

Corporate Governance and Firm Performance: A Study of Sri Lankan Manufacturing Companies

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Abstract

Corporate governance is about putting in place the structure, processes and mechanism that ensure that the firm is being directed and managed in a way that enhances long term share holder value through accountability of managers and enhancing organizational performance. Corporate governance refers to a set of rules and incentives by which the management of a company is directed and controlled. Hence good corporate governance maximizes the profitability and long term value of the firm for shareholders. There is a great awareness among the researchers to carry out the researches in “corporate governance”. Very little researches on “corporate governance” are available in Sri Lanka and need to be empowered companies to pay a special attention on corporate governance. In a way, the present study is initiated on “corporate governance and firm performance” with the samples of 28 manufacturing companies using the data representing the periods of 2007 – 2011. Board structure, board committee, board meeting and board size including executive directors, independent non-executive directors, and non executive directors were used as the determinants of corporate governance whereas return on equity (ROE) and return on assets (ROA) were used as the measures of firm performance. The study found that determinants of corporate governance are not correlated to the performance measures of the organization. Regression model showed that corporate governance don't affect companies' ROE and ROA. Further recommendations are also put forwarded in the research.

Key words: Corporate governance, firm performance, board size, board structure, board committee, board meeting.

Introduction

Corporate governance is concerned with ways in which all parties interested in the well- being of the organization attempt to ensure that managers and other insiders take measures or adopt mechanisms that safeguard the interests of the stakeholders. Corporate governance refers to a set of rules and incentives by which the management of a company is directed and controlled. Good corporate governance maximizes the profitability and long term value of the firm for the share holders (Khumani et al, 1998). La Porta, Lopez, and Shleifer (2000) view corporate governance as a set of mechanisms through which outside investors protect themselves against expropriation by insiders. Corporate governance is about putting in place the structure, processes, and mechanisms that ensure that the firm is being directed and managed in a way that enhances long term shareholder value through accountability of managers and enhancing organizational performance.

Shleifer and Vishny (1997) define corporate governance as a way in which suppliers of finance to corporations assure themselves of getting a return on their investment. Irrespective of the particular definition, the importance of corporate governance arises in a firm because of the separation between those who control and these who own the residual claims (Epps and Cereola, 2008). Corporate governance has been referred to as a collective group of people united as one body with power and authority to direct, control and rule an organization (Ruin, 2001). The Australian standard (2003) defines corporate governance as the process by which organizations are directed, controlled and held to account. This implies that corporate governance encompasses the authority, accountability, stewardship, leadership, direction and control exercised in the process of managing organizations. Corporate governance focused upon the principal –agent problems arising from the dispersed ownership in the modern corporation (Berle and Means, 1932). They viewed corporate governance as a mechanism where a board of directors is an essential monitoring device to minimize the problems board about by the principal – agent relationships. In this context agents are the managers, principals are the owners and board directors act as the monitoring mechanism. The separation of ownership from the management can lead to managers of firms taking action that may not maximize shareholders wealth, but could benefit them and not the owners. Therefore a monitoring mechanism is required to protect shareholder interests. (Jensen and Meekling, 1976).

But the fundamentals of the stewardship theory are based on the social psychology, which focuses on the behaviour of executives. Stewardship theory sees the strong relationship between managers' interests and success of their firm, and therefore the stewards at to protect and maximizes shareholders wealth. A steward, who improves performance successfully, satisfies most stakeholder groups in an organization, when these groups

have interests that one well served by increasing organizational wealth (Davis, Schoorman & Donaldson, 1997). Hence, monitoring and accountability can be provided by the adoption of corporate governance principles and practices.

A wide variety of definitions of firm performance have been proposed in the literature (Barney, 2002, Velnampy, 2005, Velnampy & Aloy Nireesh, 2012,). The existing literature on corporate governance practices has used accounting based performance measures , such as return on equity (ROE), Return on assets (ROA) and market –based measures such as Tobin’s Q , , as proxies for firm performance (Abdullah, 2004; Bhagat & Black, 2002; Daily and Dalton, 1993; Hermalin and Weisbach, 1991; Lam & Lee, 2008; Yermack, 1996). However, in the present study, board structure, board committee, board meeting and board size including executive directors, independent non executive directors and non executive directors are used as the determinants of corporate governance while return on equity (ROE) and return on assets (ROA) are used as the measures of firm performance.

The development of corporate governance structures and practices in Sri Lanka dates back to the British Colonial rule in the country from 1796 to 1948 as the corporate form of entities as well as share trading was introduced in the country during this period. Even most of the corporate entities presently listed on the CSE also have roots dating back to British era. Senaratne (2007) finds two categories of such listed companies (1) companies that have commenced during the British rule and continued after independence with or without foreign owners and (2) companies that have commenced after independence through the amalgamation of several entities formed during the British rule. Hence, the development of corporate governance best practices in Sri Lanka has been heavily influenced by British models and system, which derive from the Anglo-Saxon (Market based) model of corporate governance.

Corporate governance initiative in Sri Lanka commenced in 1997 with the introduction of a voluntary code of best practice in matters relating to the financial aspects of corporate governance. Voluntary codes of best practices on corporate governance were issued on 2003 (ICAL, 2003), and in 2007 corporate governance standards were made mandatory for all listed companies for the financial year commencing on or after 1st April 2008. This code covered the effectiveness of the board, separation of the position of CEO and the Chairman, appointment of chairman, non-executive directors, professional advice, director’s training, directors responsibility for the presentation of financial statements, compliance reporting, internal control and committee structures for boards, including audit committee, and remuneration committees and nomination committees (Kumudini and Anona, 2010).

The new Companies act No 7 was enacted in 2007 to keep abreast with prevalent international laws and to safeguard the interest of all stakeholders including directors, major shareholders, minority shareholders and creditors. The act introduced greater protection to minority shareholders, directors’ duties, and transparency and accountability. Introduction of corporate governance guidelines would be expected to be significantly related to firm performance. Even though various studies have been conducted on this area, No any detailed studies in Sri Lankan context. In order to fulfill this gap, the present study is initiated to find out that to what extent corporate governance influence on firm performance?

Review of Literature

Corporate governance tells “ways of bringing the interests of investors and managers into line and ensuring that firms are run for the benefit of investors (Mayer, 1997). Corporate governance is concerned with the relationship between the internal governance mechanisms of corporations and society’s conception of the scope of corporate accountability (Deakin and Hughes, 1997). It has also been defined by Keasey et al. (1997) to include ‘the structures, processes, cultures and systems that engender the successful operation of organizations’. From the foregoing analysis, they argue that corporate governance is represented by the structures and processes laid down by a corporate entity to minimize the extent of agency problems as a result of separation between ownership and control.

One of the most consistent empirical relationships about boards of directors is that board size is negatively related to firm performance (Hermalin and Weisbach, 2003). Yermack (1996) finds a statistically significant negative relationship between board size and firm performance as measured by Tobin’s Q with a sample of 452 large U.S. industrial corporations for the period of 1984-1991. In the same study Yermack also exhibited that companies with small boards have more favorable values for financial ratios. Similarly Eisenberg, Sundgren and Wells (1998) concluded the negative relationship between firm board size and performance measured by return on assets (ROA) for a sample of 879 small private firms in Finland.

There are various arguments regarding board sizes. Jensen (1993) argues that “Keeping boards small can improve their performance. When boards get beyond seven or eight people they are less likely to function effectively and easier for CEO to control.” Similarly Lipton and Lorsch (1992) stated “When a board has more than ten members it becomes more difficult for them all to express their ideas and opinions.” and add

that the U.S. corporate boards are overcrowded which causes shareholders to lose money, employees to lose their jobs and the corporation to lose its competitive market position. Lipton and Lorsch (1992) argue for smaller boards and recommend that board size should be limited to seven or eight members. The disadvantages of large boards lean on the idea that tasks like communication, coordination and decision making is much harder and costlier among large group of people than in smaller groups.

Jensen (1993) argued that the preference for smaller board size stems from technological and organizational change which ultimately leads to cost cutting and downsizing. Hermalin and Weisbach (2003) argued the possibility that larger boards can be less effective than small boards. When boards consist of too many members agency problems may increase, as some directors may tag along as free-riders. Lipton and Lorch (1992) recommended limiting the number of directors on a board to seven or eight, as numbers beyond that it would be difficult for the CEO to control. However, Linck et al (2008) provides evidence that smaller boards are not necessarily better than larger boards.

Baysinger and Butler (1985) found that companies perform better if boards include more outsiders. Similarly, Rosenstein and Wyatt (1990) found that a clearly identifiable announcement of the appointment of an outside director led to an increase in shareholder wealth. There have been differences in findings related to the dominance of outside directors on performance when different measures of firm performance have been utilized in academic research. For instance, studies utilizing Tobin's Q as a measure of performance (e.g., Agrawal & Knoeber, 1996) and Market Value Added (e.g., Coles, McWilliams, & Sen, 2001) have found that greater representation of outside directors has a negative impact on firm performance. Other studies, (Dalton, Daily, Ellstrand, and Johnson, 1998), found no significant association between board composition and firm performance using moderator analyses incorporating firm size, the nature of financial performance indicator and operationalization aspects of board composition.

It is broadly highly praised that good corporate governance augments a firm's performance (Brickley et al, 1994; Brickley and James, 1987; Byrd and Hickman, 1992; Chung et al, 2003; Hossain et al, 2000; Lee et al, 1992; Rosenstein and Wyatt, 1990; Weisbach, 1988. Generally effective corporate governance enhances firm performance, some studies have reported negative relationship between corporate governance and firm performance (Bathala and Rao, 1995; Hutchinson, 2002). Some other studies have not found any relationship (Park and Shin, 2003; Prevost et al. 2002; Singh and Davidson, 2003; Young, 2003). Several explanations have been given to account for these apparent inconsistencies. Some have argued that the problem lies in the use of either publicly available data or survey data as these sources are generally restricted in scope. It has also been pointed out that the nature of performance measures (i.e. restrictive use of accounting based measures such as return on assets (ROA), return on equity (ROE), return on capital employed (ROCE) or restrictive use of market based measures (such as market value of equities) could also contribute to this inconsistency (Gani and Jermias, 2006). Furthermore, it has been argued that the "theoretical and empirical literature in corporate governance considers the relationship between corporate performance and ownership or structure of boards of directors mostly using only two of these variables at a time" (Krivogorsky, 2006). For instance, Hermalin and Weisbach (1991) and McAvoy et.al. (1983) studied the correlation between board composition and performance whiles Hermalin and Weisbach (1991), Himmelberg et al. (1999), and Demsetz and Villalonga (2001) studied the relationship between managerial ownership and firm performance.

Adel Bino and Shrouq Tomar. (2012), in their study, revealed that ownership structure and board composition have a strong impact on Bank performance and Banks with intuitional majority ownership have the highest performance and that as manager's and Board member's ownership percentages increase the bank becomes more efficient. But board size has no effect on bank performance.

Chugh, Meador and Ashwin Shantha Kumar (...) found that a Governance structure incorporating largest board size creates better opportunities and more resources, thus enhancing the financing performance. Kumudini and Anona (2010), examined the relationship between Corporate Governance practices and firm performances. Study confirmed the positive relationship between governance practices (separate leadership, board composition and firm performance). Further it indicated that firms have implemented corporate governance strategies which have resulted in higher profitability and share price performance. Another study of Sanjai Bhagat and Brain Boltan (2008) divulge that governance measures are correlated future stock market performance and poor firm performance, profitability of disciplinary management turnover was positively correlated with stock ownership of board members and board independence. Velnampy and Pratheepkanth (2012), identified the impact of Corporate governance on ROA, ROE.

Objectives of the Study

The following objectives are taken for the study.

1. To identify the relationship between corporate governance and firm performance.
2. To find out the impact of corporate governance on firm performance.

3. To suggest the organization to adopt good governance practices towards the performance.

Data Collection.

The secondary data were collected from Annual reports of the companies, books, Journals, Magazines etc. The data representing the period of 2007 to 2011 were extracted from the company’s Annual reports for the analysis.

Sampling

The official list of companies in the Colombo stock exchange (CSE) contained 287 companies as of 2012 have been categorized under 20 different sectors according to the core business activities of the company. Out of 37 Manufacturing companies 28 companies were selected for the present study.

Methodology

For the purpose of empirical analysis, this study uses descriptive analysis, correlation and multiple regression analysis as the underling the statistical test. A descriptive analysis of the data is conducted to obtain sample characteristics. The multiple regression analysis is performing on the dependent variables, ROE and ROA to test the relationship between the independent variables with firm performance. The regression models utilized to test the relationship between the determines of corporate governance such as board structure (BS) , board meeting (BM), board committee (BC) including executive directors (ED), independent non-executive directors(INED), non-executive directors (NED) , and board size (BOSZ), and firm performance such as return on equity (ROE), and return on assets (ROA) are as follows.

$$ROE = \alpha_0 + \alpha_{1Bs} + \alpha_{2Bc} + \alpha_{3Bm} + \alpha_{4Bosz} + e$$

$$ROA = \alpha_0 + \alpha_{1Bs} + \alpha_{2Bc} + \alpha_{3Bm} + \alpha_{4Bosz} + e$$

Conceptual Frame work

The following conceptual model was formulated through the extensive literature.

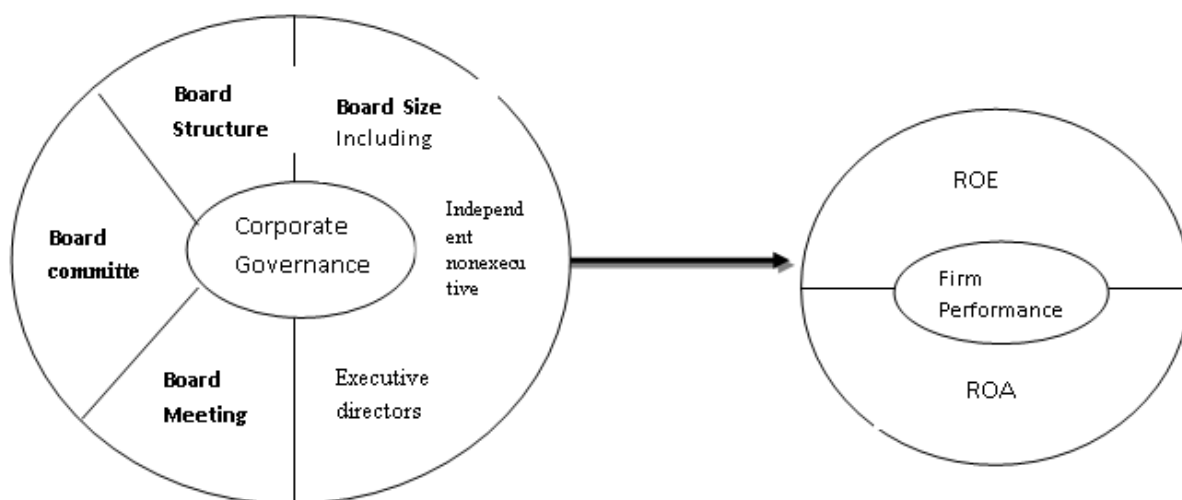


Fig: 01- Conceptual Frame work

The above model shows the relationship between the determinants of the corporate governance and firm performance.

Hypotheses

The following hypotheses are formulated;

1. Corporate governance and ROE are significantly correlated
2. Corporate governance and ROA are significantly correlated
3. Corporate governance impact on ROE
4. Corporate governance impact on ROA

Analysis and Interpretation

Descriptive statistics were carried out to obtain sample characteristics. Output of the descriptive statistics is presented in table 01

Table 01- Descriptive Analysis

	N	Range	Minimum	Maximum	Mean	Std. Deviation
	Statistic	Statistic	Statistic	Statistic	Statistic	Statistic
Board Structure	28	1	1	2	1.43	.504
Board Committee	28	3	0	3	2.00	.609
Board Meeting	28	14	0	14	7.86	3.913
Board Size	28	8	3	11	7.43	2.116
Return on Equity	28	120.00	-59.78	60.22	4.8990	21.36876
Return on Assets	28	76.26	-27.26	49.00	11.9205	16.10456

The Descriptive statistics in table 01 for the independent variables indicate that average number of directors on the board in the selected companies is about 8 persons. It is consistent with the study by Zubaidah (2009) and Lipton and Lorsch (1992). However it has been observed that some companies have directors up to 11 persons. Further study revealed that average number of meetings and committee are 8 and 2 respectively.

Correlation analysis was carried out to find out the relationship between determinants of corporate governance and the measures of firm performance.

Table 02- Correlation Matrix for manufacturing companies

Variables	BS	BC	BM	ED	INED	BOSZ	ROE	ROA
BS	1	0.121 (0.540)	0.013 (0.946)	0.008 (0.968)	0.071 (0.720)	-0.179 (0.363)	0.082 (0.676)	-0.099 (0.616)
BC		1	-0.342 (0.075)	-0.046 (0.817)	0.235 (0.229)	0.173 (0.380)	-0.135 (0.494)	0.335 (0.082)
BM			1	-0.353 (0.065)	0.046 (0.818)	-0.274 (0.158)	-0.298 (0.124)	-0.109 (0.580)
ED				1	-0.295 (0.127)	0.449* (0.017)	0.025 (0.898)	0.013 (0.947)
INED					1	0.389* (0.041)	0.152 (0.441)	0.064 (0.746)
NED						0.739** (0.000)	0.014 (0.942)	0.287 (0.139)
BOSZ						1	0.101 (0.610)	0.244 (0.210)
ROE							1	0.256 (0.189)
ROA								1

BS: Board Structure, BC: Board Committee, BM: Board Meeting, ED: Executive Directors, INED: Independent Non-Executive Directors, NED: Non-Executive Directors, BOSZ: Board Size, ROE: Return on Equity, ROA: Return on Assets.

**, Correlation is significant at the 0.01 level (2-tailed).

*, Correlation is significant at the 0.05 level (2-tailed).

The results of the correlation analysis in table 02 show that the determinants of corporate governance such as board structure, board committee, board meeting, executive directors, independent non-executive directors, non-executive directors, board size are not significantly correlated with ROE and ROA as the measures of firm performance. It means companies are still not properly practiced corporate governance guidelines. Therefore Companies should pay an attention on the role of corporate governance measures.

The regression analysis was performed to recognize the impact of corporate governance on firm performance. The results of the analysis are given in Table 03.

Table 03- Regression Analysis

Model Summary^{a&b}

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.414 ^a	.171	.027	21.07908
2	.402 ^b	.161	.016	15.97851

a & b Predictors: (Constant), BoardSize, BoardCommittee, BoardStructure, BoardMeeting

- a. Dependent Variable: ReturnonEquity
- b. Dependent Variable: ReturnonAssets

The specification of the four variables ie board size, board committee, board structure, and board meeting in the model revealed the ability to predict performance. R² Value of 0.171 and 0.161 which are in the models denote that 17.1%, and 16.1% of the observed variability in performance can be explained by the differences in both the independent variables namely board size, board committee, board structure, and board meeting. Remaining 82.9% and 83.9% of the variance in performance is related to other variable which is not explained, because they are not depicted in the model. R² values of 17.1% and 16.1% indicate that there may be number of variables which can have an impact on performance that need to be studied. Hence this area is indicated as a scope for future research.

Table 04- Coefficients for predictors of performance

Models	Unstandardized Coefficients				Standardized Coefficients		t		Sig.	
	B		Std. Error		Beta					
Dependent Variables	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA
(Constant)	28.259	-13.112	27.916	21.161			1.012	-.620	.322	.542
Board structure	5.757	-3.442	8.284	6.279	.136	-.108	.695	-.548	.494	.589
Board committee	-10.309	8.882	7.205	5.462	-.294	.336	-1.431	1.626	.166	.118
Board meeting	-2.077	.235	1.134	.860	-.380	.057	-1.830	.273	.080	.787
Board size	.720	1.392	2.041	1.547	.071	.183	.353	.900	.727	.378

The results of the regression analysis in table 04 show that the coefficient for all four variables such as board size, board committee, board structure, and board meeting are not significant. It can be inferred that board committee including independent non executive directors and executive director should have an effective and complete role in controlling the opportunistic behavior in management and also they should have regular meeting to discuss and monitor the activities of the firms. Further t values for all four variables of corporate governance are insignificant event at 5% level. It means that these variables are not contributing to the performance measures of ROA and ROE.

Conclusion and Recommendation

To conclude, listed companies under the Colombo stock exchange (CSE) are practicing corporate governance system. The results of the study provide evidence that the corporate governance measures are not significantly correlated with ROE and ROA as the performance measures. So that hypotheses one and two are rejected. R²

Value of 0.171 and 0.161 which are in the models denote that 17.1%, and 16.1% of the observed variability in performance can be explained by the differences in both the independent variables namely board size, board committee, board structure, and board meeting. Further corporate governance measures did not contribute to performance measures of ROE and ROA.

It can be suggested that the directors of the board should concentrate in playing their vital role properly for the activities of the companies and also advice the companies to have more independent directors within the benchmark for the number of directors. This is supported by Wyatt (1990) and Baysinger and Butler (1985). As per the study, average number of committees which companies had is two. It is better to have all relevant committees such as remuneration committee, audit committee and nomination committee to look after the activities and task of the companies. Some companies had no any meetings. So that the companies should have a regulate meeting. Further decisions made at the meetings are also important for the success of the company. Companies can concentrate on segregation of duties for their efficient operations.

An effective board is one that facilitates the effective discharge of the duties imposed by law on the directors and adds value in a way that is appropriate to the particular Company's circumstances. The board should be structured in such way that it:

- has a proper understanding of and competence to deal with the current and emerging issues of the business.
- exercises independent judgement.
- encourages enhanced performance of the company.
- can effectively review and challenge the performance of management.

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