Key metrics for assessing financial institutions' capital structure include the tier-one capital issue and leverage ratio (Kirimi, Kariuki, & Ocharo, 2022). As the leverage ratio requirements for insurance and banking firms are similar, this study will adopt the leverage ratio as a proxy for capital structure.

Statement of the Problem

Corporate value, a pivotal focus on finance, signifies accompanies overall worth, reflecting its financial health riding investors attractiveness (Suhadak & Handayani, 2020). Investors rely on corporate value to assess and predict a firm' s success, (Suhadak & Saifi, 2020). Despite the stability of Kenya's financial sector, there have been significant challenges in corporate value, primarily driven by profitability issues. For instance, profit before tax as a percentage of total assets in the banking sector declined from 3.4% in 2019 to 2.1% in 2020, before recovering to 3.7% in 2022. Additionally, non-performing loans increased from 6.9% in 2018 to 7.7% in 2022. In the insurance sector equity as a percentage of total assets grew from 3.5% in 2018 to 4.1% in 2022, profitability relative to the equity fluctuated indicating potential inefficiencies (Financial Sector Regulators, 2023). These profitability issues have led to a decline in corporate value, as inconsistent earnings and financial instability reduce investor confidence and market valuation. Empirical evidence suggests a significant influence of capital structure on corporate value (El-Ansary & Hamza, 2022; Mathur et al., 2021), yet research gaps persist. Conceptually, inconclusive findings exist regarding whether capital structure positively or negatively impacts

corporate value (El-Ansary & Hamza, 2022; Karim et al., 2022; Queiri et al., 2021). Methodologically, the majority of studies adopt cross-sectional designs with one-year data, which may not capture the evolutionary nature of capital structure influence on corporate value (Chatterjee & Bhattacharjee, 2020). Contextually, studies conducted outside Kenya may not directly apply due to differing geographical, legislative, and economic contexts (Fatma & Chouaibi, 2021). Additionally, existing literature in Kenya primarily focuses on non-financial firms, leaving a gap in understanding financial firms' dynamics (Abang'a et al., 2022; Korir & Tenai, 2020). To fill the gaps, this study aims to investigate the association between capital structure and corporate value among listed financial entities in Kenya, employing longitudinal research design with panel data.

Objectives of the Study

The overarching goal of this study will be to determine the effect of capital structure on corporate value of listed financial institutions at the Nairobi Security Exchange, Kenya.

Hypotheses of the Study

H_0: Capital structure has no effect on the corporate value of financial institutions listed in Nairobi Security Exchange, Kenya.

LITERATURE REVIEW

Theoretical Review

Capital structure was anchored by the trade-off theory, proposed by Myers (1984). The theory posits that the optimal capital structure is achieved when the discounted after-tax cost of debt is balanced by an increase in the discounted cost of financial distress. Myers (1984) argued that debt financing involves both costs and benefits, and determining the optimal capital structure that maximizes firm value requires balancing these factors. An organization sets its target debt level where the additional cost of debt equals its marginal benefit, thus achieving equilibrium. The theory identifies the costs of debt as comprising agency costs and financial distress costs, while the benefits include the reduction in agency costs and the tax shield associated with debt usage. This equilibrium points where these trade-offs balance is crucial for determining the firm's optimal capital structure.

According to Myers (1984), the firm's value can be maximized at the point where the marginal cost of capital is lowest. Empirical evidence provided by Agmas (2020) supports the trade-off theory, indicating that the optimal debt ratio is achieved by equating the costs and benefits of using debt. Furthermore, Myers and Rajan (1998) suggest that firms with lower debt levels and equity issuance can better maximize their value, particularly when they have good growth opportunities and stellar performance. Suhadak and Handayani (2020) highlight that the trade-off theory is based on tax deductions, as debt usage results in lower taxable profits, thereby reducing tax payments for firms. Consequently, this research study adopts the trade-off theory to inform the capital structure variable, underscoring its relevance in balancing debt benefits and financial distress costs.

Conceptual Framework

Conceptual framework guides empirical research in filling gaps identified in the literature. In addition, it shows the interrelationship among the variables in the study. Figure 2.1. Is the conceptual framework.

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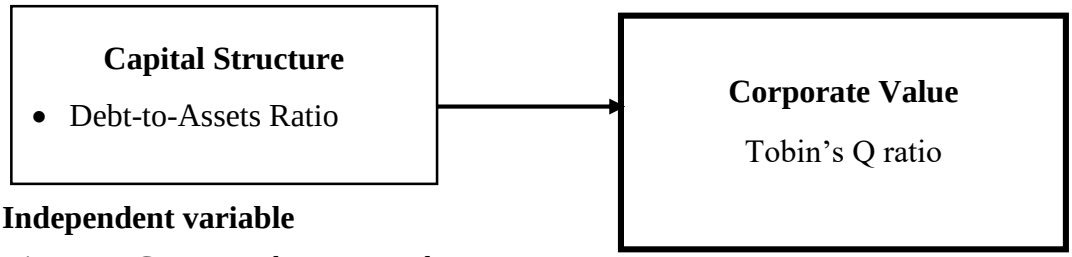

Figure 1: Conceptual Framework

Empirical Review

Ahmed and Afza (2019) examined the association between capital structure and firm value of listed non-financial entities in Pakistan from 2006 to 2013. The study used purposive sampling to select 333 firms with 2,664 firm-year observations. This comprehensive analysis utilized balanced secondary longitudinal data extracted from audited financial statements. Total-debt ratio, long-term debt ratio, and short-term debt ratio were employed as proxies for capital structure. The fixed effects ordinary least squares regression indicated that capital structure positively impacted market performance, measured as Tobin's Q, of non-financial listed firms in Pakistan. Firm size was found to moderate the relationship between capital structure and firm value. However, the study's narrow focus on capital structure overlooks other potential determinants of firm value, and its specificity to Pakistan's non-financial sector may limit generalizability.

Agmas (2020) examined the influence of capital structure on the firm value of thirty Ethiopian construction firms using time-series from 2011 to 2015. The explanatory study used secondary data from Ethiopian Revenue and Customs Authority. Three leverage ratios were used as indicators of capital structure. Return on assets and return on equity were adopted as indicators of firm value. The results showed that while debt to equity and long-term debt to total assets had positive interactions with firm value, the ratio of total debt to assets had a negative impact. However, the study's exclusive reliance on leverage ratios neglects broader financial metrics, and potential data limitations from secondary sources are not adequately addressed.

An Indonesian study by Suhadak and Saifi (2020) that examined the association between capital structure and firm value of listed manufacturing firms from 2008 to 2015. The study used purposive sampling in picking the manufacturing entities and was linked to the pecking order theory. Debt to equity and debt to asset ratios were indicators of capital structure. Tobin's Q ratio and Price-Earnings ratio were market-based measures of firm value. The pooled ordinary least squares regression method found a significant and direct linkage between capital structure and firm value in Indonesian manufacturing entities. However, the research's sole focus on the Indonesian manufacturing sector overlooks broader industry implications, and its reliance on a single theoretical framework may limit the depth of analysis.

Mathur et al.(2021) analysed the relationship between capital structure and the financial performance of 25 Indian pharmaceutical firms listed on the Bombay Stock Exchange from 2008 to 2018. They reviewed literature on pecking order and trade-off theories to understand how capital structure influenced performance. Total-debt ratio, long-term debt ratio and short-term ratio were proxies for capital structure. Tobin's Q ratio, return on assets and returns on equity were indicators of financial performance. The research utilized balanced panel data and employed random effect least squares model. The study found that high debt financing negatively influenced financial performance, supporting the pecking order theory. However,

the study fails to account for external factors that could influence the relationship between capital structure and firm performance, and its limited time frame may overlook long-term trends.

Harasheh and De Vincenzo (2022) studied the effect of leverage on value creation in 35 small and medium firms listed on the Italian securities market over four years. They used total liabilities and total assets ratio as the measure of leverage. Value creation was proxied by market capitalization and Tobin's Q ratio. The study was anchored in trade-off and pecking order theories and used multivariate linear regression with panel estimation. The results showed a negative relationship between leverage and firm value, more pronounced in manufacturing firms compared to firms in the service industry. However, the study's omission of external influences and its narrow focus on Italy's small and medium-sized firms may restrict the applicability of its findings beyond this specific context.

El-Ansary and Hamza (2022) investigated the impact of corporate financial policies on firm value using a purposive sample of 402 non-financial firms listed on public stock exchanges in twelve Middle East and North African countries from 2013 to 2019. They used pooled ordinary least squares model with panel data methodology. Market leverage was the dependent variable. Firm value was computed by dividing the sum of market capitalization and total debt by total assets was adopted as the independent variable. The study revealed a significant negative relationship between leverage and firm value, while firm size had a significant positive effect. Nevertheless, the study overlooks implications for industries beyond Indonesian manufacturing and lacks depth due to reliance on a single theoretical framework.

Research Gap

The literature has revealed several knowledge gaps concerning the relationship between capital structure and corporate value. These gaps include conceptual, contextual and methodological dimensions. Conceptual gaps pertain to the understanding of the relationship between studied, as outlined in existing literature. Contextual gaps specifically address the relevance of this concepts within the context of listed financial firms in Kenya. Methodological gaps encompass issues related to population selection, sample size determination, research design and data analysis techniques.

The literature reveals conceptual, gaps in the examination of capital structure and its relationship with corporate value. Studies predominantly focus on specific components of capital structure without considering their interplay comprehensively (Agmas, 2020; El-Ansary & Hamza, 2022; Fatma & Chouaibi,2021; Harasheh & De Vincenzo, 2022; Karim et al., 2022; Queiri et al., 2021;Suhadak & Saifi, 2020) . This narrow focus limits the holistic understanding of how different aspects of capital structure impact firm value. Moreover, there is lack of consensus and consistency in defining and operationalizing these capital structure variables across studies impeding the advancement of knowledge in this area.

Many studies rely on a single-period cross-sectional data, neglecting the long-term impact of financial architecture on firm value on a firm. For instance, while Chatterjee and Bhattacharjee (2020) provides valuable insights into the relationship between capital structure and firm value in Indian small firms, their study highlights a methodological gap in longitudinal analysis as it only relies on a single-period cross-sectional data. Contextually, most studies focus on specific industries other than listed financial firms, leaving a gap in understanding how capital structure impact on corporate value of listed financial firms.Studies by Chatterjee and Bhattacharjee (2020) , Queiri et al. (2021), Agmas(2020) , Suhadak and Saifi (2020) , Mathur et al. (2021) ,

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Harasheh and DeVincenzo (2022) , El-Ansary and Hamza (2022) , and Abang'a et al. (2022) , have examined the influence of capital structure and corporate value within various on-financial sectors, including manufacturing, pharmaceuticals, construction, and state owned enterprises.

Despite the presence of studies such as those by Fatma and Chouaibi, (2021) and Boachie (2021) which explores aspects of capital structure in financial firms, there is still need for more in-depth investigations that consider the unique characteristics and challenges faced by listed financial institutions. Some studies are limited to specific markets or regions, raising questions about their generalizability of their findings of broader contexts. For example, studies such as Chatterjee and Bhattacharjee (2020) in India, Queiri et al. (2021) in Oman, and Suhadak and Saifi (2020) in Indonesia focus on specific countries, which may limit the broader applicability of their findings. Similarly, studies like Ahmed and Afza, (2019) in Pakistan and Harasheh and De Vincenzo (2022) in Italy are confined to particular national contexts. There is therefore need for research transcends geographical boundaries to provide more robust insights in Kenyan context.

METHODOLOGY

This study will adopt a descriptive research design to ascertain the effect of financial architecture and corporate value of listed financial firms in Kenya. This research design is deemed appropriate for its ability to aid in exploring dynamic rather than static concepts (Creswell & Creswell, 2018). The target population for this study will be 16 financial sector institutions that a listed in the banking and insurance sectors of the Nairobi Securities Exchange in Kenya as of December 2023. The study covers the period from 2019 to 2023. This study will employ a census approach as its research methodology, targeting all listed financial firms in Kenya. The census method is appropriate for this research as it allows for the comprehensive collection of data from the entire population, ensuring that no significant entity is excluded (Kothari, 2004). In this study, the sampling frame comprises all 16 companies listed in the insurance and banking sectors of the Nairobi Securities Exchange (NSE) as of December 31st, 2023. Data collection will be done with help of a secondary data collection matrix. The data will be collected from financial statements of the entities. This study will use secondary panel data, which consists of observations of different units over multiple periods (Gujarati & Sangeetha, 2013). The data will be analysed using panel data regression analysis for both descriptive and inferential statistics, employing the STATA statistical package. The following panel regression model was utilized to demonstrate the link between independent and dependent variables.

$$Y = \beta_0 + \beta \quad X_{it} + \varepsilon$$ **…….. Equation 3.1**

Where:

Y represents Corporate Value

β_0 =Constant

X represents Capital Structure.

it represents firm I in time t.

ε represent error term.

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FINDINGS AND DISCUSSIONS

Descriptive Statistics

The descriptive statistics resulting from the collected data are presented in Table 1.

Table 1: Summary of Descriptive Statistics

Variable	Obs	Mean	Std. Dev	Min	Max
Capital Structure	80	0.829	0.086	0.539	1.099

The capital structure of the firms, reflected in their leverage ratios (i.e., debt-to-equity ratios), has a mean of 0.829 with a standard deviation of 0.086. The minimum capital structure is 0.539, while the maximum is 1.099. This range suggests that firms vary slightly in their reliance on debt, potentially reflecting cautious borrowing practices aligned with regulatory limits. These results are similar to those found by Ahmed and Afza (2019) in Pakistan and Agmas (2020) in Ethiopia, where capital structure had a significant impact on firm value, particularly when measured through leverage ratios. The results of this study suggest that Kenyan firms follow a similar trend in leveraging their capital to enhance corporate value, as seen in other developing economies**.**

Inferential Statistics

The study sought to establish the statistical relationship between the variable through panel regression analysis and chi square test.

Model Summary

The model summary provides an overview of the goodness of fit and the explanatory power of the fixed-effects regression analysis. The R-value of 0.7702 indicates a strong positive correlation between the observed values of Corporate Value and the predicted values from the independent variable in the model. The R-squared value of 0.5917 signifies that approximately 59.17% of the variation in Corporate Value within the firms is explained by the independent variable: Capital Structure.

The adjusted R-squared value of 0.5611 accounts for the number of predictors in the model, providing a more accurate measure of its explanatory power. This indicates that after adjusting for the number of independent variables, 56.11% of the variability in Corporate Value can still be attributed to the model. The standard error of 0.0792 represents the average distance that the observed values deviate from the regression line, reflecting the precision of the model's predictions**.**

Table 2: Regression Model Summary

Model	R	R Square	Adjusted R Square	Standard Error
1	0.7702	0.5917	0.5611	0.0792

Analysis of the Variance

In this study, ANOVA was conducted to determine the extent to which Capital Structure explain the variations in Corporate Value. The results are presented in Table 3.

The given multiple linear regression analysis explores the relationship between the dependent variable and the independent variable. The F-statistics, with a value of 21.74, tested the overall significance of the model. The associated p-value, which was zero, indicated that the model as

a whole was statistically significant, suggesting that the independent variable had a significant impact on Corporate Value

Table 3: ANOVA Analysis Results

	df	SS	MS	F	Significance F
Regression	4	0.662	0.1655	21.74	0.0000
Residual	75	0.457	0.0061		
Total	79	1.119			

Regression Coefficients

This section presents the results of the fixed-effects regression analysis conducted to examine the relationship between Corporate and Capital Structure.The observed relationship between the independent variable and the dependent variable, Corporate Value, can be summarized through the following equation.

$$Y_{it} = 0.39 + 0.53X_{2it} \ldots\ldots\ldots\ldots \text{Equation}$$

The fixed-effects regression results indicate that the constant term of 0.39 represents the baseline corporate value when all independent variable are set to zero. Capital structure has a positive coefficient of 0.53, suggesting that firms with higher leverage tend to have higher corporate value.

Table 4: Regression Coefficients Test Results

Variables	Coef.	Std. Err.	t-statistics	P-value
Capital Structure	0.53	0.08	6.36	0.00
Constant	0.39	0.07	5.47	0.00

Hypothesis Testing

This section of the research paper focuses on presenting the results of the hypotheses tests and interpreting those results. To establish connections among the hypothesized relationships, the study adopted a bivariate panel data regression analysis approach, enabling to assess the effect of each independent variable on the dependent variable. The objective was to assess the effect of capital structure on the corporate value of financial institutions listed in Nairobi Security Exchange, Kenya. The results revealed a strong positive relationship, with a coefficient of 1.0115, suggesting that a one-unit increase in capital structure corresponds to a 1.01-unit increase in corporate value. The p-value of 0.000 confirmed the statistical significance of this relationship, leading to the rejection of (H_{02}) and concludes that capital structure has a significant positive relationship with corporate value. This outcome is consistent with studies by Ahmed and Afza (2019), who reported a similar positive relationship between capital structure and firm value. However, contrasting findings were reported by Agmas (2020) and Mathur et al. (2021), who observed mixed or negative impacts of capital structure. These variations highlight that industry-specific and contextual factors may influence the relationship between capital structure and corporate value across different settings.

Table 5: Hypothesis Test Result for Capital Structure and Corporate Value

Variable	Coef.	Std. Err	t-Statistic	P-Value
Capital Structure	1.0115	0.0421	24.05	0.000

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SUMMARY, CONCLUSION AND RECOMMENDATIONS

Summary

The objective was to assess the impact of capital structure on corporate value. The analysis revealed a positive relationship between capital structure and corporate value, indicating that higher leverage positively influences corporate value. This significant relationship underscores the importance of leverage management in enhancing corporate value. By effectively managing their capital structure, firms can optimize resource allocation and risk management, thereby strengthening their overall market position and long-term sustainability.

Conclusion

The findings underscore the significant role of capital structure in enhancing corporate value. Higher leverage is instrumental in supporting value growth through optimized resource allocation and risk management. The strategic use of debt facilitates financial institutions' access to resources necessary for expansion, thereby fostering corporate growth. Therefore, maintaining an optimal capital structure is pivotal in balancing risk and reward, positioning firms to effectively capitalize on growth opportunities. This equilibrium not only bolsters investor confidence but also positively impacts market perception and long-term sustainability. Ultimately, leveraging capital effectively is paramount to reinforcing corporate value.

Recommendations

This section offers key recommendations based on the research findings, focusing on improving ownership structure, capital structure, corporate governance, and board processes to enhance the corporate value of financial institutions in Kenya

Financial Institutions

Strategic management of capital structure holds paramount importance for financial institutions. To achieve this, institutions should carefully evaluate the ideal equilibrium between debt and equity components within their capital structure. Striking this balance becomes a pivotal lever in managing risk and pursuing growth objectives. Notably, a steadfast commitment to capital adequacy is fundamental. By ensuring robust levels of capital, financial stability is reinforced, thereby exerting a favourable impact on the overall corporate value of the institution.

Banking Sector Regulatory

It is recommended the CBK should enforce and refine risk-based capital adequacy requirements, including Tier 1 and Tier 2 capital thresholds, to ensure banks maintain sufficient buffers to absorb financial shocks. These targeted regulatory measures, aligned with the banking sector's governance framework, are essential for fostering systemic stability, enhancing investor confidence thus supporting long-term corporate value of listed financial institutions.

Insurance Sector Regulatory

IRA should intensify the enforcement of industry-specific capital requirements, such as solvency margins and risk-based capital provisions, to safeguard policyholders' interests and maintain financial soundness. These regulatory interventions, tailored to the insurance sector, are critical for promoting sustainable corporate value creation while fulfilling the IRA’s mandate to uphold sound governance and financial integrity.

Suggested Areas for Further Research

Future research should expand beyond the Kenyan context to investigate how capital structure impacts corporate value in diverse global settings. Comparing results across countries and cultures can provide insights into the generalizability of the relationships identified. In addition, researchers should consider extending their investigations beyond financial institutions to include other industries and conduct cross-industry comparative studies Cross-industry studies can provide a broader understanding of how capital structure influences corporate value across various business sectors. Researchers should explore potential mediating factors that might influence the observed relationships. Industry-specific attributes, market conditions, and regulatory environments could impact the strength and direction of these relationship

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