

The Impact of Corporate Governance on Firm's Performance: Evidence from Ethiopian Insurance Companies

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Abstract

The issue of corporate governance has long been ignored in developing economies like Ethiopia. This study examines the impact of corporate governance mechanisms on the performance of Ethiopian insurance Companies using a panel data model for the period covering from 2009 to 2013. Both descriptive and regression analyses were conducted on the selected samples of 10 insurance companies out of 15 operating in the market. The findings from the study indicated that board meeting and board compensation had statistically significant positive impact on return on equity (ROE) of the Ethiopian insurance Industry. But the results failed to show any significant impact of board size, audit committee, and gender diversity on the proxy of companies' performance. Moreover, the Size of the companies had a significant positive impact on ROE. Hence, the study recommends that efforts to improve the corporate governance system of insurance companies in Ethiopia should focus on the number of meetings to be held by directors, the level of board compensation, as well as on the size of firms, and these in turn improve the performance of the insurance companies. Finally, the study also recommends the participation of all stakeholders in the industry at the time of developing the governance system of these companies.

Keywords: Corporate Governance, Corporate Governance Mechanisms, Performance,

Introduction

In Ethiopian context, modern form of financial institutions has been started since the early time of the 19th century. The agreement made in 1905 between Emperor Minilik II and Mr. Ma Gillivray, representative of the British owned National Bank of Egypt, becomes the basis to launch the then bank of Abyssinia. This bank, with full foreign ownership, was the pioneer to start the modern financial institution services of both bank, and insurance as an agent in Ethiopia. The bank delivered the insurance service as an agent of the foreign insurance company. During the time from the establishment of this institution, in 1906, till its liquidation, in 1931, the institution was administrated by the Egyptian National Bank.

The commercial code of Ethiopia was introduced in 1960s; since then, the financial institutions similar to other corporate business entities have been using the Commercial Code of Ethiopia as their administrative tool. In addition, the Maritime Code of Ethiopia was also designed to govern the maritime insurance companies. Furthermore, in 1970 Proclamation no. 281/1970 was issued to provide for the control and regulation of insurance business in Ethiopia.

Concerning ownerships of these institutions, a survey taken in 1961 documented that the number of insurance companies at that time was 34 of which one was domestic insurance (i.e Imperial insurance company Ltd) whereas the rest are working as agent of foreign insurance. However, after the military government (1974), it culminated foreign ownerships through the process of nationalization which merged and transferred all insurance companies in the country to a unitary system of a state owned insurance company named as Ethiopian Insurance Corporation. During this period, the administrations were made through centrally planning organ.

In the year 1991, following the collapse of military government, the transition government crafted a new proclamation refereed as proc. No. 183/1994 which permits the participation of private investors with Ethiopian nationality in the ownership of the financial institutions. And this paves a new era in the formation and management of financial institutions to take part in the economic development of the country. As a result, a number of private insurance companies started to evolve into the market and their number becomes 15 as of June 30, 2013. Though, private ownerships of the companies were made through publicly sold shares, the absence of secondary stock market may have limited the wide accessibility of the share of these companies. In sum, during the current regime, the insurance companies are being administrated through the commercial code, regulations, directives, articles and memorandum of association of the insurers as a tool, to enhance for good corporate governance mechanism.

Corporate governance is a multidisciplinary concept that can be described in different ways. In this paper, corporate governance is defined as the mechanisms by which "resource owners of corporations assure themselves of getting a return on their investment" [1].

Despite the newness of the phrase "corporate governance" which has got its popularity since 1980s, its

practice is as old as trade [2]. Shakespeare (1564-1616) applied the concept of governance in his famous play: *The Merchant of Venice*, Act 1 Sc 1, scripted as follow; “Antonio, his Merchant of Venice¹, worried as he watched his ships sail out of sight. But his friends reminded him that he had entrusted the success of the venture and his fortune to others: no wonder he was worried”.

In this play of Shakespeare, which is believed to have been written during 1596-1598, the concept that underlies the issue of corporate governance was highlighted in the script. Basically, the discussion had come to the scene by the separation of the owner from his resources. Moreover, trust had been the pillar that holds the two entities: the owners (principal) and managers (agents). The question is to what extent the manager of these firms will keep their promise. In fact, since the time of Adam Smith, it has been recognized that managers may not always act in the best interest of the owners (Henderson & J.P., 1986). This issue has been exacerbated in the modern form of corporate entity in which the managers have got the opportunity to make a free ride of the organizations with their own interests which may not alien the interest of the owners [3]. Moreover, “it is not possible for principals to know beforehand which agents will or will not act opportunistically” [4] .

In the past three decades, the issue of corporate governance has become a contemporary agenda which has been repeatedly cited as a cause for the failures of many of the corporate entities worldwide. Primarily, this has resulted in a lack of trust from the societies due to the absence of the corporate accountability for the resources entrusted to such institutions. And trust is the pillar for institutions maneuver, especially for financial institutions, its value is as equal as the value that they worth and their existence in the market. Moreover, the crises have also exhibited a loss of investment by shareholders. This has given a great lesson that good corporate governance has a great role in ensuring the stability and wellbeing of an economy. Hence, all these effects in the form of scandals and crises contributed to the popularity of the issue of corporate governance.

On the other hand, the existence of good corporate governance is an interest to nations (Xun, 2005). It also brings prosperity to a given economy by attracting domestic investment and ensuring greater inflow of foreign direct investment [5]. Indeed, investors are interested to pay a premium for investments made in a firm with good governance system (McKinsey & Company, 2002). In this regard, stakeholders, including the World Bank, the IMF, G20 and the OECD have given progressive attention to the character of good corporate governance with the view to ensure a safe playing field for participants in the economy. As a result, various laws, provisions and regulations were designed to mitigate the adverse consequences of poor corporate governance. Namely, Sarbanes-Oxley Act (SOX) of 2002, OECD best practice Guideline, and the Combined Code of the UK’s Best Practice Guideline, Basel accords were developed aiming not only as the means of managing the risk of corporate failure but also as the route to improve performance of the economy, facilitate access to capital, stabilize the market volatility, and enhance the investment climate [6].

The discussion so far reveals that the corporate governance system has an important role in the stability and improvement of an economy. The performance of the economy is the aggregate sum of the performance of corporate entities. Hence, the governance systems of the corporate entity have a great stake in the performance of an economy. As a result, a number of researches have been focusing on the relationship between corporate governance and firm’s performance. In this way, most of the earlier investigations Roman (1996); McConnella & Henri (1990) used one or two corporate governance variables as a proxy for corporate governance mechanism. The selection of specific parameters as a proxy for the corporate governance mechanism makes the task of generalizing the relationship between corporate governance and firm’s performance to be a lengthy process. As a solution to this, recent studies (see for example Gompers, et al. (2010); Bebchuk, et al., (2009); Brown & Caylor (2006)) developed indices as tools for measuring the corporate governance variables of a firm by using a specific summary number that help to rate the quality of firms’ governance mechanism.

Although, through time, there is a development in the methodology of the studies, the findings from these studies still reveal mixed output. For instance, a recent study made by Gompers, et al.(2010) identified that firms with the poorest corporate governance consistently underperformed as compared to those with the best corporate governance. Also, the indices developed by Bebchuk, et al.(2009); Brown & Caylor (2006) indicated positive associations between their indices’ rankings of governance quality and firms’ performance. Further study made by Bhagat & Bolton (2008) using the indices of Gompers, et al.(2003), and Brown & Caylor (2004) found that stock ownership of board members, and CEO-chair separation had significant and positive correlation with operating performance. However, they did not find any relationship between the indices and stock market performance. Also, a study made across Sub-Saharan African countries found a positive association between their constructed index and accounting performance, but a negative relationship between corporate governance index and the market valuation [7] .

As exhibited above, the results from previous studies that deal with the impact of corporate governance on the firm’s performance have shown mixed outcomes. Besides, in developing economies like Ethiopia, the issue of corporate governance has been ignored by the stakeholders in the field. Hence, this paper seeks to fill

¹ William Shakespeare: *The Merchant of Venice*, Act 1 Scene 1, first folio 1596/8.

this research gap. The paper specifically studies the impact of corporate governance mechanisms on performance of insurance companies in Ethiopia. Particularly, it assesses the impact of 5 selected corporate governance variables on the performance of 10 private insurance companies which is measured in terms of return on equity (ROE).

The paper is organized as follows: the next section presents relevant literature on the subject matter. This is followed by a discussion of the method and model specified which were developed in undertaking the study. Then, analysis and interpretation of the results are made. Finally, the paper ends by drawing conclusions and recommendations.

2. Literature Review and Hypotheses Development

A great number of studies reviewed the relation between corporate governance variables and performance of firms in various economic contexts, but the results from these studies have been found to be inconsistent. From these studies, conceptual and empirical evidences that deal with the corporate governance mechanisms such as board size, board meetings, audit committee, gender diversity, and board compensation are summarized in relation to firm performance, and discussed below.

2.1. Board Size

In the early conceptual contribution about board size, Lipton & Lorsch (1992); Jensen (1993) suggested limiting the size of a board enhances board effectiveness. They argue that small or moderate board size allows members to know each other and gives an opportunity to discuss on matters and to reach on an agreement. On the contrary, Pearce & Zahra (1992) argue that larger boards have the advantage of multiple networks which enables to provide better access to firm's stakeholders, risk reduction as well as acquisition of critical organizational resources needed for firm performance.

Empirical evidence made by Yermack (1996), using 452 major companies in U.S for the period (1984-1991), reveals that increasing board size results in an adverse impact on firms' market value as measured by Tobin's Q. Similarly, Eisenberg, et al. (1998) on a sample of small and midsize Finnish firms confirmed the result found by Yermack's. On the other hand, a large board may have more problem solving capabilities. More recently, Coles, et al.(2008) provide evidence that the nature of the firm determine the size of the board. They also noted that, for firms with character of large size, highly leveraged or diversified nature, board size and performance have positive relationships. The above arguments lead to develop the following hypothesis;

H₀: As the number of board size increase, it will improve performance of the firms.

2.2. Board Meetings

The board meeting is a means of providing information for board members in order to perform their basic activities of guidance and oversight. Effective board meetings provide useful information in a timely manner which is critical for any board's effectiveness (Argüden, 2009). To this effect, the boards of directors will be informed in advance of the meetings to be held at specific times, at least before the quarterly release of financial information to the users (Tonello, 2010).

According to an early empirical investigation on board meeting by Vafeas (1999), he found an increase in the level of board activity through board meetings following poor firm performance, and this subsequently leads to an improvement in the firms' performance. Nevertheless, the frequency of meeting to be held by the board depends on the size and volatility nature of the businesses. Firms with small size and stable environment are expected to have less number of meetings than large and risky businesses (Colley, et al., 2005). In this regard, the following hypothesis was developed;

H₀: The meetings held by the board members have a positive impact on the firm's Performance.

2.3. Audit committee

The audit committee is a subcomponent of the main board which is responsible for overseeing the company's financial reporting process. According to the best practice set by SOX, the audit committee is required to be composed of more than three members, of which at least two third from outside directors and at least one being financial expert. This committee ensure that accounting policies are sound and financial statements are properly prepared and audited (Green, 2005). The existence of these experts in the firm will create a transparent and credible environment between management, external auditors and the board members.

The evidence suggests that having experts with qualification of accounting and finance in the audit committee improves governance quality. For instance, Defond, et al., (2005) indicated a positive reaction of the market for firms having an audit committee which is composed of accounting background than those with non accounting background. Likewise, audit committee with the member qualification of a CPA or similar degrees had also resulted in fewer restatements of firms' financial report as compared to committees with other qualifications (Agrawal & Chadha, 2005). This leads to develop the following hypothesis;

H_0 : The existence of the audit committee will have a positive impact on the company's performance.

2.4. Directors Compensation

Directors require compensation for the duties and responsibilities which is expected from them. And most directors would be unwilling to undertake their services on a pro-bono basis (with the exception in non-for-profit organization). Therefore, the level of compensation must be attractive enough to get and retain qualified professionals with the knowledge required to advise and monitor the corporation (Larcker & Tayan, 2011).

There is a large volume of published studies evidencing the importance of top executive compensation on firms' performance, such as Murphy (1985); Jensen & Murphy, (1990). Further investigation on whether the type of compensation (cash or equity) give rise to a variation in performance was made by Mehran (1995) and the finding shows a positive relationship between equity rather than cash compensation with firms' performance. This supports the development of the following hypothesis;

H_0 : The compensation to directors will have a positive impact on the company's performance.

2.5. Gender Diversity

In recent years, there has been an increasing interest in investigating the impact of gender diversity on the firm's performance, which is whether the addition of a woman to the board affects performance, and a number of research projects have attempted to provide evidence for or against this argument. Those who hold the view in favor of gender diversity in enhancing firms' performance argue with the anecdotal evidence that women may have a competence and network which may be absent with male board members, and this directly contributes to product, process, organizational and market development, and subsequently improves firm's performance (Huse, 2007). But there is a common caveat with diversity; it should not be made for tokenism.

The above assumption has got a support from empirical findings. For instance, the study made on 2500 Danish firms identified that women working in top management positions have a positive effect on the firm's performance (Smith, et al., 2005). A recent study, which was conducted in the UK companies listed in the FTSE, also identified a positive result in the firms' performance for existence of gender diversity in the boardroom. This study revealed that operational and share price performance was significantly higher for firms with 20% or more women on boards than those below that (Bhogaita, 2010). Moreover, a more recent study which was conducted in listed firms in China, also verified the positive relationship (Liu, et al., 2014). Furthermore, a survey conducted for Heidrick & Struggles Consultancy by Groysberg & Bell (2010) identified that the majority of women surveyed directors (51%) remark for the participation of at least three women directors in the boardroom to bring boardroom efficacy. Therefore, the hypothesis that supports gender diversity can be developed as follows;

H_0 : Gender diversity in the boardroom will bring positive impact on firms' performance.

3. Research Methodology and Model specification

3.1. Sample Selection and Source of Data

3.1.1. Sample Selection

According to the data gathered from the National Bank of Ethiopian website the number of insurance companies operating in the market at the end of June 2013 counts to 15. In terms of ownership, there are 14 private insurance companies, and one state owned insurance company. Purposively, 14 of the sampled insurance were initially considered for the analysis. However, to make use of a balanced panel data analysis, the study excludes four private insurance companies which were found to be incomplete with the panel data for the analysis. As a result, 10 private insurance companies having data for the panel period from 2009 to 2013 were selected to make the analysis.

3.1.2. Selection of the variables

Corporate governance mechanisms such as board size, number of board meetings, existence of audit committee, board compensation, and gender diversity of the board were selected as independent variables in the study. Whereas, return on equity was selected as a dependent variable, since return on asset is embedded in return on equity, it is a plus to have this variable. Moreover, age and size of the institutions were also incorporated as control variables. Table 1, presents further information about each of the variables in the model.

Table 1. Variables, representation symbol and description

Variables	Representation symbol	Description
1. Corporate Governance variables		
Board Size	BSIZE	The number of board of directors
Board Meeting	BMEET	The number of board meetings conducted per the fiscal year
Audit Committee	AUDCOM	The existence of audit committee, 1 if audit committee exists , 0 otherwise
Board compensation	BCOMP	The compensation made to board members
Gender Diversity	GENDIV	The presence of female directors on the board , 1 if exists , 0 otherwise
2. Performance Variables		
Return on Equity	ROE	The profit before tax divided by the total equity
3. Control Variables		
Firm Size	InFSIZE	Log of total assets

3.1.3. Source of data

The audited financial reports of the insurance companies for the panel period from 2009 to 2013 were gathered from the annual reports of each insurance company. Besides, they have also provided the survey responses for the data concerning their corporate governance mechanisms.

3.1.4. Model Specification

The following model was used to examine the relationship between the corporate governance variables and the impact on the firms' performance;

$$Y_{it} = \alpha_0 + \beta_1 x_{1it} + \beta_2 x_{2it} + C_{it} + \varepsilon_{it}$$

Where;

Y = A measure of firm performance; α = Intercept coefficient;

β_1 = vector of coefficients of corporate governance variables; x_1 = A vector of the measures of corporate governance variables; β_2 = A vector of coefficient of board control variables;

x_2 = Vector of control variables; C = The vector of control variable unit specific error component

ε = The error component; Subscripts i and t refers to each firm i in year t.

$$Y_{it} = \alpha_0 + \beta_1 BSIZE_{it} + \beta_2 BMEET_{it} + \beta_3 AUDCOM_{it} + \beta_4 BCOMPEN_{it} + \beta_5 GENDIV_{it} + \beta_6 INSIZE_{it} + \beta_7 BC_{it} + \beta_8 AGE2_{it} + \varepsilon_{it}$$

BSIZE- board size, BMEET- board meeting, AUDCOM – audit committee,

GENDIV- gender diversity, INSIZE- Insurance company size, BC- control variable, AGE2 – Age square of the insurance companies

3.2. Test for the Regression Assumptions

As indicated in the above model, all relevant variables which are required to satisfy the linear regression assumptions, including the constant and error terms are incorporated, and also the assumptions under here are checked for fitness of the data to the model. Finally, to select a best fitted model between the alternatives of random effect model and fixed effect model, Hausman test was conducted which resulted in a selection of fixed effect rather than a random effect model.

The first assumption demands a normally distributed curve for the regression equation. Initially, some of the values of dependent variable such as size and compensation were not nicely fitted with normal distribution curve, and then the variables are transformed using logarithmic function to meet this assumption. Second, the value of the Durbin-Watson statistic with value of 1.43 implies the absence of autocorrelation. Here, the statistical values of F and X2 also indicate the absence of a sign for heteroskedasticity. On the other hand, multicollinearity assumption was checked using the variance of inflation factor (VIF) and this statistical result reveals values below 3.1. This implies the absence of multicollinearity with the threshold level of 10 VIF value (Asterious & Hall, 2007).

4. Analysis and Interpretation of Results

4.1. Descriptive Analysis

Table 2., reports the descriptive statistics of the dependent and independent variables for the panel period from 2009 to 2013. The table presents the mean, minimum, maximum, standard deviation, for the panel data variables.

Table 2. Descriptive statistics

	Mean	Min	Max	Std. Dev
ROE	0.13	-0.06	0.23	0.06
BSIZE	7.93	5.00	11.00	1.75
BMEET	21.40	6.00	38.00	12.42
AUDCOM	0.52	0.00	1.00	0.50
GENDIV	0.23	0.00	1.00	0.47
InINSIZE	8.96	6.44	12.19	1.23
InBCOMPEN	5.40	3.40	6.80	1.10

Source: Authors' computation

The average return on equity (ROE) for the ten insurance companies included in this study is 0.13, while the minimum and maximum return being -0.06 and 0.23, respectively. The mean of board size is nearly 7.93 with minimum size of 5 and maximum of 11 members. In fact, the ceiling and floor of the board size are within the requirements of the Commercial Code under Art.347 (2), which state that an incorporated body should have a minimum of 3 and a maximum of 11 board members. However, in the case of Ethiopian insurance companies with the growing nature of the industry, the size of the board needs to be large enough to form different subcommittees and to take the advantage of directorial network.

With regard to the average number of board meetings (BMEET) the number nearly is 21 with minimum meetings of 6 and maximum of 38. Audit committee (AUDCOM) is the other independent variable with the average occurrence of 52 percent of the time, during the panel period. This indicates the absence of audit committee in 48% of the panel period, and still in some insurance companies the committee is under consideration. In fact, this is due to the newness of this committee in the industry. Gender diversity (GENDIV) also indicates a 0.23 % ratio for the presence of female directors in the board's of the insurance companies. A further investigation of the gender diversity remarks that the maximum observation for women director in a single board is 2 during the panel period. Board compensation (BCOMPEN), measured by the logarithm of board compensation, and shows a significant difference between the highest and the lowest compensation. The logarithm of the mean value of the board compensation is 5.48 with a minimum value of 3.40 which a low rate of compensation in some insurance companies due to low performance resulting in undeclared dividends and the compensation constitute the monthly remunerations. On the other hand, there are also boards with maximum board compensation of logarithmic value of 6.80. The size of the sampled insurance companies, taken as the logarithmic function of total asset, indicated a mean value of 8.96, and a minimum and a maximum value of nearly 6.44 and 12.19, respectively. The next section is devoted to describe the output of the regression analysis.

4.2. The Regression Analysis

The regression analysis showing the impact of corporate governance mechanisms on the performance of Ethiopian insurance companies is shown in Table 3..

The result of the regression model revealed that the corporate governance variables in the model are a good fit with (R^2) value of 54%. This means that the selected variables explain 54% of the profitability of the insurance companies and the remaining percentage is due to an error and other factors.

Board Meetings and Firms' Performance

From the regression output in table 3., this study finds empirical evidence which indicates a positive impact of the number of board meetings on the performance of insurance companies in Ethiopia, and this is congruent with previous study made by (Vafeas, 1999). This implies that as the number of meetings increases, it also improves the performance of the insurance companies. The increase in the number of meetings might have resulted from the presentations held by top executive managers to clarify technical and operational activities of the companies as it deemed by the directors. As a result, the meetings update directors on the status of their company and also a good means of monitoring the governance gaps in their firms. Moreover, it may assist directors to assess the knowledge gap or the requirement of trainings, and to take appropriate measures that in turn improve the firm's performance. However, extreme involvement of top executives in the meetings might call for a caution that needs to be made to avoid interference in the duties of managers.

In this regard, as the meetings of the board have significant impact on the insurers' performance, attention also must be given by the regulatory body too. Of course, in such large and volatile industry, board of directors needs to have a regular meeting to get in line with the industry status. However, some of the increase in the board meeting may be due to the deliberation of all corporate matters by the full board. Hence, the board needs to delegate some of the tasks to a special committee which is to be composed of directors with specific educational, training or experience for the duties and responsibility to be assigned. However, this doesn't mean boards need to be experts, but at least they need to have trainings. Together with this, the supervisory body needs to monitor and follow-up the relevance of the board's agenda.

5. Conclusion and Recommendation

Corporate governance has been cited as a cause for the failure of many of the corporate entity throughout the world. Consequently, the topic has become a hot issue for research among academicians and researchers. The impact of corporate governance mechanism on firms' performance has become one of the corporate governance streams of research. But the result from the previous studies has been inconclusive. Besides, most of these studies were conducted in the context of developed economy. Hence, this research aims to fill this research gap, by examining the impact of the corporate governance mechanisms on the performances of selected Ethiopian insurance companies. For this purpose 10 private insurance companies were selected with the panel period from 2009 to 2013. In this regard, both descriptive and regression analysis were conducted. The findings from the regression analysis reveal that board meeting, board compensation and size of the insurance companies were found to have a significant positive impact on the firms' performance. Therefore, this study suggests that the stakeholders which encompasses shareholder, regulatory and supervisory body, board of directors, insured, and employees of the institution need to give enough attention to the following corporate governance mechanisms;

- The number of board meetings has a significant impact on firms' performance. This deserves attention not only by the insurance companies, but also by the regulatory body of these companies. Of course, in such large and volatile industry, board of directors needs to have a regular meeting to get in line with the industry status. However, some of the increase in the board meeting may be due to the deliberation of all corporate matters by the full board. Hence, the board needs to delegate some of the tasks to a special committee which is to be composed of directors with specific educational, training or experience for the duties and responsibility to be assigned. However, this doesn't mean boards need to be experts, but at least they need to have trainings. Together with this, the supervisory body needs to monitor and follow-up the relevance of the board's agenda.
- The compensation to the board is the other important factor that leads to improved firms' performance. This implies the need to make attractive reward for boards to improve firms' performance. However, a caution needs to be made in the level of compensation of the boards, since within the same industry, having a comparable experience and qualifications there is a wider gap in the compensation of the directors. Thus, the regulatory body together with the shareholders of the insurance company's should limit the ceilings of the board compensation as it might result in a conflict of interest among shareholders following high performance of these firms.
- Moreover, the regulatory body is required to increase the minimum required capital for insurer which enables them to get the trust and confidence of insured and society.

Finally, it is recommended that with the participation of all stakeholders in the industry a comprehensive framework of corporate governance system should be designed which enables the firms to mitigate from the potential hazards as well as to realize a fair return on investment.

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Table . 3 Regression result

Variables	t- statistic	Prob.
BMEET	1.8421	0.0032 *
BSIZE	2.4973	0.6466
AUDCOM	1.0218	0.5833
GENDIV	0.5207	0.6406
LnBCOMPEN	1.0720	0.0047*
LnINSIZE	1.5740	0.0031*
Weighted Statistics		
R-squared	0.5422	
Adjusted R-squared	0.4612	
S.E. of regression	0.0009	
F-statistics	9.1047	
Probability	0.0001	
F-statistics		

* Indicate significance at 5% level.

Source: Authors' computation

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