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European Journal of Business and Management
ISSN 2222-1905 (Paper) ISSN 2222-2839 (Online)
Vol.9, No.13, 2017
www.iiste.org

Corporate Governance and the Firm's Performance: A Managerial Perspective

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Abstract
Corporate governance is a system where owners of a corporation have absolutely no direct power to have a control a company whereas others i.e. directors and managers who possess no shareholding or ownership are the ones that run the corporations but are appointed by the shareholders indirectly through electoral process. This system gained negative popularity when two giant companies (Enron Xerox and Worldcom) shocked their shareholders through different illegal means. Moreover, literature suggests that there are other several examples as well in the world that highlights the problems in this form of governance mechanism. Considering the importance of this issue the study has conceptualized to explore the main issues of corporate governance exists in Pakistani scenario. It is also worth mentioning here that many prior researches are mainly focused on the role of corporate governance in enhancing financial performance of the corporations. This research is significance in two ways, first, it is focused primarily on the effects of corporate governance mechanism on management of corporations, secondly, thematic approach has been used to understand the governance system along with the issues exist and no secondary data taken to check the effects on financial growth of corporations. The top management of several corporations was interviewed in the study to understand the governance and issues exists in the country. It has been observed that many of the issues that are discussed in the literature are same whereas some new and interesting findings are also come out due to several factors e.g. work ethics, culture, family businesses etc. Finally, the study also suggests ways to improve governance mechanism especially in Pakistani environment. The results may be interesting if future researchers step in this field and explore the field by various dimensions e.g. by adding shareholder's perspective, incorporating creditors and taking views of the regulators.
Keywords: Corporate Governance, Governance Mechanism, Financial Performance, Family Businesses

Introduction

1.1 Overview and Background

The affiliation of corporate governance and its application with international standards has already become a significant to the success of corporate world. It has therefore assumed that good governance in corporate is essential for any company to manage its resources to compete at national and international level effectively and vice versa. This governance system came into power since the management of issues between investors and managers take place. Likewise the history of corporate governance extends to the making of East Indian Company, the Levant Company and the Hudson's Bay Company and other important chartered companies of 16th and 17th centuries (Wells, 2010).

Addressing all the relevant and systematic history of the corporate governance is an intimidating challenge but the recent past is vibrant in exposing the system to the world's arena. The United States of America is the first country that documented the system and named it corporate governance which is being under discussion for strategist, academia, investors and executives. Federal Securities and Exchange Commission of United States brought the system onto the main agenda in the mid 1970s. In 1976, the term Corporate Governance appeared first in the Federal register which is the official Federal Government Journal. The purpose of SEC was to start the managerial accountability issues and in 1974, proceedings against three outside directors of a company started (Cheffins, 2012).

The governance system has primarily emerged to govern the corporations where shareholders have no powers to have a control the company and others (usually Board of Directors & Managers) who actually do not have any kind of ownership in the corporations are appointed to run them. Shleifer and Vishny (1997) added that corporate governance deals in a way which shareholders supply finances to corporations who assure themselves of getting returns on their investments. Broadly, the scope of corporate governance system has been identified with takeovers of companies, restructuring of financial systems, activism of institutional investors etc (Bocean & Barbu, 2005).

John and Senbet (1998) presents the most relevant and comprehensive definition on the system that it deals with the process by which stakeholders of a company take control over management such that their interests are better protected. The stakeholders are not only shareholders but also the small and big debtholders, non-financial stakeholders, the employees of an organization, its suppliers, customers and other related parties.

A study conducted by OECD (1999) stated that corporate governance is a system through which companies are controlled and directed. The structure of corporate governances identifies the duties and responsibilities of different actors in the systems including shareholders, directors, managers, debtholders and other major stakeholders and also defines the range of decisions by the different authorities on corporate affairs. By having such mechanism, the system provides strong structures through which the objectives of the corporations are set, achievement of corporate objectives and monitoring the performance at different layers. Garvey and Swan emphasized on the connection between those who authorized to award contracts and how decisions from top managers actually manage the contracts of important nature (Garvey & Swan, 1994).

The area has gained significant importance in both public and academic over the last two decades (Vo & Nguyen, 2014). In United States after the Enron Xerox and Worldcom the confidence of stakeholders especially stockholders shocked. Moreover, the credibility of the firms and the information they used to issue found suspicious after those major scams. Sarbanes-Oxley act, the legislation was passed in the year 2002 to raise the corporate governance system's standards especially in restoration of confidence of public, maintain the accuracy and reliability of financial information received, the governance system may be more strong than before and the priority given to monetary revolution (Ming-Cheng, Hsin-Chiang, & Lin, 2009). Many studies have been conducted during the period to find the relationship between this governance system and the performances of the firms. However, in Pakistan, studies related to corporate governance are very rare.

1.2 Research Question

What are the factors that have an impact on the performance of firms using corporate governance system?

1.3 Statement of Problem

In corporate governance, firm performance is largely affected by Board size CEO-Duality, independent members in the board, audit committee size, independent members in the audit committee to assure the transparency.

1.4 Rationale behind the Research

Corporate governance system carries massive burden by having control over the recourses of other people. Since the system is practiced Pakistan as well therefore this study tried to explore the major factors contributing in the success/failure of corporate governance system in the country. The corporate governance system has not been explored in Pakistan considering its nature to run a big business. Moreover, the study also focused to check the management side of the system instead of financial side, in many empirical studies, financial part has been highlighted.

1.5 Significance of the Study

The research identifies the gaps in the corporate governance system and highlights the issues related to the firm performance which is dependent on many factors of corporate governance. The study pointed out the relevant issues that may cause in affecting the firm's performance in corporate governance system. The significance of the study is to provide the primary support to improve the governance mechanism in corporations working in Pakistan. It is important because when the industry stands on strong pillars it remains efficient and effectives for longer period of time.

1.6 Scope of the Study

The basic and core reason to explore this area is to let the people know about the reality of corporate governance system and its working in Pakistan. Studying corporate governance in Pakistan's economy is important because the type of business is not explored by the researchers as required in the past. The study is focused to identify major factors influencing the performance and help the companies to improve their performances in Pakistani context. The study may become the base research for future researches to explore the area further upon their interests. Future researchers are benefited with the model added in this research; the model may be changed and applied to a specific industry to explore the results in detail. The research aimed to help the governments to take necessary actions in order to ensure the transparent system in the field of corporate governance.

1.7 Objective(s) of the Study

The main purpose of the research is to identify and explore the major factors influencing the performance of the corporations in corporate governance system in the context of Pakistani environment. Some specific objectives are also needs to be highlighted in this study are mentioned below:

- To identify the Importance of corporate governance system in Pakistan
- To find out the role of board size in corporate governance.
- To find out the role of CEO-Duality in corporate governance.
- To explore the independence of the members of the boards.
- To understand the audit committee, its working and its size in different organizations.
- To find out the importance of independent members of audit committee.

Literature Review

2.1 Board of Directors

Veliyath(1999) pointed that board has a critical role that creates a bridge between managers and owners, moreover it is the duty of a board to protect the interests of the shareholders. More specific duties includes management and supervision of the system, to check the behavior of managers towards shareholders, making important decisions, management of employees and administering companies to obey the laws.

Fama and Jensen in 1983 identified different types of directors including internal and external directors. Authors explained that internal directors due to their positions possess much more information than external ones and can conspire with managers to make decisions against the shareholders of the company. Contrary to this, external director's holds neutral positions and act as a supervisory role, they are kind of ideal to resolve or eliminate the problems between agency and principal.

Beasley in 1996 highlighted the relationship between financial scandals and board composition; the study revealed that independent director's ratio in companies with no scandals is greater than companies that are caught in changing the financials. (Beasley, 1996)

Bhagat and Black (2002) conducted a study and took the ratio of independent directors and minuses the ratio of internal directors, the results shows that independence of board negatively and significantly correlates with short term performances but this independence makes almost zero difference in improving the performance of corporate.

Study of Rashid, De, Lodh and Rudkin (2010) explored that non executive independent directors should not have any interest in the corporation as they are appointed from outside. Authors identified the shortcomings of the directors appointed from outside along with their limitations. In another study conducted by Nicholson & Kiel(2007)presented the argument that internal directors live within the company and they are much better understanding than those of outside directors to make better decisions.

Cho and Kim (2007) have raised questions on the quality of external directors who are considered to be independent are not competent to perform the given assignments because they are not full time directors and do not possess internal information of the company that is required to take decisions.

Board size has been discussed widely in the literature and relationship between board size and firm's performance by two difference school of thoughts. One of them argues that small boards contributes more positive towards the performance of the corporation and vice versa,

Companies having large board size face some issues e.g. diversity among the directors results in showing a great deal of variety in opinion and hence it becomes difficult for the members to reach on to the consensus. Jensen in 1993 explained that this problem affects companies to achieve the efficiency level (Jensen, 1993). Yermack (1996) revealed that size of the board is negatively related performance of companies.

Study conducted by Bacon (1973) explains different point of view that board having large number of directors is beneficial for companies due to the diverse background of directors and viewpoints; this helps companies to make quality decisions. Moreover, differences in interest may neutralize the decisions. The argument was also endorsed by Zahra and Pearce in 1989 that board size is positively related to company's performance.

2.2 CEO Status

The variable is focused on explaining CEO duality which means that the CEO is also holding a position as a board chairman. Though researchers failed to give unanimous opinion view on this variable and its impact on corporation's performance but there is a consensus among shareholders, investors from institutions and the policy makers that chairwoman or chairman of the board should not be the same as CEO of the company in advanced country. In the study by Dahya, Garcia and van Bommel (2009) have proven this with empirical study that from 1994 till 2003, advanced countries and United Kingdom recommended that chairwoman or chairman of the board should not be the same as CEO. As per Heidrick and Struggles (2009), 84% of the firms have separated the roles of chairman or chairwoman of the board and the CEO of the company. The variable is widely discussed in the world literature and responses are mixed in this case, however in Pakistan's context this variable is yet to be explored.

As per agency theory, a chairman, when assumes the role of CEO results in becoming the supervisor and taking the control as decision maker at the same time. Then the function of the board that works on

minimizing the cost of agency could be weaken drastically, at the end, this action leads to decline in corporate performance (Jensen & Meckling, 1976). Research conducted by Daily and Dalton (1993) revealed that dual status of CEO can bring negative effects on the performance of the company. However, as per theory stewardship, responsibility of executives can counteract personal interest derived from dual status of CEO and this may cause in even more devotion towards enhancing the performance of the corporations. Later on this theory was also endorsed by Boyd (1995) that dual status of CEO brings positives effects in the performance of corporations.

2.3 Audit Committee

Siagian and Tresnaningsih (2011) have explained that audit committees and directors who are independent or separate from management much enhance the reporting system of the corporation and improve quality of earnings as they are not considered to be the potential conflict of interests which decreases the capacity. The argument was endorsed by Nguyen and Nielsen (2010) and added that independent directors serves in different companies and hence they should care about their reputation to improve the performance, the committee must include other members of the firm along with the independent directors of the board.

Islam, Islam, Bhattacharjee and Islam (2009) highlighted the importance of independent audit committee mechanisms, authors explains that need of internal and external users of financials should fulfilled by the committee, studies conducted previously also recorded the independent members and their role in these audit committees to maintain the quality and integrity of financial reporting system.

Some studies also reported the negative association between independent directors of the audit committee and the management of earnings of the corporations. Xie, Davidson and DaDalt (2003) explored that independent directors that are from investment banking or corporate firms are associated negatively with the management of earnings.

2.4 Director's Remuneration

Executive remuneration also remains the hot topic in corporate governance because the directors receives remuneration in large amount and when it is compared by the amount received by the junior staff it faces serious criticism especially related to corporate governance (Fahlenbrach & Stulz, 2011).

Agency theory addressed the issue that because of their low involvement of the owners of corporation in corporate governance it was proposed that executive compensation policies should be aligned with their performances (Fama & Jensen, 1983). The theory has been challenged in recent times by paying massive compensation packages to corporate executives (Friedrichs, 2009), agency theory in this regard is also criticized and challenged due to it inability and inefficiency to explain the differences of cultures (Haubrich & Popova, 1998).

Organizational and business theorist have identified the limitations of agency theory and narrated more as a political theory. These theorists dig deeply to identify the powers of CEO and the board that may affect the executive remuneration (Finkelstein, 1992). One major observation identified is that CEOs are in special condition to establish their own compensation because of the ability to influence and affect the board behavior (Zajac & Westphal, 1994).

Methodology

The main objective of this particular research is to identify the key issues pertaining to corporate governance as a system to govern and manage companies in Pakistan and for the purpose it w use as imperative to have a qualitative research so that the data is acquired from the experts of the same field. Phenomenology, one of the techniques of qualitative research has been used to acquire the data and interpretation. The interviews were conducted in detailed from the existing directors of the different companies for in-depth and rich data extraction. It is also imperative to mention here that the research is not limited to any area of corporate governance, but consist of general issues that were highlighted in the literature. For sampling technique, Purposive sampling technique was used as it is more consistent and respondents were targeted non-randomly from the various area of corporate governance. Four directors have been selected as respondents on the basis of their knowledge about the corporate governance and experience in the field. They were taken into confidence about their personal details and informed about the purpose of the research before providing their inputs. The directors selected were from various industries to make sure that a complete and unbiased picture of corporate governance system exists in Pakistan. All the interviews were conducted face-to-face from directors; there were four different questions asked on four different topics and also some counter questions to have a clear view about the topic.

Data Analysis

4.1 Board of Directors

Respondent 1: Board size not always affects positively, it depends on company's operations, its size and

number of departments. I believe that size should be as per company's ordinance 1984 e.g. 7 to 9 directors and I will go with 7. Large board size will reduce the efficiency and it will be difficult to agree upon some agenda.

As far as non-executive directors are concern, it's good to include them in the board to ensure transparency and SECP code of corporate governance also states that the Board must consist of executive and non-executive directors.

Respondent 2: Organizations operating in Pakistan may have 7 to 8 directors but as far as banking sector is concerned, there must be 11 to 13 directors to enhance the performance, in UBL there are 14 directors in the board.
Independent directors are the custodians of good corporate governance system, though not require to involve in day to day operations, but it is expected from them to monitor the actions of executives to safeguard the interests of stakeholders. Directors use to sanction risky loans so their importance in Banking Industry automatically increases.

Respondent 3: Company having large board has an advantage and disadvantage as well. In large board, every member has his/her own strategies and strengths so the strategic input becomes important for a company whereas too large board size faces conflicts too because it becomes difficult to reach to a conclusion. Moreover board size should be in odd numbers because whenever decision making is required, there is no chance of having equal voting.
Independent directors are essential part of the system as they ensure transparency in the boards.

Respondent 4: There is no ideal size of directors are formalized in any of the Article of Memorandum means that there could be any numbers, but most importantly decisions are rely on the most influential one at the end of the day. Therefore, this whole sums up like this way that it is healthier for the companies to keep the board size small carrying only those directors who always speaks in the best interest of the company.

Researcher's Conclusion

For many industries, board size should not be large as it becomes difficult to reach to conclusion on any agenda but it's important to have a large board in the banking sector, moreover the independent members in the board are essential part to ensure transparency.

4.2 CEO Status

Respondent 1: Yes, there is a conflict if the CEO and Chairman is a single person, as the both roles are having different powers, as if CEO leads the operational matter, and Chairman leads the Board of Director meeting, or any meeting that is for the company affairs. In the absence of CEO, Chairman works as acting CEO as well, mostly in especial cases, but can exercise it any time in the absence of CEO.

Respondent 2: If CEO and Chairman is the same person, there will be a conflict and it is seen that banks that have two different persons for these two positions yields positive performance and striving towards best.

Respondent 3: CEO's work is to run functional organization that is why he/she knows day to day operations more than board chairman. Having same person running both, the company operations and the board may arise some serious conflicts moreover if line of demarcation is clear about the role of CEO and role of Board then there shall be no conflict of interest.

Respondent 4: I admit the fact that it does arrive because of the powers and sometime CEO are not competitive enough to ensures the strategic plans for the companies interests then the chairman takes on leads to satisfy the shareholders plus the employees, and sometimes is vice versa.

Researcher's Conclusion

Both the offices have different roles to play and therefore there shall be no single person handling these two mentioned offices. Even if there are two persons running these two offices and their duties and responsibilities are clear, then there shall be no conflicts. It is therefore concluded that CEO and Chairman should not be a single person.

4.3 Remuneration Committee

Respondent 1: The remuneration issue is decided by the board and has to present or inform the shareholder, after they have approved, the remuneration is set to disburse. Yes, you are right, that there must be in combination, but we have made a committee, where all three members in remuneration committee are non-executive directors, whereas chairperson is also a Non-executive member of the committee.

Respondent 2: It will be effective to use independent directors in the remuneration committee in Pakistan as it leads to transparency in more effective way. In present banking system, members of the committees use to avoid going against the strong executives especially the CEO and other directors. Therefore independent directors are a good way to ensure transparency in the system.

Respondent 3: In public limited companies, financials are disclosed before the shareholders and in AGM's everything becomes transparent. Director's remuneration should be with the consent of shareholders but generally they are not considered but informed about every financials. Moreover, if independent members are included, it will be a great step to ensure transparency.

Respondent 4: The respondent clearly supported the discussion that there should be independent directors in companies to ensure transparencies. Second, point which was raised was regarding the disclosure of the remuneration of independent directors and again he completely agrees this by explaining one practical experience of himself as an independent director/executive of one of the leading corporate banks in Pakistan.

Researcher's Conclusion

It is evident that inclusion of independent members in the remuneration committee is encouraged for transparency and to avoid corporate governance system whether it is banking or any other industry. It is therefore concluded that having independent and non-executive members in the remuneration committee are good for the system.

4.4 Audit Committee

Respondent 1: It is not always a matter that independent member, or non-executive member must bring transparency, it is also a matter of secrecy of company information that can be open to general public before its publications. So in my opinion having non-executive member in a committee is good for transparency and to give or adjust the account as per their knowledge. However, committee must have some limits to check the account before finalization, and when the committee members are agree on values and heads of accounts, there should be no role of non-executive members before the accounts are presented in board meetings. Audited accounts are presented by CFO in the meeting presiding by Chairman or CEO in the presence of the all directors. If having any objecting, CFO has to answer to the board.

Respondent 2: It is cent percent right that many audit firms are 100% dependable and it is a duty of a board to ensure the transparency in company accounts so that shareholders have a clear idea about financial performance. To my opinion, non-executive of independent director has an important part to play in making financial affairs more transparent.

Respondent 3: Generally non-executive or independent members are not involved in audits as this is a role of external auditors. Teams of auditors are involved in the process to prepare impartial reports and if discrepancies found, board is liable to answer the shareholders.

Respondent 4: The respondent agrees with the discussion that there must have some independence in the audit committee process, so far the board with its independent members is responsible for doing it but if an independent member included in the audit process then there must be some better and transparent process.

Researcher's Conclusion

It is found that present governance system is totally dependent on external auditors and the reports of the auditors are presented and evaluated in the board meetings. Inclusion of non-executive or independent members in the audit process is not found positive by the sample taken in this research.

5. Conclusion and Recommendation

The main objective of this research was to identify the managerial perspective of the corporate governance issues in Pakistan. As mentioned, 3 different experts were taken as respondents. These experts were from different background just to have a complete idea of what are the main challenges. Qualitative method was used in the study and found that there are several things which are same as the rest of the world, but few things are different as per Pakistani perspective. One of the most important things which the Pakistani managers differ was the role of independent directors in the Audit Committee, they believe that this may hurt their privacy and it is sensitive to share the accounts with external members before it is presented to the Board. The research concluded that the large board size is not beneficial for many industries as there will be more conflicts, it may be alright in Banking industry, moreover, there must be two different offices for CEO and the Chairman, as the specialization is increases and it is also good to have these two persons to avoid conflicts. Furthermore, the research is also able to conclude that independent members in the remuneration committee is good to ensure the transparency, this may satisfy all the stakeholder of a limited company.

The research aimed to highlight the important issues the managers are currently facing in corporate governance system. Based on the study of literature, learning corporate governance codes of Pakistan and observations during taking the interviews of the experts its recommended to the state institutions especially SECP that they should ensure transparency at various levels especially in the board, audit committee, remuneration committee and appointment of the key executives.

It is also recommended that there should be some sort of motivation for the independent directors so that they could deal with the company affairs religiously. It was one of the key findings of the study that independence of the board is positively related to company's performance, therefore steps must be taken to ensure more transparency. It was also noted that almost all of the respondents were on the same page along with the corporate governance code 2012 that no independent member is involved in the process of audit, however literature suggest that there may also be an independent director to have more transparency in the system.

It is also recommended to the officials of government and the directors to design a mechanism of disclosure of information with the stakeholders as sometimes it becomes highly important to share the true picture especially in case of shareholders and creditors. It is obvious that there are many things which remain secret but if things are transparent then there will be more trust on the company by its stakeholders.

There is a great scope of future researchers in the field of corporate governance, as this research left many areas i.e. they can take the viewpoint of the shareholders to highlight their problems, creditors who also lend money to the company were also left out from the research, academia may step-in to discuss the issues they face in the system.

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