

Relationship between Corporate Governance and Firm Performance: An Introspection of Empirical Evidences in search of a Solution

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ABSTRACT

In the complex global business environment, the relationship between corporate governance and firm performance has got much attention in recent times. The key question the study aims to address is whether there has been any consensus between corporate governance and firm performance based on accounting and market -based measures.

The findings of our review can be characterized as being unable to reach a consensus regarding the nature of the said relationship. However, majority of the studies in our review suggests a significant positive relationship between corporate governance and various dimensions of firm performance, while there are some studies that have questioned the aforesaid relationship. This calls for more in-depth research in this area.

For a deeper insight into the problem, the said relationship may be examined between corporate governance index and firm performance index in order to capture the influence of several mechanisms of corporate governance and firm performance.

1. Introduction

Corporate Governance may be defined as a system of structuring, operating and controlling a company in order to achieve long term strategic goals to satisfy the different stakeholders, and complying with the legal and regulatory requirements. The Cadbury Report (U.K.) states:

“Corporate governance is the system by which business are directed and controlled”.

Over the years, corporate governance is considered as one of the most important mechanism to build a marketplace confidence and to attract positive investors. After the failure of business giants such as Enron, Xerox, Satyam etc., corporate governance has gained more importance in the developed as well as in the developing nations of the world. Therefore, good corporate governance standards have emerged as the key driver in attracting investment capital, reducing risk and developing firms' performance. With respect to firm performance, there are three main approaches: market prices, accounting ratios and total factor profitability (Bocean & Barbu, 2007). One of the popular market -based ratio for measuring corporate governance is Tobin's Q, while the popular accounting ratios for measuring firm performance are Return on Equity (ROE), Return on Asset (ROA), and Economic Value Added (EVA).

To achieve the objective of the study, the remaining portion of this research paper is structured as follows: statement of the problem is stated in section 2, while objectives and research methodology of the study are presented in section 3 and 4 respectively. Findings and analysis are shown in section 5. Section 6 presents concluding observations and section 7 states the recommendations of the study. Finally, section 8 shows research opportunities of the study.

2. Statement of the Problem

One of the widespread beliefs about corporate governance is that good corporate governance is an important factor in improving the firm performance. But, there is plethora of studies that have questioned such relationship. Thus, corporate governance has become a central issue of policy debate for more than three decades now (Bhayani, 2014). In this backdrop, the researcher has tried a different approach that focus on corporate governance and its relationship with market and accounting -based measures of firm performance in order to get an insight into the problem of indifferent results of the relationship between corporate governance and firm performance.

3. Objectives of the Study

In the light of the above problem statement, the objectives of the study are stated as follows:

- To find out whether there has been any consensus between market -based measures of firm performance with corporate governance on the one hand and accounting -based measures of firm performance with corporate governance on the other hand.
- To make some recommendations in order to arrive at a probable solution of the problem relating to the relationship between corporate governance and firm performance.

4. Research Methodology

The present study is descriptive in nature. It is mainly based on secondary information which has been collected from various sources i.e., journals, books, working papers, Ph.D. thesis, master thesis, etc. After collection of necessary information from the above stated sources, these have been suitably classified, analyzed and summarized as per requirements of the study.

5. Findings and Analysis

5.1. Review of Previous Empirical Findings

There are several studies that have been carried out in this area. The notable studies in this context are briefly and chronologically stated as follows:

Labelle (2002) examined the relationship between corporate governance and performance using multidimensional variables during the period 1996-1997. The researcher used ratings from a statement of Corporate Governance Practice (SCGP) developed by the Canadian Institute of Chartered Accountants (CICA) with respect to disclosure quality of corporate governance, while firm performance was represented by ROE. The study found no significant relationship between firm performance and disclosure quality of corporate governance during the period under study.

Gompers et al. (2003) developed a complex index (G-index) regarding all corporate governance which was composed of 24 distinct corporate governance variables grouped in 5 categories for a span of 10 years (1990-1999). The study revealed a strong correlation between G-index and the financial indicators (represented by stock performances, Tobin's Q, net profit margin, and sales growth).

Drobetz et al. (2004) attempted to examine the relationship between corporate governance and firm performance in Germany during the period 1998 to 2002. To carry out the study, the researchers used an index called Corporate Governance Rating (CGR) system which is based on multidimensional answers to a questionnaire as per Germany Corporate Governance Code, while firm performance was measured by Tobin's Q and market to book value. The findings of the study showed a positive correlation between corporate governance and firm performance (better-operating performance, higher market valuation).

Bauer, G. et al. (2004) developed a Deminor Corporate Governance Ratings (DCGR) index formed by 300 criteria grouped into 4 categories for the period 2000-2001. The outcome of the study revealed an insignificant negative relation between firm performance (represented by net profit margin and ROE) and corporate governance standards.

Brown and Caylor (2006) framed the Gov-Score index that included variables grouped into 8 categories as follows: audit, board of directors, charter/bylaws, director education, executive and director compensation, ownership, progressive practices and state of incorporation. The study showed a positive correlation between the Gov-Score index and firm value (measured through Tobin's Q) in the year 2002.

Javed, Attiya Y. and Iqbal, Robina (2006) examined the relationship between corporate governance indicators and firm value (represented by Tobin's Q) for a sample of 50 companies listed at the Karachi Stock Exchange. The study results revealed that all the elements of corporate governance were important. The board composition, ownership, and shareholdings of the listed sample companies had a significant impact on firm performance. However, disclosure and transparency had no significant impact on firm performance.

Adjaoud et al. (2007) attempted to examine the relationship between firm performance and scores based on corporate governance compliance. The researchers found no significant relationship between the scores and accounting-based measures of performance (i.e., ROI, ROE). On the other hand, the relationship between the scores and market-based measures of performance was generally significant.

Heenetigala, K. (2008) argued that there was a relationship between the corporate governance initiative and the growth in the performance of firms from 2003 to 2007. The study examined the relationship between corporate governance practices and firm performance for a sample of 37 companies selected from the top 50 listed companies in The Lanka Monthly Digest 50 (LMD) for the years 2003 and 2007. The study found a positive relationship between governance practices (separate leadership, board composition, and board committee) and firm performance based on return on equity, and board composition, board committees and performance measured by Tobin's Q. These relationships indicated that firms had implemented corporate governance strategies, which had resulted in higher profitability and share price performance during the study period.

Ntim (2009) developed the South African Corporate Governance Index (SACGI) with eleven parameters of corporate governance in order to examine the impact of SACGI on firm performance (measured by Tobin's Q and ROA) during the period 2002 to 2006. The researcher observed a positive relationship between SACGI and firm performance.

Bozec et al. (2010) examined the relationship between corporate governance index (CGI) developed by Global and Mail Report on Business and Tobin's Q for a period of five years (2001-2005). The researchers found no relationship between the CGI and firm performance (measured by Tobin's Q) during the period under study.

Yasser, Q.R. et al. (2011) examined the relationship between four important corporate governance mechanisms (board size, board composition, CEO/Chairman duality and audit committee) and two firm performance measures [Return on Equity (ROE) and Profit Margin (PM)] for a sample of 30 Pakistani listed firms during the period 2008 to 2009. The study results showed evidence of a positive significant relationship between ROE and PM and three corporate governance mechanisms (board size, board composition and audit committee). However, no significant relationship was found between the two performance measures (ROE and PM) and CEO/Chairman duality.

Al-Haddad, W.M.Y. et al. (2011) examined the relationship between corporate governance and firm performance for a sample of 44 Jordanian industrial companies listed at the Amman Stock Exchange (ASE) in order to solve the agency problem. The study concluded that there was a direct positive relationship between profitability [measured either by Earnings per Share (EPS) or Return on Assets (ROA)] and corporate governance. The study also observed a positive direct relationship between each of liquidity, dividend per share, and size of the company with corporate governance.

Finally, the study found a positive direct relationship between corporate governance and corporate performance.

Okougbo, P.O. (2011) investigated the relationship between corporate governance and firm performance for 52 non-financial firms in Nigeria listed on the Nigerian Stock Exchange during the period 2003 to 2008. The study examined whether corporate governance mechanisms- CEO duality, board size, audit committee independence, and ownership concentration had an impact on firm performance surrogated by Return on Assets (ROA); Return on Equity (ROE), Profit Margin (PM). By the technique of Generalized Least Square (GLS) regression, the study results revealed that board size, audit committee independence, and ownership concentration had a significant relationship with ROE and PM. It was also observed that CEO duality had no impact on firm performance.

Fauziah, W. et al. (2012) examined the relationship between corporate governance and firm performance for a sample of 813 listed companies representing nine sectors of the main board of Bursa Malaysia from 2009 to 2011. Corporate governance was measured by three components - proportion of Non-Executive Directors (NED), board leadership structure, and board size. On the other hand, firm performance was measured by Earnings per Share (EPS) and Return on Equity (ROE). The study found that the influences of the three corporate governance measurements on both dimensions of firm performance from the years 2009 to 2011 were mixed.

Cheema, K.U.R, and Din, M.S. (2013) attempted to examine the relationship between corporate governance and financial performance in cement industry of Pakistan. In the study, corporate governance was measured by three variables which include board size, family controlled firms, and CEO duality. On the other hand, firm performance was measured by return on equity, return on assets, earnings per share, debt to equity, and current ratio. The study revealed positive relationship between corporate governance and firm performance during the period under study.

Danoshana, S. and Ravivathani, T. (2013) in their study considered the impact of corporate governance on the performance of listed financial institutions in Sri Lanka. For this purpose, the researchers used return on equity and return on assets as the key variables for measuring firm performance. On the other hand, board size, meeting frequency, and audit committee of the company were used as variables to measure corporate governance. 25 listed financial institutions were selected as sample size for the period from 2008 to 2012. The study found that the variables of corporate governance had significant impact on firm performance and board size and audit committee size had positive impact on firm performance. However, meeting frequency had negative impact on firm performance during the study period.

Flodberg, D. and Nadjari, D. (2013) attempted to establish a link between corporate governance and firm performance in the Nordic countries for a sample of 190 Nordic firms with Tobin's Q as the dependent variable measuring firm performance, corporate governance index as the independent variable while controlling for total assets, financial risk,

systematic risk, unsystematic risk and growth to evaluate the impact upon firm performance during the period 2004 to 2011. A positive relationship was observed between corporate governance and firm performance as well as statistically significant control variables.

Vo, D. and Phan, T. (2013) attempted to quantify the relationship between corporate governance and firm performance for a sample of 77 listed firms in Vietnam trading over the period from 2006 to 2011. Using the flexible generalized least squares (FGLS) technique, the study revealed that the elements of corporate governance such as the presence of female board members, duality of the CEO, working experience of the board members, and the compensation of board members had a positive impact on the performance of firms, as measured by the Return on Assets (ROA). However, board size had a negative impact on the performance of the firms under study. The study also showed that ownership of board members had a non-linear relationship with firm performance.

Amba, S.M. (2014) examined the impact of corporate governance variables (represented by CEO duality, chairman of audit committee, proportion of non-executive directors, concentrated ownership structure, and institutional investors) on firms' financial performance (represented by Return on Assets [ROA] for firms traded in Bahrain bourse. The findings of the study revealed that corporate governance variables influenced the performance of the firms selected in the study. CEO duality, proportion of non-executive directors and leverage had negative influence and board member as chairman of audit committee, proportion of institutional ownership had positive influence on firms' financial performance.

Paul, K.C. and Ghosh, Sudipta (2014) attempted to empirically examine the Corporate Governance (CG) compliance practices and its relationship with profitability of 5 leading Indian infrastructure companies during the period 2007-08 to 2009-10. Clause 49 of the listing agreement of SEBI was considered as the basic framework for calculating the Corporate Governance Index (CGI).

The findings of the study indicated a high rate of CG compliance by the sample companies. Moreover, there were significant differences in CG performance among the sample companies. In spite of high rate of CG compliance, no significant relationship was found between CGI and profitability which was measured by Return on Capital Employed Ratio (ROCER) of the sample companies during the period under study. This showed that profitability performances of the sample companies were not driven by their CG performance.

Haider, N. et al. (2015) attempted to examine the relationship between corporate governance practices and firm's financial performance in the Islamic banking sector. Corporate governance was represented by three parameters - board size, number of meeting, and audit committee size. On the other hand, firm's financial performance was measured by three parameters - return on equity, return on asset, and earnings per share. The study revealed positive relationship between

corporate governance and financial performance of the Islamic banking sectors. The most significant results of the study had considerable and strong positive relationship between large board size and firm's financial performance in developing countries like Pakistan.

Ahmed, Esra and Hamdan, Allam (2015) examined the impact of corporate governance characteristics on firm performance for a sample of 42 financial companies which were listed in Bahrain Stock Exchange during the period 2007 to 2011. The descriptive results indicated that the sample firms fulfilled corporate governance variables about 61.2% for the entire study period. The empirical findings of the study revealed that performance measures such as return on assets and return on equity were significantly related to corporate

governance in Bahrain. However, earning per share did not show any significance impact related to corporate governance. Overall, the study found a positive impact of corporate governance mechanisms on firm performance for the entire firm in Bahrain Stock Exchange.

5.2 Summary of the Findings of the Study

Based on the review of previous empirical findings and keeping in view the objectives of our study, the summary results are divided into two segments: i) Table-1 showing the relationship between corporate governance and market -based measures of firm performance, and ii) Table-II showing the relationship between corporate governance and accounting -based measures of firm performance.

Table – I: Summary of the Findings relating to the Relationship between Corporate Governance and Market –Based Measures of Firm Performance

| SL. No. | Title of the Study | Year | Author(s) | Variable(s) used for measuring | | Findings |
|---------|---|------|------------------------------------|---|---------------------------------|--------------------------|
| | | | | Corporate Governance | Firm Performance | |
| 1 | Corporate Governance and Equity Prices | 2003 | Gompers, P. et al. | CG Index | Stock Performances; Tobin's Q | Strong correlation |
| 2 | Corporate Governance and Expected Stock Returns: Evidence from Germany | 2004 | Drobetz et al. | CG Index | Tobin's Q; Market to Book Value | Positive correlation |
| 3 | Corporate Governance and Firm Valuation | 2006 | Brown, L.D., Caylor, M.L. | CG Index | Tobin's Q | Positive correlation |
| 4 | Corporate Governance and Firm Performance: Evidence from Karachi Stock Exchange | 2006 | Javed, Attiya Y. and Iqbal, Robina | Board Composition; Ownership; Shareholdings; Disclosure; and Transparency | Tobin's Q | Significant relationship |
| 5 | The Effects of Board's Quality on Performance – A Study of Canadian Firm | 2007 | Adjaoud, F. et al. | Scores based on Corporate Governance Compliance | MVA; Market to Book Value | Mixed relationship |

Table – I: Summary of the Findings relating to the Relationship between Corporate Governance and Market –Based Measures of Firm Performance (Continued)

| SL. No. | Title of the Study | Year | Author(s) | Variable(s) used for measuring | | Findings |
|---------|---|------|------------------------------|--|------------------|-----------------------------------|
| | | | | Corporate Governance | Firm Performance | |
| 6 | The Impact of Corporate Governance on Firm Performance in an Unstable Economic and Political Environment: Evidence from Sri Lanka | 2008 | Heenetigala, K. | Leadership; Board Composition; and Board Committee | Tobin's Q | Positive relationship |
| 7 | Internal Corporate Governance Structures and Firm Financial Performance: Evidence from South African Listed Firms | 2009 | Ntim, C.G. | CG Index | Tobin's Q | Positive relationship |
| 8 | Governance -Performance Relationship: A Re-examination Using Technical Efficiency Measures | 2010 | Bozec, R. et al. | CG Index | Tobin's Q | No relationship |
| 9 | The Link between Corporate Governance and Firm Performance in the Nordic Countries | 2013 | Flodberg, D. and Nadjari, D. | CG Index | Tobin's Q | Significant positive relationship |

Notes: CG Index = Corporate Governance Index; MVA = Market Value Added.

From Table – I, it is observed that all the studies (except the studies by Bozec, R. et al., 2010 and Adjaoud, F. et al., 2007) reveal significant relationship between corporate

governance and market –based measures of firm performance. This implies that firm performance is driven by corporate governance compliance by the companies under study.

Table – II: Summary of the Findings relating to the Relationship between Corporate Governance and Accounting –Based Measures of Firm Performance

| SL. No. | Title of the Study | Year | Author(s) | Variable(s) used for measuring | | Findings |
|---------|--|------|--------------------|---|---------------------------------|-------------------------------------|
| | | | | Corporate Governance | Firm Performance | |
| 1 | The Statement of Corporate Governance Practices (SCGP) - A Voluntary Disclosure and Corporate Governance Perspective | 2002 | Labelle, R. | SCGP with respect to Disclosure Quality of Corporate Governance | ROE | No significant relationship |
| 2 | Corporate Governance and Equity Prices | 2003 | Gompers, P. et al. | CG Index | Net Profit Margin; Sales Growth | Strong correlation |
| 3 | Empirical Evidence on Corporate Governance in Europe: The Effect on Stock Returns, Firm Value and Performance | 2004 | Bauer, G. et al. | CG Index | Net Profit Margin; ROE | Insignificant negative relationship |

Table – II: Summary of the Findings relating to the Relationship between Corporate Governance and Accounting –Based Measures of Firm Performance (Continued)

| SL. No. | Title of the Study | Year | Author(s) | Variable(s) used for measuring | | Findings |
|---------|---|------|-----------------------------------|---|--|-----------------------------------|
| | | | | Corporate Governance | Firm Performance | |
| 4 | The Effects of Board's Quality on Performance – A Study of Canadian Firm | 2007 | Adjaoud, F. et al. | Scores based on Corporate Governance Compliance | ROI; ROE; EPS; EVA | Mixed relationship |
| 5 | The Impact of Corporate Governance on Firm Performance in an Unstable Economic and Political Environment: Evidence from Sri Lanka | 2008 | Heenetigala, K. | Leadership; Board Composition; and Board Committee | ROE | Positive relationship |
| 6 | Internal Corporate Governance Structures and Firm Financial Performance: Evidence from South African Listed Firms | 2009 | Ntim, C.G. | CG Index | ROA | Positive relationship |
| 7 | Corporate Governance and Firm Performance in Pakistan: The case of Karachi Stock Exchange (KSE)-30 | 2011 | Yasser, Q.R. et al. | Board Size; Board Composition; CEO/Chairman Duality; and Audit Committee | ROE; PM | Significant positive relationship |
| 8 | The Effect of Corporate Governance on the Performance of Jordanian Industrial Companies: An Empirical Study on Amman Stock Exchange | 2011 | Haddad, W.M.Y. et al. | Ownership | EPS; ROA; Liquidity; DPS; Size of the Company; Business Risk; and Leverage | Direct positive relationship |
| 9 | Corporate Governance and Firm Performance: Empirical Evidence from Selected Listed Companies in Nigeria | 2011 | Okougbo, P.O. | CEO Duality; Board Size; Audit Committee Independence; and Ownership Concentration | ROA; ROE; PM | Significant relationship |
| 10 | Corporate Governance and Firm Performance of Listed Companies in Malaysia | 2012 | Fauziah, W. et al. | Proportion of Non-Executive Directors (NED); Board Leadership Structure; and Board Size | EPS; ROE | Mixed relationship |
| 11 | Impact of Corporate Governance on Performance of Firms: A Case Study of Cement Industry in Pakistan | 2013 | Cheema, K.U.R, and Din, M.S. | Board Size; Family Controlled Firms; and CEO Duality | ROE; ROA; EPS; DER; CR | Positive relationship |
| 12 | The Impact of the Corporate Governance on Firm Performance: A Study on Financial Institutions in Sri Lanka | 2013 | Danoshana, S. and Ravivathani, T. | Board Size; Meeting Frequency; and Audit Committee | ROE; ROA | Mixed relationship |

Table – II: Summary of the Findings relating to the Relationship between Corporate Governance and Accounting –Based Measures of Firm Performance (Continued)

| SL. No. | Title of the Study | Year | Author(s) | Variable(s) used for measuring | | Findings |
|---------|--|------|---------------------------------|---|------------------|-----------------------------|
| | | | | Corporate Governance | Firm Performance | |
| 13 | Corporate Governance and Firm Performance: Empirical Evidence from Vietnam | 2013 | Vo, D. and Phan, T. | Board Size; Presence of Female Board Members; CEO Duality; Working Experience of the Board Members; and Compensation of Board Members | ROA | Positive impact |
| 14 | Corporate Governance and Firms' Financial Performance | 2014 | Amba, S.M. | CEO Duality; Chairman of Audit Committee; Proportion of Non-Executive Directors; Ownership Structure; and Institutional Investors | ROA | Mixed relationship |
| 15 | Corporate Governance Compliance and its relationship with Profitability: An Empirical Investigation of Some Selected Indian Infrastructure Companies | 2014 | Paul, K.C. and Ghosh, Sudipta | CG Index | ROCER | No significant relationship |
| 16 | Impact of Corporate Governance on Firm Financial Performance in Islamic Financial Institution | 2015 | Haider ¹ , N. et al. | Board Size; Number of Meeting; and Size of Audit Committee | ROE; ROA; EPS | Positive relationship |
| 17 | The Impact of Corporate Governance on Firm Performance: Evidence from Bahrain Stock Exchange | 2015 | Ahmed, Esra and Hamdan, Allam | Ownership; Size of the Board of Directors; Independency of Board of Directors; Posts of Chairman and CEO; Property of Managers | ROA; ROE | Positive relationship |

Notes: ROE = Return on Equity; ROI = Return on Investment; ROA = Return on Assets; PM = Profit Margin; EPS = Earnings per Share; DPS = Dividend per Share; DER = Debt-Equity Ratio; EVA = Economic Value Added; CR = Current Ratio; ROCER = Return on Capital Employed Ratio; SCGP = Statement of Corporate Governance Practice; CG Index = Corporate Governance Index.

On the contrary, Table – II shows different results regarding the relationship between corporate governance and accounting -based measures of firm performance. Three studies reveal insignificant relationship, while four studies show mixed relationship (i.e., significant as well as insignificant relationship). The remaining ten studies reveal significant relationship.

6. Concluding Observations

The relationship between corporate governance and firm performance has got much attention in recent times. Over the years, it has become a debatable issue on whether corporate governance does indeed positively affect firm performance.

The findings of our review in the present study can be characterized as being unable to reach a consensus regarding the nature of the relationship between accounting and market-based measures of firm performance with that of corporate governance. However, majority of the studies in our review suggests a significant positive relationship between corporate governance and various dimensions of firm performance, while there are some studies that have questioned the aforesaid relationship. This calls for more in-depth research in this area.

7. Recommendations of the Study

To arrive at a probable solution of the said relationship, let us first point out the factors that might be the reason for such inconclusive results as observed in some cases of the empirical studies reviewed by us:

- Some studies applied market-based measures of firm performance (like Tobin's Q), while others used several accounting-based measures of firm performance (like ROA, ROE, EPS EVA etc.).

- For measuring corporate governance, some studies employed several dimensions of corporate governance, while other studies used a comprehensive index that captured several mechanisms of corporate governance.
- The studies reviewed by us are conducted in both developed and developing countries. So this raises a question on whether corporate governance principles for developed economies do hold for developing economies or not.

In attaining a deeper insight into the said relationship, the study makes some recommendations to that effect:

- There are several dimensions for measuring corporate governance and firm performance. Therefore, in the matter of selection of variables, the technique of factor analysis (principal component method) may be applied in order to identify the principal factor(s) that govern corporate governance and firm performance.
- Corporate governance index may be prepared after taking into account of the institutional differences that operate between developed and developing economies.
- In most of the studies reviewed by us, market - based measures of firm performance is represented by Tobin's Q which is a single measure of firm performance. On the other hand, in accounting -based measures of firm performance, several variables are used to measure firm performance. Therefore, a comprehensive firm performance index may be developed to overcome this limitation.
- To arrive at a more meaningful conclusion, the said relationship may be examined in the light of

a comprehensive approach i.e., between corporate governance index and firm performance index over a longer period of time in order to capture the influence of several mechanisms of corporate governance and firm performance.

8. Research Opportunities

The findings of our study have important implications for the researchers, senior policy makers, and corporate boards. Hence, the recommendations of our study have opened up new areas for further research.

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