

Empirical Evidence of Corporate Governance on Firms Performance in Dhaka Stock Exchange

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Abstract

The research paper examined the practices of corporate governance and the relationship of specified practices with the performance of firms listed at 'Dhaka Stock Exchange (DSE)'. There is five parameters that have been used to measure the corporate governance and performance of particular firms. The Performance of firms is measured through Return on Assets (ROA) and Earnings Per Share (EPS) and a total number of directors in the board (BOD Size), Non- Executive Directors (NEDs) proportion to total board and number of NEDs in audit committee were used to measure corporate governance. The data analyzed through the Pearson Correlation, Johansen Cointegration, Vector Error Correction Model (VECM) and Granger Causality in order to specify the particular direction of the relationship and cointegration between the variables of the study. According to the empirical evidence, it is concluded that the increase in BOD size, NEDs proportion to total board and NEDs in audit committee, the EPS of firms also increases and there is a weak or no correlation of BOD size, NEDs proportion to total board and NEDs in audit committee with ROA although there is long-term cointegration between all variables as well as no granger causality is found. The study concluded that the policies, procedures, and code of corporate governance may affect the financial performance of the organizations.

Keywords: Financial performance, Dhaka stock exchange, Board size, Non-executive directors, Earning per share, Return on assets

Introduction

Corporate governance is a set of specific procedures, practices, policies, and code of conducts through which the organizations are directed to operate, provide assistance in the administration and control the operational activities conducted by individuals and groups associated with particular organizations. It governs the long-term management and operations and describes briefly whether the organizations are operating with the responsibility and transparency or not (Cadbury, 2000).

The practical implications of corporate governance around the world vary accordingly due to its vast diversity properties. Particularly, nations around the world have applied a set of specified codes in order to govern the organizational activities, which shows the importance of corporate governance mechanisms. The improvement in practices of corporate governance has now become the cornerstones for attaining and sustaining the economic benefits for the countries. (Ibrahim, Rehman, & Raof, 2010).

The fundamental need for the developing the corporate governance mechanisms is backed by the pressure between both parties i.e., shareholders and their managers (Berle & Means, 1991; Jensen & Meckling, 1976). Usually, The most prioritized concern of shareholders is a return on investment divergent to the managers of organizations, that are interested in power and status as well as monetary and other benefits. So, there may exist a conflict of interests between both of the parties, because managers have greater accessibility of companies affairs and inside information, there is a need to the transparency of companies' affairs to the shareholders in order to build trust and satisfaction. (E. Fama & Jensen, 1999).

A strong organization focuses on the institutional framework in order to improve the accountability, transparency, and also equity and fairness. Usually, The organizations with the strong institutional framework are likely to develop the good corporate governance opposed to the organizations lack in the rigid institutional framework (Al Farooque, Van Zijl, Dunstan, & Karim, 2007). In Bangladesh, there are Dhaka Stock Exchange (DSE), Chittagong Stock Exchange (CSE), Securities and Exchange Commission (SEC), Central Bank (Bangladesh Bank) and other financial institutions, Institute of Chartered Accountants of Bangladesh (ICAB) and audit firms. The stated institutions are regularized by the Companies Act 1994, Securities and Exchange

Commission Act 1993, Bangladesh Bank Order 1972, Bank Companies Act 1991, Financial Institutions Act 1993, Insurance Act 1938, Income Tax Ordinance 1984, DSE and CSE listing rules, and the system of accounting and auditing standards (Al Farooque et al., 2007). Bangladesh follows the framework which is the mixture of 'Market-Based System', created by the United States and the United Kingdom and 'Insider Dominated System', developed by Germany and Japan.

The importance of a specified set of rules and procedures raised due to Enron Scandal, in which the 'WorldCom' faced conviction in accounting falsifications and resulted in decrease the trust and credibility on financial statements and negatively impacted the confidence of investors. This is the beginning of advancement in governance practices for improvements and suggestions to restore the investors' confidence and financial statements' integrity and to prevent to occur similar incidents in the future (Wu, Lin, Lin, & Lai, 2009).

The preliminary objective of this research is to study the possible connections of governance practices with the financial performance of organizations specifically operating in 'Dhaka Stock Exchange (DSE)'. The Financial performance is measured through the Return on Assets (ROA) and Earnings Per Share (EPS) and practices of governance selected to examine are Numbers of Board Directors (BOD size), Number of Non-Executive Directors (NEDs) inboard and NEDs proportion in the audit committee. A sample of 25 organizations of DSE selected and data of specified organizations are collected through the yearly financial reports. The general objective of the study is to identify the relationship of good governance practices with the performance of organizations. Following are the specific objectives of the study:

- Is there any significant relationship between good governance practices with the performance?
- To specify the direction of the relationship of ROA with board size, NEDs to board proportion and NEDs proportion to the audit committee.
- To identify the direction of the relationship of EPS with board size, NEDs to board proportion and NEDs proportion to the audit committee.
- To intensify the stability among studied variables over time.

Corporate governance is a broad phenomenon due to its empirical implications and monitoring properties. It becomes necessary to study whether the efforts of improvement in governance policies and procedures positively impact the performance or not. There is a need to conduct the scientific research to examine the particular relationship, which results would be beneficial for the organizations and investors, especially of Bangladesh. This study is quite different from earlier studies like Paik, Lee, & Krumwiede (2017), Javed, Iqbal, & Hasan, (2006), Baysinger & Butler (1985) and Imam & Malik (2007) in aspects of variables selected to measure the constructs of the corporate governance and performance of organizations, these studies mostly used gross profit margin ratio, gross profit net profit, and earnings per share to conclude the outcomes. This study investigates the relationship of governance policies and firms' performance to measure the significant relationship between them. The outcomes of this study may help individuals and organizations to understand the importance of the implication of governance policies. It may also help for the directors and senior executives in order to understand the significance of rigid governance procedures. Meanwhile, the results of the study may provide significance directly to the insider and indirectly to the outsider of organization and may assist to ensure the transparency of firms' operation, upon these particular estimations, individuals can predict stock returns.

Literature review

In 1999, the World Bank has explained the framework of corporate governance into two parts, internal governance which prioritized the shareholders' interests and provides specific direction to the board of directors to monitor the top management and external corporate governance which concerns with the behaviors of managers through external forces of regulation. Wu et al. (2009) have examined the effects of governance practices onto the organizations performance during the tenure of the financial crisis (2007-2008) and concluded that organizations with a more independent board of directors raised up equity capital even in the toughest market conditions. Few other studies of Yermack (1996), Eisenberg, Sundgren, and Wells (1998) and Singh and Davidson III (2003) disclosed a negative relationship of board size and performance while Bacon (1973) stated the contrast opinion and concluded that the larger size of the board may strengthen the diversity of

directors' background and may assist in improving the quality of decisions. In this regard, Jensen (1993) stated that the larger of the size of directors may diverse the opinions and ultimately becomes difficult to agree on the best-fit decision for the shareholders' interest.

Zahra and Pearce (1989) and Kiel and Nicholson (2003) stated that board size is positively linked to the firms' performance moreover, Veliyath (1999) added up that it is the responsibility of the directors to protect the shareholders' interests through an act as an intermediary between the managers and shareholders. In this regards, Fama and Jensen (1983) explained that executive directors usually attain the reliable information due to their position that may create a conflict of interests between the director's shareholders and non-executive directors perform as the supervisors and play a neutral role in the organization which eradicates the principal and agency problem. Similarly, Beasley (1996) stated that financial scandals may decrease with the increase of independent directors.

Brown and Caylor (2004) disclosed that the better-governed organizations tend to earn relatively high profits. Simultaneously, Lipton and Lorsch (1992) and Jensen (1993) stated that smaller the size of board leads to the advancement of the organizations because it may difficult to communicate and making a decision in a large board size (Aggarwal, Erel, Stulz, & Williamson, 2010).

There are many other studies focused on the impacts of governance good practices in various counties all over the world. In this regard. a noteworthy research paper conducted by Mitton (2002) has examined organizations of Korea, Malaysia, Indonesia, Philippine, and Thailand and stated that the framework of corporate governance procedures strongly influences the performance of organizations during the East Asian crisis 1997-1998. The organizations retaining a larger number of non-executive directors are likely to perform relatively efficiently to the organizations contain less diversified board.

Theoretical framework

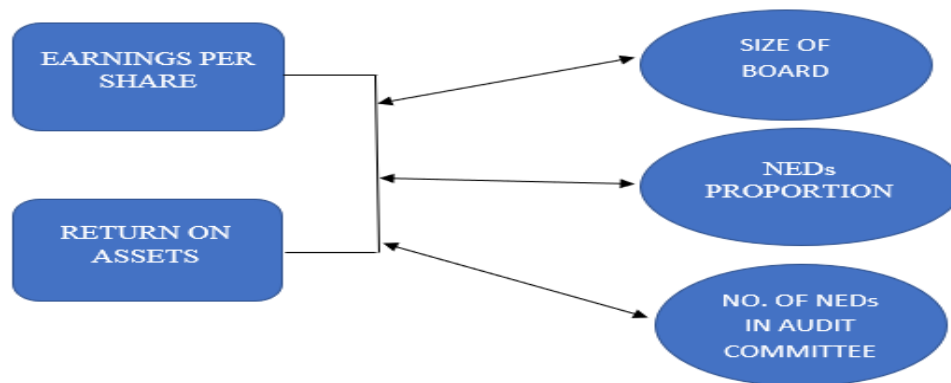


Fig 1: Theoretical framework

HYPOTHESIS

H1: There is a significant relationship of ROA with board size and audit committee

H2: There is a significant relationship of ROA with NEDs proportion

H3: There is a significant relationship between EPS and BOD size, NEDs proportion and no. of NEDs in the audit committee

H4: There is a significant cointegration between all stated variables.

METHODOLOGY

Research Design

In this research paper, the researcher examined the correlation between all the variables in order to determine the direction of the relationship between them. The stationarity of data is at a level which is examined by the Unit-Root Test through Augmented Dicky-Fuller (ADF) method. Further, the Johansen Cointegration applied and disclosed the significance results, further Vector Error Correction Model and Granger Causality Test are applied. The Data of study collected through audited financial statements and annual statements of organizations registered at Dhaka Stock Exchange (DSE) during the time period of 2014 to 2018. The sample of

twenty five organizations selected on the basis of convenient sampling. It is comprised of different sectors of DSE i.e., textile, banking, oil and gas, chemical, food, cement, pharmaceutical, and automobile.

Results & Discussions

Descriptive Statistics

Table 2 below explained the descriptive of the specified variable. The average of ROA and EPS are 6.93 and 4.32 respectively, which stated that the total return increased in organizations is 6.93% of the total assets of the company. Similarly, the earnings of organization per share are 4.32, which stated that the averagely each organization’s earnings with respect to one share are 4.32 rupees. The mean of a number of directors in the board is 9 and there are 27% non-executive directors in the board moreover, 81% of audit committee consisted of NEDs. The organizations of Bangladesh are fulfilling the requirements of the code of good governance policies by arranging NEDs in the audit committee in a particular framework consisted of NEDs more than half of the total committee.

Table 1. Descriptions of the variables

No.	Variables	Descriptions
1	Size of the board	Total board members
2	NEDs proportion	The proportion of non-executive directors to the board
3	Audit Proportion	The proportion of non-executive directors to the board
4	Earnings per share	Net income ÷ No. of ordinary shares
5	Return on assets	Net income ÷ Total assets of the organization

Table 2: Descriptive

		boardsize	NEDsProp	AuditNEDs	ROA	EPS
N	Valid	125	125	125	125	125
	Missing	0	0	0	0	0
Mean		8.86	.2691	.8153	6.9380	4.3201
Median		8.00	.2500	1.0000	5.0600	1.9300
Mode		8	.25 ^a	1.00	6.08	.73 ^a
Std. Deviation		4.051	.27918	.34696	6.60112	8.07966
Skewness		1.815	8.986	.907	1.103	4.211
Std. Error of Skewness		.217	.217	.217	.217	.217
Kurtosis		2.878	92.081	2.454	.813	18.125
Std. Error of Kurtosis		.430	.430	.430	.430	.430
Minimum		4	.06	.09	.02	.08
Maximum		22	3.14	2.00	32.55	48.55
Sum		1107	33.64	101.91	867.25	540.01

a. Multiple modes exist. The smallest value is shown

Pearson Correlation

Table 3a: Pearson Correlation with ROA

		<u>boardsize</u>	<u>NEDsProp</u>	<u>AuditNEDs</u>	ROA
<u>boardsize</u>	Pearson Correlation	1			
	Sig. (2-tailed)				
	N	125			
<u>NEDsProp</u>	Pearson Correlation	-.178*	1		
	Sig. (2-tailed)	.048			
	N	125	125		
<u>AuditNEDs</u>	Pearson Correlation	-.146	-.325**	1	
	Sig. (2-tailed)	.104	.000		
	N	125	125	125	
ROA	Pearson Correlation	-.058	.015	-.126	1
	Sig. (2-tailed)	.522	.865	.160	
	N	125	125	125	125

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

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

Table 3b: Pearson Correlation with EPS

		<u>boardsize</u>	<u>NEDsProp</u>	<u>AuditNEDs</u>	EPS
<u>boardsize</u>	Pearson Correlation	1			
	Sig. (2-tailed)				
	N	125			
<u>NEDsProp</u>	Pearson Correlation	-.178*	1		
	Sig. (2-tailed)	.048			
	N	125	125		
<u>AuditNEDs</u>	Pearson Correlation	-.146	-.325**	1	
	Sig. (2-tailed)	.104	.000		
	N	125	125	125	
EPS	Pearson Correlation	-.023	.020	-.212*	1
	Sig. (2-tailed)	.797	.822	.018	
	N	125	125	125	125

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

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

The table 3a and 3b consisted of the outcomes of the correlation between studied variables. The outcomes of table 3a concluded a significant weak positive correlation between the ROA and NED’s proportion and the insignificant (negative) relationship between the rest of governance mechanisms which are BOD size and NED’s in Audit committee. The table 3b stated the correlation between EPS and BOD size, NED’s PROP and Audit committees proportion of NEDs. And disclosed a significant correlation among EPS and studied corporate governance mechanisms. Though the correlation of EPS with the BOD size and NED’s PROP is strongly positive and although weak positive with the NED’s proportion in the audit committees.

Johansen Cointegration

Table 4: Johansen Cointegration

Unrestricted Cointegration Rank Test (Trace)

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.654064	234.2058	69.81889	0.0000
At most 1 *	0.346053	106.8255	47.85613	0.0000
At most 2 *	0.202616	55.85804	29.79707	0.0000
At most 3 *	0.159727	28.68771	15.49471	0.0003
At most 4 *	0.062966	7.804260	3.841466	0.0052

Trace test indicates 5 cointegrating eqn(s) at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

**MacKinnon-Haug-Michelis (1999) p-values

Unrestricted Cointegration Rank Test (Maximum Eigenvalue)

Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.**
None *	0.654064	127.3803	33.87687	0.0000
At most 1 *	0.346053	50.96747	27.58434	0.0000
At most 2 *	0.202616	27.17034	21.13162	0.0062
At most 3 *	0.159727	20.88345	14.26460	0.0039
At most 4 *	0.062966	7.804260	3.841466	0.0052

Max-eigenvalue test indicates 5 cointegrating eqn(s) at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

**MacKinnon-Haug-Michelis (1999) p-values

Table no. 4 stated the conclusions of the Johansen cointegration test. It is used to explore whether the distance between all studied variables will become constant over the period of time or not. It investigates the no. of explanatory variables for an m time series variables hold through the stationary process. All the variables are stationary at a level which is tested through 'Unit Root Test', which enabled the researcher to apply Johansen cointegration test. The results concluded the variables of the study are long term co integrated because of the value of $P < 0.05$ in case of all mentioned variables. Furthermore, the outcomes of 'Maximum Eigenvalue' exhibited the p value less than 0.05 and explained about the occurrence of cointegration. The results of Trace and maximum eigenvalue both disclosed the significant cointegration between the ROA or EPS with the good governance mechanisms that are dependent variables (board size of the organization, NED's proportion in total board and audit NED's proportion).

The two test forms of the Johansen test are Trace Test and Maximum Eigenvalue. And also;

- Trace test for $K_0 = 0$
- Maximum Eigenvalue test for $K_0 = m-1$

Vector Error Correction Model

Table 5: VECM

Cointegrating Eq:	CointEq1
AUDITNED(-1)	1.000000
BOARDSIZ(-1)	-0.056229 (0.05028) [-1.11839]
EPS(-1)	0.203258 (0.03211) [6.32960]
NEDSPROP(-1)	-4.460805 (1.13529) [-3.92922]
ROA(-1)	-0.052729 (0.03726) [-1.41504]
C	0.471334

R-squared	0.367869	0.060843	0.304546	0.402885	0.101124
Adj. R-squared	0.304656	-0.033073	0.235001	0.343174	0.011237
Sum of squares	11.61467	808.0067	1155.028	11.09560	3173.075
S.E. equation	0.324943	2.711267	3.240410	0.317599	5.370890
F-statistic	5.819518	0.647844	4.379095	6.747204	1.125009
Log likelihood	-29.66364	-288.4793	-310.2299	-26.86471	-371.8751
Akaike AIC	0.682847	4.925890	5.282457	0.637126	6.293034
Schwarz SC	0.958652	5.201695	5.558263	0.912932	6.568839
Mean dependent	0.000000	-0.008197	-0.306885	0.000228	-0.106721
S.D. dependent	0.389679	2.667515	3.704840	0.391881	5.401292
Determinant res id covariance (dof adj.)		10.51652			
Determinant res id covariance		6.260665			
Log likelihood		-977.5024			
Akaike information criterion		17.09020			
Schwarz criterion		18.58415			

Table 5 stated the outcomes of ‘Vector Error Correction Model (VECM)’ of the study, which is used to determine the stationarity of variables in order to conclude the cointegration relationship. The particular outcomes demonstrated that there is a long-term equilibrium between each variable. VEC model may demonstrate the deviations present in the equilibrium of relationships between specified variables. The p value of the results should significant and the coefficient should negative in order to conclude that the variable may able to restore equilibrium in a long run relationship. Similarly, if the value of the coefficient is insignificant (negative) and the t test is significant (less than 0.05), it may also predict that the variable restores the equilibrium of relationship with other variables. Moreover, the above results demonstrated that the EPS may not restore the equilibrium after the disturbance in cointegration because the value of its coefficient is in negative and T value is also insignificant ($p > 0.05$). The ROA also showed the negative coefficient and insignificant T-stats. The Audit NED’s demonstrated a positive coefficient value it may also not able to restore its equilibrium. Further, the audit NED’s showed the negative coefficient value and significant t statistics, however, the board size demonstrated the positive coefficient value and insignificant statistics(P more than 0.05).

Granger Causality

The Table 6 is concluded the outcome of ‘Granger Causality Test’ of the study, which obtained after the ‘Vector Error Correction Model’. It gives detailed information about how one variable may cause the other variable. The VECM and granger casualty test may only beneficial to apply if there is cointegration in variables. However, if the results of cointegration in the stationary variables are significant then the VECM and granger may apply. In the study, the researcher examined the casualty of ROA and EPS by board size, NED’s proportion and NEDs in the audit committee. The particular outcomes described the board size doesn’t cause an increase in the ROA and EPS because the F-test is insignificant (P-value less than 0.05). Similarly, the NED’s proportion in the board and Audit committee NED’s do not cause the profitability of a firm which measured in EPS and ROA. There may exist the casualty relationship in the variables if the F-test showed the significant.

Table 6: Granger Causality

Null Hypothesis:	Obs	F-Statistic	Prob.
BOARDSIZ does not Granger Cause AUDITNED AUDITNED does not Granger Cause BOARDSIZ	111	1.13404 1.24072	0.3421 0.2631
EPS does not Granger Cause AUDITNED AUDITNED does not Granger Cause EPS	111	1.89377 0.71687	0.0389 0.7516
NEDSPROP does not Granger Cause AUDITNED AUDITNED does not Granger Cause NEDSPROP	111	2.34931 0.57030	0.0087 0.8806
ROAdoes not Granger Cause AUDITNED AUDITNED does not Granger Cause ROA	111	1.37655 1.37399	0.1835 0.1848
EPS does not Granger Cause BOARDSIZ BOARDSIZ does not Granger Cause EPS	111	1.05676 0.25782	0.4083 0.9966
NEDSPROP does not Granger Cause BOARDSIZ BOARDSIZ does not Granger Cause NEDSPROP	111	0.25889 2.61040	0.9965 0.0036
ROAdoes not Granger Cause BOARDSIZ BOARDSIZ does not Granger Cause ROA	111	1.26668 1.59426	0.2461 0.0982
NEDSPROP does not Granger Cause EPS EPS does not Granger Cause NEDSPROP	111	0.52632 1.08250	0.9109 0.3854
ROAdoes not Granger Cause EPS EPS does not Granger Cause ROA	111	0.64803 0.74929	0.8167 0.7190
ROAdoes not Granger Cause NEDSPROP NEDSPROP does not Granger Cause ROA	111	0.24780 0.30598	0.9973 0.9919

Conclusion

In this research paper, the researcher attempted to study in order to fulfill the existing gap of knowledge relating to the corporate governance and firms performance. The results of correlation have explained that there is no relationship of ROA with board size and audit committee and there is a significant relationship between the ROA and NEDs proportion and also between EPS and board size, audit committee, and NEDs proportion. Further, there is a cointegration relationship between the ROA, EPS, BOD size, NEDs proportion and NEDs proportion in the audit committee. Similarly, there is no granger causality relationship between all the selected variables of the study. The outcomes of the analysis showed that the code of corporate governance may affect the financial performance of the organizations. According to the above analysis, the following are the outcomes of the study:

NO.	Hypotheses	Results
1	H1: There is significant relationship in ROA with board size and audit committee	Rejected
2	H2: There is significant relationship in ROA with NEDs proportion	Accepted
3	H3: There is significant relationship between EPS and BOD size, NEDs proportion and no. of NEDs in audit committee	Accepted
4	H4: There is significant cointegration between variables	Accepted

Limitations

The sample size of this study is twenty five and mainly concerned with Dhaka stock exchange which made it limited to the generalizability. The future researchers may increase the sample size and/or may include cross countries stock indices to examine the values which may better represent the relationship of governance policies with the performance of organizations. The governance mechanisms selected for the study is purely based on convenient data collection which may also limit the investigation of a specific relationship. Further, this study collected the data limited to the time period of 2014-2018.

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