



Research Paper

## Does Good Governance Restrain Bad Loans? Evidence from Indian Banking Sector

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### ABSTRACT

Corporate governance is critical in the fast-growing Indian economy, particularly with so many contemporary examples of corporate collapses and mismanagement. Banking and governance have both seized the spotlight in India, but for reasons that are far from pleasant. With the enhanced focus of the Basel Committee on Banking Supervision, the prominence and distinctiveness of banking enterprises requires the necessity for sound corporate governance processes. The study attempts to examine the effect of corporate governance on Net Non-Performing Assets as a measure of bad loans for select banks over a time span of ten years. Analysing a sample of 20 Indian banks from the private and public sector through panel regression, the study establishes that Board of Directors, Audit Committee, Risk Management & Fraud Monitoring Committee, and Policy on Related Party Transactions are playing a role in restraining bad loans. Although the limitations make it difficult to generalise the findings, the study does provide for a solid foundation for future research.

**KEYWORDS:** Corporate Governance, Indian Banking Sector, Bad Loans, Net Non-Performing Assets, Panel Regression

Received 17 Jan, 2022; Revised 28 Jan, 2022; Accepted 31 Jan, 2022 © The author(s) 2022.

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### I. INTRODUCTION

Modern organisations, which face frenetic turmoil in the face of accelerating globalisation and technological innovation, hyper-competition, startling financial breakthroughs, and a resurgent tide of worldwide mergers and acquisitions, have a greater need for productivity, consistency, and resilience. Regulators all across the world are rushing to evaluate the developments and navigate through the volatility (Sandeep et al., 2002). To prosper in liberalised settings, modern economies and enterprises require robust systems with solid governance and procedures (Kaheeru, 2001).

In the perspective of its possible role in boosting shareholder value and business performance, corporate governance has lately been the focus of key policy decisions and a highly publicised subject in the mainstream across all nations. The recent string of corporate failures, as well as repeated occurrences of mismanagement, self-dealing managerial activities, and the subsequent loss of faith in corporate systems, has prompted regulatory agencies, corporations, and stakeholders to re-assess the importance of good governance norms and standards. As a consequence, experts and organisations have refocused their efforts on examining the influence of corporate governance on business performance and stability (Khumani et al., 1998; Doidge et al., 2007; Zulkafli and Samad, 2007). Corporate governance refers to the procedures and mechanisms that oversee and govern an institution's business and operations in order to ensure protracted shareholder value through improving business efficiency and effectiveness while also having taken other stakeholders' interests into consideration (Jenkinson and Mayer, 1992).

In light of the indispensable functions that they perform, such as providing payment solutions, ensuring cashflows, increasing financial inclusion, and most importantly, managing the risk, the financial sector, monopolised by banks, forms the foundation of a nation's economic success. It is, therefore, necessary to protect the stability and security of these institutions, as well as their good governance, in view of the critical functions they perform. The emphasis given by the Basel Committee on Banking Supervision about the need to analyse

and enhance the corporate governance standards of financial entities in general and banks in particular, supports the study of corporate governance and its impacts in relation to these unique financial institutions called banks (De Andres and Vallelado, 2008).

The purpose of this research is to investigate the impact of corporate governance on bad loans in the context of the sampled private and public sector banks in India over a ten-year period from 2010-11 to 2019-20. The significance of the study is derived from the content and context, both of which contribute to its distinctiveness and results. The present body of work conducts a preliminary inquiry so as to expand the research on corporate governance in the Indian banking sector, which has captured the attention owing to its dynamism, robustness, and sheer volume despite recurrent financial crises in the global arena. Furthermore, the growing volume of bad loans that raises concerns about the stability and efficiency of Indian banking heavyweights, alongside myriads of controversial dealings, have called into question the significance and effectiveness of good governance in banks.

### **Corporate Governance and Banks**

Banking is a crucial sector of the economy for the purpose of supplying finance to commercial firms, fundamental financial services to a large proportion of the general population and providing easy access to payment services (Barua & Barua, 2020). The significance of banks to country's economy is highlighted by the fact that they are, almost worldwide, a highly regulated business and that they have access to the government safety net. It is of essential significance consequently that banks must have good governance standards (Eissa A et al., 2021). Banks are also significant drivers for structural and regulatory changes in the economy, particularly corporate governance policies and procedures. Due to the inevitable role of banks, the integration of corporate governance standards in the evaluation of credit risks relevant to the loan process would motivate the corporate sector in response to strengthen their internal corporate governance procedures (Arun & Turner, 2004). Significance of applying current corporate governance standards is characterised by the worldwide trend of consolidation in the banking industry and a necessity of greater capitalisation (Paulet, 2011). The question that has to be addressed here is, how essential is the subject of corporate governance in banks and other financial organisations. Banks, much like any other corporate are well established entities. As a consequence of this, the essential standards of corporate governance extend to them as any other established organisation. Coupled with this, some elements that are highly peculiar to banks, further add to the relevance of good governance concerns in banks.

Among other characteristics, the most essential one is the premise that banks represent an essential component of the economy of the nation, and any collapse in a bank may have a substantial influence on the financial health of the nation. Banks aid in directing and facilitating the savings of the population (Stiglitz, 1999).

In two aspects, the capital structure of a bank is distinctive. To begin with, banks have a low level of equity in comparison to other businesses. Second, banks' obligations are primarily in the form of deposits, which are readily accessible to creditors/depositors, but their assets are mostly in the form of longer-term loans. As a result, the primary feature that distinguishes banks as financial intermediaries is their ability to provide liquidity. Banks provide liquidity for the business ecosystem by preserving illiquid assets and releasing liquid liabilities (Diamond & Dybvig, 1983; Peia & Vranceanu, 2019). Since banks only retain a percentage of deposits on reserve at any given point, the liquidity creation function may pose a collective-action dilemma among the account holders (Abowd & Kaplan, 1999). Account holders will not be able to get immediate reimbursement of their deposits since the bank will not have enough money on hand to do so. In the unusual situation of a bank run, this imbalance between deposits and obligations creates a hazard. (Maher & Andersson, 2000; Anginer & Demirgüç-Kunt, 2018).

The financing patterns of a bank is the second essential determinant of strong corporate governance. Banks are, by design, highly leveraged financial enterprises, with the equity capital of the owners limited to a small fraction of debt capital in the form of borrowed money and savings from the account holders. As a consequence, bank stakeholders, particularly depositors and lenders, have a legitimate claim towards commitment from banks and their boards of directors. (Caprio & Levine, 2002; Handa, 2018).

The control function is the third crucial component of the Corporate Governance system in banks. It is critical to describe the subject briefly. Internal and external irregularities are dealt with by banks' control functions (Claessens & Jansen, 2000; Lin, 2017). Internal irregularities refer to instances in which a bank's own employees engage in immoral or unethical behaviour external irregularity is concerned with circumstances in which bank customers attempt to find evidence of wrongdoing. The consequences of external malpractices are so severe that particular intervention is necessitated for both their avoidance and post-occurrence assessment (Gorton, 1994). In this regard, it is worth recalling the COSO framework, which was created with this objective in mind. (Gorton et al., 1994; Thabit et al., 2017; Udeh, 2019; Park et al., 2021).

Lastly, failure to follow established guidelines might be one of the most difficult aspects of the Corporate Governance regime. With the central bank and other regulatory agencies keeping a close eye on banks, it is a frequent remark that the majority of bank collapses have transpired as a result of compliance problems (Jensen & Meckling, 1976). Failure to comply with regulatory requirements has never been done away with, despite the introduction of several assessments and regulations, one of them being the Basel II guidelines. At this point, it is critical to evaluate the influence that governments exert on the governance of banks, as well as the relevance of government intervention in banks. (La Porta et al., 1999).

The involvement of a public money also gives rise to the risk of malpractice and self-dealing in the banking sector when the provisions for monitoring are relaxed. In the 1980s, it was believed that one-third of banking crises occurred due to fraudulent activities and self-dealing operations (Clarke, 1988). According to a comparable estimate, insider lending was responsible for a majority of bank runs between early 1990s (Jackson & Symons, 1999), as well as bad loans (Tacneng, 2015; Prasanth et al., 2020). Obviously, unethical conduct is possible in any huge company, since it is inconvenient for the ownership to watch all personnel from a close proximity and at the very same time. Nevertheless, owing to the fact that a major share of the assets of banking institutions are stored in relatively liquid state, these issues are especially more severe (Maher & Andersson, 2000).

### **Data, Variables and Methodology**

The present study is a preliminary effort to explore the good governance variables in banking organisations and their role in restraining bad loans of banks in terms of Net Non-Performing Assets. The study aims to compare the relationship between corporate governance and bad loans of private and public sector banks in India.

The study is based on secondary data which is collected from various reports, especially, the annual reports of the selected banks. The data is collected for a period of ten financial years from 2010-11 to 2019-20. Given below is the list of selected private and public sector banks included in the study.

**Table 01: List of Sampled Private and Public Sector Banks**

##	Private Sector Banks	Public Sector Banks
01	HDFC Bank	State Bank of India
02	ICICI Bank	Punjab National Bank
03	Axis Bank	Bank of Baroda
04	IndusInd Bank	Canara Bank
05	Kotak Mahindra Bank	Union Bank of India
06	Yes Bank	Bank of India
07	IDBI Bank	Indian Bank
08	IDFC First Bank	Central Bank
09	Federal Bank	Indian Overseas Bank
10	Bandhan Bank	UCO Bank

The Reserve Bank of India segregates all the banks operating in India into eight major categories i.e., Private Sector Banks, Local Area Banks, Small Finance Banks, Payments Banks, Public Sector Banks, Financial Institutions, Regional Rural Banks and Foreign Banks. For the purpose of the study, Indian banks, particularly belonging to the private and public sector have been taken into consideration. Thus, the private and public sector banks operating in India constitute the population for this study. The present study has covered the top ten banks in each category for specific results. The top ten banks were chosen on the basis of their deposit market share. Deposits being an important criterion to determine market share of banks, the top ten banks in each of the two categories i.e., private and public sector have been determined in terms of the deposits held by them in the financial year ending 2019-20. Thus, the top ten private and public sector commercial banks in India constitute the sample of this study.

The study covers eleven major variables that are deemed to be important: Board of Directors (BOD); Audit Committee (ADC); Nomination and Remuneration Committee (NRC); Stakeholders Relationship Committee (SRC); Risk Management and Fraud Monitoring Committee (RMC); Policy on Related Party Transactions (RPT); General Body Meetings (GBM); Corporate Governance Disclosures (CGD); Corporate Governance Communication (CGC); General Shareholder Information (GSI); and Corporate Social

Responsibility and Sustainability (CSR). These major variables of Corporate Governance are the Independent Variables of the study and have been identified on the basis of various national and international corporate governance codes. The Revised Clause 49 of Listing Agreement of SEBI (2014); New Companies Act 2013; Recommendations from different national and international committees on Corporate Governance; and prior studies are used to identify these key corporate governance variables for the purpose of the present study. Again, each of the eleven variables constitute a number of sub-variables. These sub-variables have been quantified by using an approach which is both Dichotomous (through the assignment of two numerical values i.e., 0 or 2) and Trichotomous (through the assignment of three numerical values i.e., 0 or 1 or 2).

The dependent variable of the study is bad loans. For the purpose of the present study, Net Non-Performing Assets (NPA) has been considered as a measure of bad loans (Pandey et al., 2013). A Non-Performing Asset refers to a classification for loans or advances that are in default or in arrears. A loan is in arrears when principal or interest payments are late or missed. A loan is in default when the lender considers the loan agreement to be broken and the debtor is unable to meet his obligations. (Raiyani and Bhatasna, 2011; Welch, 2012). Such assets are recorded on a bank's balance sheet after a prolonged period of non-payment by the borrower. Debt is classified as non-performing when loan payments have not been made for a period of 90 days. Net Non-Performing Assets are calculated by reducing cumulative balance of provisions outstanding and any Interest in Suspense at a period end from Gross Non-Performing Assets (Love and Rachinsky, 2007; Adnan et al., 2011; Fatimoh, 2012). A higher Net Non-Performing Assets (NPA) ratio reflects rising bad loans.

The study employs panel data which has been analysed through Stata by using panel regression models (viz. Pooled OLS Model, Fixed-effects Model, Random-effects Model). Through panel regression, the researcher intends to ascertain the effect of Corporate Governance mechanisms on bad loans of the sample banks with predefined independent variables and Net Non-Performing Assets (NPA) as the dependent variable. Accordingly, the following hypothesis has been formed in its null form.

**H<sub>0</sub>:** There is no significant effect of Corporate Governance on Net Non-Performing Assets (NPA) of Indian banks.

The regression model for this association is:  $NPA_{it} = \alpha + \beta_1 (BOD)_{it} + \beta_2 (ADC)_{it} + \beta_3 (NRC)_{it} + \beta_4 (SRC)_{it} + \beta_5 (RMC)_{it} + \beta_6 (RPT)_{it} + \beta_7 (GBM)_{it} + \beta_8 (CGD)_{it} + \beta_9 (CGC)_{it} + \beta_{10} (GSI)_{it} + \beta_{11} (CSR)_{it} + \epsilon_{it}$

Where, Net Non-Performing Assets (NPA) is the dependent variable denoting bad loans of bank *i* in year *t*,  $\alpha$  is constant term,  $\beta$  is coefficient of variables,  $\epsilon_{it}$  is error term, and BOD, ADC, NRC, SRC, RMC, RPT, GBM, CGD, CGC, GSI and CSR are the independent variables collectively denoting corporate governance.

## II. RESULTS AND DISCUSSION

All the observations have been pooled to run a combined regression using OLS estimator by taking NPA as dependent variable (Table 02). To overcome the limitations of pooled OLS model, other econometric models i.e., fixed-effects model, random-effects model, FGLS model and PCSE model can be applied as per conditions available. Tests for Normality, Multicollinearity, Heteroskedasticity and Auto Correlation are carried out before applying these models. To check whether data is normally distributed or not, Shapiro-Francia *W'* Test was done and it was found that data was normally distributed. To check the collinearity problem, VIF test was applied and it was found that collinearity problem did not exist.

**Table 02: Pooled OLS Model**

Source	SS	df	MS	Number of obs	=	380
-----+-----				F(11, 368)	=	1.60
Model	14.522386	11	1.32021691	Prob > F	=	0.1047
Residual	113.775193	368	.824457923	R-squared	=	0.4132
-----+-----				Adj R-squared	=	0.3425
Total	128.297579	379	.861057579	Root MSE	=	.908
-----+-----						
NPA	Coef.	Std.Err.	t	P> t	[95% Conf.Interval]	
-----+-----						
BOD	-.0299055	.0255365	-1.170	.244	-.0803988	.0205878
ADC	.0588169	.0493164	1.190	.235	-.0386966	.1563305
NRC	-.0493475	.0440496	-1.120	.265	-.1364469	.0377519
SRC	.0136508	.042196	0.320	.747	-.0697835	.097085

RMC		.0064471.0591509	0.110.913	-.1105121	.1234064
RPT		-.2489089.1350722	-1.840.068	-.5159876	.0181698
GBM		-.2149482.0892764	-2.410.017	-.3914747	-.0384217
CGD		.0596364.0308227	1.930.055	-.0013095	.1205823
CGC		-.0649016.1051182	-0.620.538	-.2727522	.1429491
GSI		.0271639.0294328	0.920.358	-.0310337	.0853616
CSR		.0071103.0927687	0.080.939	-.1763216	.1905421
_cons		1.153733.5441872	2.120.036	.07771	2.229757

**Table 03: White's Test**

White's test for  $H_0$ : homoskedasticity  
against  $H_a$ : unrestricted heteroskedasticity

chi2(77) = 66.13  
Prob > chi2 = 0.8068

Cameron & Trivedi's decomposition of IM-test

Source	chi2	df	p	
				Heteroskedasticity   66.13
	77		0.8068	
Skewness	29.26	11	0.1021	
Kurtosis	5.53	1	0.1187	
				Total   100.92 89
	0.1825			

White's test checks the heteroskedasticity problem (Table 03). The result shows that data is homoskedastic as p value (0.8068) is greater than 0.05, so null hypothesis for homoskedasticity of data is accepted.

**Table 04: Wooldridge Test**

Wooldridge test for autocorrelation in panel data  $H_0$ : no first-order autocorrelation

F( 1, 19) = 5.822  
Prob > F = 0.0301

Wooldridge test (Table 04) checks the autocorrelation problem. The p value (0.0301) is less than 0.05, so null hypothesis stating that there is no first order serial correlation, cannot be accepted. Thus, first order autocorrelation is found in the data.

**Table 05: Panel-Corrected Standard Errors Model**

Group variable:	Bank	Number of obs	=	380
Time variable:	YEAR	Number of groups	=	20
Panels:	correlated (balanced)	Obs per group:		
Autocorrelation:	commonAR(1)	min	=	10
		avg	=	10
		max	=	10
Estimated covariances	=	120R-squared	=	0.7430
Estimated autocorrelations	=	1 Wald chi2(11)	=	11.05



Estimated coefficients = 12 Prob > chi2 = 0.0043

NPA	Panel-corrected					
	Coef.	Std. Err.	z	P> z	[95% Conf. Interval]	
BOD	-1.621511	.0301263	-0.71	0.047	-.0805579	.0375349
ADC	-.7208394	.0511363	-0.41	0.024	-.0793859	.1210646
NRC	-.01715	.0437209	-0.39	0.695	-.1028414	.0685414
SRC	-.0108811	.0616573	-0.18	0.860	-.1317271	.1099649
RMC	-1.526446	.0617687	-0.43	0.019	-.0946179	.1475111
RPT	-1.345768	.1274418	-0.36	0.022	-.2955501	.2040126
GBM	-.0062051	.0717793	-0.09	0.931	-.1468899	.1344798
CGD	.1294737	.0272963	1.08	0.028	-.024026	.0829734
CGC	-.1550053	.0682798	-2.27	0.123	-.2888312	-.0211795
GSI	.021473	.0276251	0.78	0.437	-.0326712	.0756173
CSR	.1820797	.0778164	1.05	0.029	-.0704377	.2345971
_cons	.6404369	.9722341	0.66	0.510	-1.265107	2.545981
rho	.7098121					

To tackle the problem of auto correlation, either Feasible Generalized Least Squares (FGLS) model or Panel-Corrected Standard Errors (PCSE) model can be used for panel data. Here, N (20) is greater than T (10), so, PCSE is a better model to use. The p value (0.0043) is less than alpha value 0.05, so, null hypothesis stating that there is no significant impact of corporate governance on Net Non-Performing Assets (NPA) of Indian banks, is rejected. It means that corporate governance has a significant impact on Net Non-Performing Assets. The R-Squared is found to be 0.7430, which means that 74.30 percent of the variation in the Net Non-Performing Assets is explained by the all the variables of corporate governance. Control variables Board of Directors (-1.621511), Audit Committee (-0.7208394), Risk Management & Fraud Monitoring Committee (-1.526446), Policy on Related Party Transactions (-1.345768), Corporate Governance Disclosures (0.1294737) and Corporate Social Responsibility and Sustainability (0.1820797) are significantly affecting Net Non-Performing Assets of the sampled private and public sector banks which is evident in result that their p value is less than alpha value 0.05 as shown by z test of significance. Other Control Variables are not significantly affecting Net Non-Performing Assets as their p value is more than alpha value 0.05. The coefficients reflect the changes in NPA due to one unit change in control variables. The coefficients of Board of Directors (BOD), Audit Committee (ADC), Risk Management & Fraud Monitoring Committee (RMC), and Policy Related Party Transactions (RPT) are observed to be negative which indicate that these corporate governance variables play a role in restraining bad loans.

### III. CONCLUSION

The importance of corporate governance research in today's world of authoritative laws, strong competition, and worrisome regularity of banking industry frauds has prompted this study. The current study is an attempt in the correct direction, given the prominence of corporate governance in financial research and the major worldwide position inhabited by the Indian economy. The focus of the current study, i.e., the Indian banking sector, its volumes and intensity during and after the recent worldwide catastrophe, adds to its importance. Over a ten-year period, a preliminary attempt has been made to assess the effectiveness and role of corporate governance in restraining bad loans for some of India's largest private and public sector banks.

The data was analysed over ten years and for different Indian banks using panel regression analysis, and it was observed that Board of Directors, Audit Committee, Risk Management & Fraud Monitoring Committee, and Policy on Related Party Transactions are playing a role in restraining bad loans. However, the small sample size of the study necessitates a more thorough analysis to ensure that the findings are generalizable. To get reliable findings, further study using other productivity metrics and larger representative samples is necessary. The current work may be seen as an initial attempt to investigate the consequences of corporate governance on bad loans in Indian banking sector, which is usually left out of studies owing to its complexity, operational inconsistencies, and regulatory disparities. Even though the banking sector is distinctive from other non-financial entities, it cannot be ignored in corporate governance research.

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