

The impact of corporate governance mechanisms on firm performance in Pakistan

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Abstract: *In this paper, we investigated the impact of corporate governance mechanisms on the firm performance of listed firms in Karachi stock exchange. Data was collected from 100 firms in the financial year 2014 and multiple regression analysis was used to determine whether the existing corporate governance mechanisms influence the firm performance or not. We find that Institutional investor has significant and positive impact on firm performance. Government Ownership, Debt to Equity Ratio and Board Size have negative and significant impact on firm performance. The remaining three variables (Firm size, CEO duality and Non Executive director) have non-significant relationship with firm performance.*

Key Words: *Corporate Governance, Karachi Stock exchange, Debt to Equity ratio, Board size, Firm size, Government Ownership, CEO duality, Non-executive director, Institutional investors.*

I. Introduction

Now a day's corporate governance is the center of attention in business world. Due to rapid growth of the capital market in Pakistan and unique ownership characteristics of Pakistan listed firms, there is growing interest in studying the impact of corporate governance on the firm performance in Pakistan. This is especially due to the large number of stakeholders whose wealth and interest are at stake in the business. Corporate governance makes aware the companies about their stakeholder's interest. Any business cannot survive without the existence of corporate governance.

Corporate governance is the set of processes, policies, customs, laws and institution affecting the way a corporation is directed, controlled and administered. Corporate governance also includes the relationship among the many stakeholders involved and the goals for which the corporation is run. The principal stakeholders include shareholders, board of directors and management other stakeholders are employees, suppliers, customers, lenders, banks, regulators, environment and community at large. In March 2002 Securities and Exchange Commission of Pakistan issued the code of corporate governance to establish a framework for good governance of companies listed in stock exchanges of Pakistan. The code was a first step in systematic implementation of principles of good corporate governance in Pakistan.

Our research topic is "Impact of corporate governance mechanisms on firm performance in Pakistan". This study is about the relationship of corporate governance mechanisms on firm performance in Pakistan. The objective of the study is to investigate whether the existing corporate governance mechanisms influence the firm performance in Pakistan. These study reveal that firms with robust corporate governance mechanisms seem to be more successful than with those companies that having weak corporate mechanisms.

Karachi stock exchange is biggest and most liquid stock exchange in Pakistan. Karachi stock exchange was established on September 18, 1947. It was incorporated on March 10, 1949. Only five companies were initially listed with a total paid-up capital of 37 million rupees. Now there are 577 companies listed in Karachi stock exchange and the total market capitalization is Rs 6136.963 billion and there are total 36 sectors listed on Karachi stock exchange. The listing of companies is done on the basis of rules and regulation mentioned by security and exchange commission of Pakistan. We take a sample size of 100 firms for our study and collect data of all variables from their annual reports. All sample firms are listed in Karachi stock exchange of Pakistan. A multiple regression analysis will employ to test if there is a significant impact of corporate governance mechanisms on firm performance. These are some variables which we used in our study. Independent variables are board's size, firm's size, institutional investor, CEO duality, non-executive directors, government ownership and debt to equity ratio. On the other hand dependent variable is firm performance

II. Literature review (SEC-1):

Mashayekhi & Bazaz (2008) they applied no relationship between leadership structure and firm performance. Likewise, the presence of institutional investor on board of director was not positively associated with firm performance. The findings of the present study support the contention that smaller board was likely to be more efficient in monitoring management. Our study confirmed a positive relationship between outside (independent) director & firm performance.

Guo & KGA (2010) they applied the relationship between board size and Tobin's Q were marginally negative but the result was not statistically significant. Data was collected from 174 firms in the financial year 2010. A negative correlation between the proportion of non-executive directors & ROA was found to be insignificant but it was contrary to other findings, indicated a positive relation. They were constructed to find that positive and negative relationship between board size and firm performance. It was evident that large boards were less effective than small ones.

Rehman & Hussain (2013) investigated effects of elements of corporate governance practices on performance of companies (with varying governance style) and how much shareholders affected the financial performance of the firm. Shareholders were normally interested in higher share prices. Regression statistics showed the casual effects of the independent variable on the overall firm performance. The model showed that 20.4% of the variance is caused by the three independent variables. The overall statistic findings showed that all the three variables included as independent variables so that study did not have strong impact on overall firm performance.

Christensen et al. (2010) a negative relationship between board size & ROA supported the corporate governance recommendation that the board should be limited so as to encourage efficient decision making. Their research was undertaken in an Australian setting using a sample of 1039 companies listed in stock exchange in 2004. A negative relation with Tobin's q suggested that market place a higher value on longer board. Results suggested that recommended corporate governance structure related to the adaption of board subcommittees were sound policy recommendations that enhanced performance by using accounting measure. ROA & market based measure Tobin's q. In contrast, the emphasis on board independence guidelines specifically having outside independent directors had a negative impact on ROA & Tobin's q.

Cheema & Din (2013) they applied the relationship between corporate governance and firm financial performance in cement industry of Pakistan. For the purpose of this study, panel data set covered data of 15 companies of the cement industry of Pakistan including family & nonfamily from the period of 2007 to 2011. The required data was gathered from the annual reports of these firms. This study took earning per share to measure the earning on per share so that average earning on per share was 1.67 (in Rupees) on the base of data available. It was concluded that CEO duality had the impact on the firm performance, so CEO duality was negative and significantly related to the cement industry performance.

Aljifri & Moustafa (2007) they applied the positive relationship between institutional investor, government ownership & firm performance and negative relationship between board size and firm performance. Their study utilized a sample of 51 firms using the accounting and market data available for 2004. A cross sectional regression analysis was employed to test the hypothesis of this study. This study concluded that three (Government ownership, debt ratio & dividend payout ratio) of the corporate governance mechanisms used in this study appeared to be strong enough effect on firm performance. On the other hand, institutional investor, board size, firm size, audit type was found to be weak enough effect on the firm performance. They concluded that mean, standard deviation, minimum, maximum, correlation, R, R square, adjusted R square, F test & regression.

Eisenberg et al. (1997) found a significant negative correlation between board size and profitability in a sample of small & mid-size firms as measured by industry adjusted return an asset and board size. They concluded that a board size effect for a new separate class of firms affects the range explanations for the board size effect. It was concluded that a board size effected in a random sample approximately 900 small finish firms. And if there was an ideal board size, the board size effect in their firms suggested the ideal board size varies with firm size. Alternative explanation was that board size reflected the composition of the board.

Haniffa & Hudaib, (2000) applied the relationship between corporate governance structure & performance of 347 listed companies on a Kuala Lumpur Stock Exchange (KLSE). They found board size & top five substantial shareholdings been significant relationship between multiple directorship & market performance. On the other hand, managerial shareholdings were associated with accounting performance. The result market returns suggested that large board was less effective in monitoring performance however, analysis was considered in terms of accounting return large board seemed to provide the firms diversity in contacts, experience and expertise needed to enhance performance.

WookJoh (2002), this study examined how ownership structure & conflicts of interest among shareholders under a poor corporate governance system affected firm performance before the crisis. They used 5893 Korean firms subject to outside auditing 1993 to 1997. This paper found to be firm with low ownership concentration show low firm profitability, so poor corporate governance was a major cause of recent economic crisis. This paper also elaborated that some evidence of non-linearity of ownership effects on firm's profitability, moreover moved resources to further lower profitability. These results suggested that Korea's weak corporate governance system. Weak corporate governance allowed poorly managed firms to stay in the market & resulted in inefficiency of resource allocation despite low firm profitability for many years.

Huther (1996), this paper recommended that use of data from an industry which had publicly available data on firm cost, rural distribution of electricity. The study of this industry suggested that corporate boards are inefficiently large. In (1993) boards' sizes in the US were very large, no more than 8 directors. It concluded that efficiency gained for US firms that can reduce the size of their governing boards.

John & Senbet (2006) Board effectiveness in its monitoring function was determined by its independence, size and composition. It found that there was inverse relationship between firm's market valuation and size of board of directors. Limited size of board may improve efficiency as compare to large size. The effectiveness of the board may be affected not only by its composition and size but also by its internal administrative structure. Regression analysis and summary statistics were used to test the hypotheses.

Koh (2003), they applied the relationship between institutional ownership and aggressive earning management strategies in Australia. In Australia, institutional ownership was governed to about 49% of the listed equities by 1997. A positive association was found at the lower institutional. On the other hand, a negative association was found with the higher. Within the higher institutional ownership region, consistent with the long term oriented view institutional investor. Argued that the institutional investor was short term oriented and created incentives for managers for their portfolio firms to manage earning aggressively and these institutional investors focused on current earnings performance.

Klapper & Inessa (2003) they explored the differences in firm level governance mechanisms, their relationship with the country legal environment and the correlation between governance and performance. The selection of sample was based on the two criteria: firm size & investor interest. Corporate governance was a composite of 57 qualitative and binary (yes/no) questions. Average firm level governance was lowered in countries with weaker legal systems. They found that better corporate governance was highly correlated with better operating performance and market valuation. They provided evidence that firm level corporate governance provisions matter more in those countries which had weaker legal environment.

Back et al (2002) they examined the importance of corporate governance measured in determine firm value during crisis. Their sample consisted on the non-financial firms listed on the KSE between November 1997 and December 1998. Firms with larger equity ownership by foreign investors experienced a smaller reduction in their share value. Firms with higher disclosure quality and alternative sources of external financing suffered too but for a short span of time. They found that the firms in which controlling shareholders' voting right exceeded their cash flow right and those which borrowed more from the banks also had significantly lower return. They found same effects for highly diversified firms, those with high leverage & those that were small and risky.

Basu et al. (2006) investigated the association between top executive compensation & effectiveness of corporate governance mechanism for Japanese firms. The initial screen resulted in a sample of 200 firms which were among the largest in Japan. It was found that top executive pay was higher in firms with weaker corporate governance mechanisms. It was noted that smaller board and outside director's presence was associated with lower top executive pay. It was concluded that greater stock ownership by board is associated with higher top executive income. Similarly, greater family influence on firms was associated with top executive income. Overall it was found that top executive compensation decreased as a corporate governance structure became stronger.

Sami et al. (2006) investigated the relationship of corporate governance to firm performance and evaluation in the emerging markets of China. From 1995 to 2005, the number of listed companies in China increased from 323 to 1300 & market capitalization increased from \$28.92 billion to 439 billion. It was hypothesized that better governance Chinese firms would have greater performance & higher evaluation. It was founded that they had implications for policy makers, regulators, managers, investors & researchers in the emerging markets of China. In addition to that, the findings had implications for managers of public companies. Managers and board of directors of listed firms should adopt high standard of corporate governance. This study suggested that better governed firms perform better so investor should know the corporate governance metrics of the firms in China, in which they had invested.

Amar & Andre (2003) this study analyzed the relationship between ownership structure and acquiring firm performance. They found the average acquired firm announcement period abnormal return for this sample of 327 Canadian transactions were positive over the 1998 to 2002. This study had examined value creation in mergers and acquisition in Canada. Their results confirmed that Canadian acquiring firms' shareholders on an average obtain positive announcement date abnormal returns as opposed to the negative results. Their study examined the market perception with respect to the merger and acquisition decision made by Canadian firms and did not attempt to measure potential wealth transferred by them. Their study was also limited to a specific country, time period & may not be generalized to other contexts and further studies should pursue these issues.

Agrawal & Knoeber (1996) their paper examined the use of seven mechanisms to control agency problem between managers and shareholders. To empirically investigate this issue, they constructed a data set containing approximately 400 large firms. They found that simultaneous equations system and found evidence

of interference in the use of control mechanisms. They applied cross sectional OLS estimates in which firm performance measured by Tobin's Q had regressed on individual control mechanisms to other estimates.

Fama (1980) attempted to explain with the separation of security ownership & control typical of large corporations, may be efficient from economic organization. The firm was disciplined by competition from other firms, which forced the evaluation of devices for efficient monitoring of the performance of entire team and also its individual members. Individual participants in the firm and in particular managers faced both the discipline and opportunities provided by the market for their services, both within and outside the services.

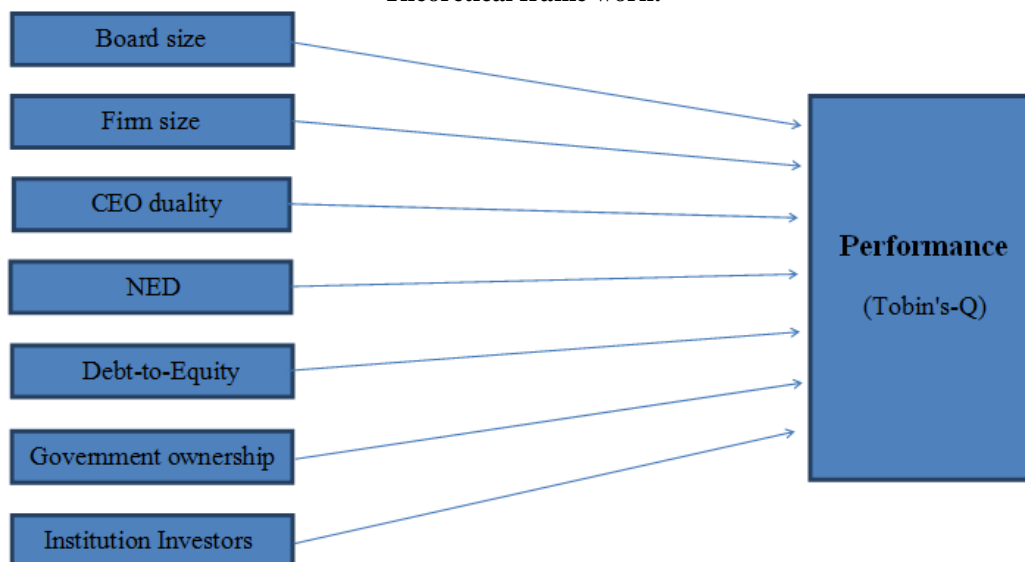
Drobtetz et al. (2004) had the strong positive relationship between the quality of the firm-level corporate governance and firm valuation. It was evident that expected stock returns were negatively correlated with firm level corporate governance, if dividend yields were used as proxies for the cost of capital. In that study, the researcher filled the gap for the German capital market. It should have also been pointed out that adequate firm-level governance standards were not a substitute for the solidity of the firm's business model. It was believed that professional investors will become more active in shareholders engagement programs in the future.

III. Data & Methodology (SEC-2):

In this paper we examined some corporate governance mechanisms relationship on firm performance in Pakistan. For this purpose we have collected data of year (2014) from annual reports of listed companies. Total sample size was 100 firms. All these firms were listed in Karachi stock exchange later on we applied multiple regression analysis on data for checking the relationship among corporate governance mechanisms (Board's size, Company's size, CEO duality, Debt to equity ratio, Government ownership, non-executive directors and institutional investor) with firm performance (Tobin's Q).

$$\text{Tobin's Q} = a + b_1 \text{bos} + b_2 \text{cos} + b_3 \text{CEO duality} + b_4 \text{Ned} + b_5 \text{Debt equity ratio} + b_6 \text{Gov} + b_7 \text{ii} + e$$

Theoretical frame work:



Variables (SEC-3):

Independent variables which were considered are as follow:

Company size: Company size is measured by natural logarithm of sales.

Board size: Board of directors have a key role in any listed company as they are the monitoring body who monitor or supervise the work of management and approved plans, budget, financial statements, appoint and remunerate the senior executive etc. Board of director may be non-representative director, representative director and independent director. Our work is not about the composition of board so this variable computed as total number of board of directors.

CEO duality: CEO duality is a dummy variable we give one to those firms who have CEO duality and give two to those companies who don't have CEO duality.

Non-executive director: Non-executive directors are those members of the board of directors who are not an employee of company. They only attend the board meetings and provide guidance, advice the board and exert supervision on the executive directors. We computed this variable by taking number of NED in Board.

Debt to equity ratio: Every company has composition of debt and equity in its capital structure, here as some companies prefer debt on equity but if they don't use debt in proper manner then it may lead to bankruptcy. Other companies prefer equity on debt. But the board of directors is more prefer debt than to equity. According to state bank of Pakistan, a company can take maximum debt of 70% and minimum 30% equity. So companies should restrict their board of directors on taking more debt. Debt to equity ratio measured by total liabilities divided by equity.

Government ownership: Government should have very important role in the performance of companies. The general perception of people in Pakistan is that the government of Pakistan is not playing important role in firms performances because if they invest they will influence in every issue of company. So most Pakistan listed firms don't want government investment in their firms. We compute government ownership as a percentage of holdings shares in listed companies.

Institutional investor: Institutional investor are some financial institution who invest in shares or in bonds of other companies for example Mutual fund, managed funds, pension funds, life insurance companies and banks. They all are professional in their fields and invest in other businesses after completing technical analysis and fundamental analysis. We computed this variable as a percentage of shares held by the institutional investor in listed companies.

Dependent variable: Dependent variable is firm performance that was measured by Tobin's Q. We computed Tobin's Q by the sum of market value of equity plus book value of debt divided by book value of total asset.

IV. Results and discussion:

The table 01 summarized the descriptive statistics for the variable employed in the study.

Mean	0.114427	22.61795	1.439216	1.453354	0.010621	0.539114	2.056382	0.016825
Median	-0.043255	22.68601	1.609438	1.965713	-0.030459	0.693147	2.079442	0.000000
Maximum	2.632466	26.22173	2.079442	3.507657	2.632608	0.693147	2.484907	1.050000
Minimum	-1.657795	15.71657	0.000000	-4.605170	-2.995732	0.000000	1.386294	0.000000
Std. Dev.	0.807097	1.738717	0.568690	1.972642	0.998668	0.290483	0.164079	0.132273
Skewness	0.933442	-1.094967	-1.368875	-1.500460	-0.027182	-1.336306	-0.345215	7.745926
Kurtosis	4.057026	6.168381	4.384893	4.568403	3.269316	2.785714	6.455729	61.00507
Jarque-Bera	12.08171	38.94043	24.70966	30.09669	0.198153	18.87054	32.59923	9462.036
Probability	0.002380	0.000000	0.000004	0.000000	0.905674	0.000080	0.000000	0.000000
Sum	7.208889	1424.931	90.67062	91.56128	0.669117	33.96421	129.5520	1.060000
Sum Sq. Dev	40.38718	187.4345	20.05131	241.2616	61.83494	5.231599	1.669168	1.084765
Observations	100	100	100	100	100	100	100	100

The table 01 showed that average performance of firm is 0.114427 with a standard deviation of 0.807097 with regard to all the 100 firms observed and has a range from 1.657795 to 2.632466. The average firm size is 22.61795 with a standard deviation of 1.738717 and has a range from 15.71657 to 26.22173. Non-executive directors have a range from 0.000000 to 2.079442 and its average 1.439216 with a standard deviation of 0.568690. Institutional investor average is 1.453354 with a standard deviation of 1.972642 and has a range from -4.605170 to 3.507657. Other variable debt to equity ratio average is 0.010621 with a standard deviation of 0.998668 and its range lies from 2.995732 to 2.632608. CEO duality has range from 0.000000 to 0.693147 and its means that 0.539114 with a standard deviation of 0.290483. Another variable Board size average is 2.056382 per board with a standard deviation of 0.164079 and has a range from 1.386294 to 2.484907. This table also shows that the mean of governmental ownership in firm is 0.016825 with a standard deviation of 0.132273 and have a range from 0.000000 to 1.050000.

Table-2:

Dependent Variable: Performance
 Method: Least Squares
 Date: 10/07/15 Time: 17:48
 Sample :2 100
 Included observations: 99 after adjustments
 Convergence achieved after 10 iterations

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Firm Size	0.059077	0.061928	0.953960	0.0943
Non-executive directors	-0.025350	0.181242	-0.139869	0.2193
Institutional investors	0.088980	0.048602	-1.830793	0.0328
Government ownership	-1.049178	0.765812	1.370020	0.0465
Debt-to-equity Ratio	-0.237605	0.097844	2.428400	0.0186
CEO-duality	0.411804	0.336656	1.223219	0.3267
Board Size	-1.140948	0.682361	1.672058	0.0004
C	-3.663243	1.414902	-2.589044	0.0124
AR(1)	-0.178395	0.140093	-1.273400	0.0084
R-squared	0.697427	Mean dependent var		0.093566
Adjusted R-squared	0.678359	S.D. dependent var		0.796379
S.E. of regression	0.656253	Akaike info criterion		2.331642
Sum squared resid	27.95447	Schwarz criterion		2.640420
Log likelihood	-63.28091	Hannan-Quinn criter.		2.452876
F-statistic	2.543622	Durbin-Watson stat		1.934266
Prob(F-statistic)	0.0000020			
Inverted AR Roots	-.18			

Multiple regression analysis employed in table 2 and it indicates that only institutional investor has significant and positive impact on firm performance. It means if a firm has more Institutional investor than the performance of the firm will be high while Government Ownership, Debt to Equity Ratio and Board Size have negative and significant impact on firm performance. While Firm size, CEO duality and Non Executive director are non-significantly related with firm performance. Probability F-statistics is 0.000020 (less than 5%) which means our results are jointly significant. The Durbin-Watson stat is good because it is near about 2. R-square value is 0.69 which means that the independent variable explains about 69% of the value of Tobin's Q.

Regression-line:

$$\text{Performance} = 0.0590768267821 * \text{firm Size} - 0.0253501165901 * \text{non-executive directors} + 0.0889796671427 * \text{Institutional investor} - 1.04917792691 * \text{Government ownership} - 0.23760496097 * \text{Debt-to-equity ratio} + 0.411803655166 * \text{CEO-duality} - 1.14094766244 * \text{Board size} - 3.66324291884 + [\text{AR}(1) = -0.178395018211]$$

Table-3 is about co-relation:

	Perf	Firm Size	NED	I-I	Gov	De-to-E	CEO	Board size
Perf	1.000000	0.170180	0.104477	-0.215926	0.026985	0.340780	0.140761	0.286829
Firm size		1.000000	-0.194165	-0.015660	-0.314897	0.086271	0.049425	0.443063
NED			1.000000	0.129254	0.079736	0.089888	0.143330	0.245562
I-I				1.000000	0.021489	-0.110045	-0.002481	-0.027200
Gov					1.000000	-0.185260	-0.239884	-0.085156
De-to-E						1.000000	0.045020	0.154492
CEO							1.000000	0.063555
Board size								1.000000

The nstitutional investors have negative relation with performance while all the other variables (firm size, board size, government ownership, debt-to- equity ratio, CEO duality and non-executive directors) have positive relation with performance.

V. Conclusion & Recommendations

The objective of the study was to examine whether the existing corporate governance mechanisms influence the firm performance in Pakistan. The conclusive notes drawn on the findings of data analysis could be summarized as follow:

Institutional investor has significant and positive impact on firm performance. It means if a firm has more Institutional investor than the performance of the firm will be high. Government Ownership, Debt to Equity Ratio and Board Size have negative and significant impact on firm performance. The remaining three variables (Firm size, CEO duality and Non Executive director) have non-significant relationship with firm performance. The study recommends that some corporate governance mechanisms are not properly implementing in listed firms of Pakistan and government of Pakistan also have influence on listed firms which are affecting the performance of firms negatively. So policy makers and SECP in Pakistan should develop corporate governance code and internal control mechanisms. These codes should be according to the Pakistan business environment and also covering the international corporate governance standards. We expected that if these codes will really have implemented in Pakistan then it will contribute to improve efficiency, governance and effectiveness in the Pakistan stock markets. SECP should have to develop a committee which checks that whether the corporate governance codes are implemented or not. If any listed firms are not implementing these codes, then the SECP should un-listed these companies.

Future research should be conducted by taking into consideration some important corporate governance variables like audit committee members, non-independent directors, holding if associated companies, holding of directors and corporate social responsibility etc. Additional research on this topic might be conducted by using larger samples and a longer time series.

Abbreviations:

SECP (Security and exchange commission of Pakistan), **CEO** (Chief executive officer), **NED** (Non-executive director), **II** (Institutional investors), **BOS** (Board size), **COS** (Company size), **DE-TO-E** (Debt to equity ratio), **Perf** (Performance), **GOV** (Government Ownership)

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