



Impact of Corporate Governance on Firm's Return: Special Reference to Listed Entities in Colombo Stock Exchange in Sri Lanka

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ABSTRACT

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Corporate governance is a system which comprises the rules and regulations that should be adapted by the firms in order to run the business. The core intent of this research is to investigate the influence of corporate governance mechanisms on firm's return of listed companies in CSE. From the published annual reports of 200 non-financial companies, data were obtained during the period from 2015 to 2020. Size of the board, Board composition, percentage of Institutional ownership and Chief executive duality were considered to measure the corporate governance mechanisms while Return on Equity and Net Profit Ratio were used to measure the firm's return. According to summary of panel data analysis, Board size and board composition have the positive impact on net profit ratio as well as return on equity even though CEO duality have the positive impact on net profit ratio but not significant on return on equity. The reason for positive impact of board size and board composition on return directors of the board enrolls as spokespersons of the company's state holders and monitors the performance of the company along with the deeds of the managers, to increase the return of the company by decreasing the agency cost. On the contrary, the institutional ownership has the negative impact on the corporate Return. Institutional investors will have greater power in making integral decisions of company. This integral decision making results in taking decisions to improve their own benefits rather than the common objective of the company, which is raising the company's value via enhancing shareholders' wealth.

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1. Introduction

At the outset of the 21st century the financial crisis that took place globally caused diffidence on the economy of the country. The frauds and the bribery were set up to be the predominant cause for the collapse of the companies that had occurred worldwide (Ahmed & Hamdan, 2015). The necessity for the implementation of the good corporate governance (CG) was felt because of the collapse of the companies. Topic of corporate governance has perceived more attention due to scandals and corporate collapses worldwide via WorldCom (US), Enron (US), Satyam and Reebok (India) etc. involving unethical behaviour, mistreatment of leader's

power and suspected illegal activity by key executive peoples. As per the previous findings, when investors invest in the developing countries they search the best investment which equates risks and associated returns. Implementation of governance practices properly lowers the risk level of that company (Andrews, Linn and Han Yi, 2017). Scholars and Policy makers identified that the drawback in the corporate governance on firm performance was one of the reason for the 2008-2009 global financial crisis, so they took the necessary steps to reconstruct the corporate governance in order to improve it. The importance of corporate governance has been increased since the failure of Enron and Arthur Andersen in U.S and similar failure in U.K (Bhatt & Bhatt, 2017). Thus, the governance issues has been concerned by international organizations. As a prerequisite for the programs (Khanchel, 2007) governance improvements are insisted by the international monetary fund in its debt assistance programs. Through this they enhance the interaction among governance participants with system and also build a basic framework for them.

Past researches have taken altered types of measures to identify the corporate governance practices of developed and developing countries. In this study, board and ownership structures based research is carried out. Board size, board independence and CEO duality were taken to assess the board structure, meanwhile the institutional ownership was taken to evaluate the ownership structure. Ichev (2023) stated that that when institutional investors are large and have significant power on the company's decision, they can take decisions that benefit themselves instead of maximizing the value of the company and the wealth of all the shareholders.

Samaha, Dahawy, Hussainey & Stapleton (2012) remark that the implementation of corporate governance mechanism increases the credibility of the national economy and the improvement of the strength of the capital market. Previously conducted studies found that firms performed better with boards of directors dominated by outside people (John and Senbet 1998) whereas Leung & Cheng, (2014) find no correlation in terms of accounting profit or firm value. However, corporate governance mechanisms should be practiced in firms to maximize shareholders' interest in the market. However, the capital market in Sri Lanka makes a remarkable contribution to the economic growth in Sri Lanka .Only when the companies achieve the appropriate profit, they can continue to exist in the market. The overall performance of the CSE is estimated by All share price Index (ASPI), when the companies function in a profitable manner, the market price of the shares rise. Because of the rising of price of the shares the ASPI rise. The earning of the shares depends on the market price of the shares.

During this period when the ASPI observed, ASPI index was higher in 2022. Table 1 clearly shows that stock market performance and share price movement also volatile during the period of 2015-2022.

Table 1: All Share Price Index

Index	2015	2016	2017	2018	2019	2020	2021	2022
ASPI	6894.50	6228.30	6369.30	6052.40	6129.20	6774.22	12,226.01	8,502.49

Source: Central Bank report (2022)

When observing the ASPI index during the period of 2021 and 2022, The ASPI value had been reduced by 30.46%. Share price movement has a greater influence on the financial stability of Sri Lankan economy. As a result, it may have major impacts on the investor's faith and market values of the company. The declining the profitability of the companies is the cause assignable to the deduction of the ASPI. However, the implementation of the corporate governance mechanism in companies makes a major contribution to the growth of economy and will confer on the firm's many favorable results (Adeola, 2003). However, most of the studies were conducted out in developed countries and less number of studies are available on the impact of Corporate Governance on corporate profitability in developing nations like Sri Lanka. The current financial crisis in Sri Lanka has made significant fluctuations on share market performance. By carrying out this research, there is a necessity to make the companies aware about the importance of properly adapting the corporate governance system and its effects of return during the period of crisis. Thus, this research study aims to fill this research gap. Key objective of this study is to investigate the effect of CG Mechanisms on firm's return of the companies listed in CSE.

2. Literature Review

On the basis of explanatory variable taken in this study, literature is carried out and summarized as follows.

Board size and Corporate Return

As per the perspective of John (2013) a poor performance of firm will be resulted due to a firm having more board members. A contradictory relationship between size of board and value of firm was found by him. Moreover large part of failure in firm value was indicated by the results obtained due to the inclination of the board size. In addition to that, the survey also depicted that a firm with lesser board members tends to have better operating productivity. An adverse liaison between size of board and profitability of the firms was reported by Eisenberg, Sundgren and Wells (1998). Kowalewski, (2019) depicted the negative association of occurrence of board meeting and worth of the company. So the board has the responsibility to observe, regulate and take necessary actions over the ineffective management.

CEO duality and Corporate Return

The Chief Executive officer which is also holding a position as a chairman of the board of directors is called CEO duality. "If a board chairman is also a CEO, he will reward enough dominating power to get more personnel benefits" as per the arguments of agency theorists. (Finkelstein and D'Aveni, 1994). on the other hand when CEO is also playing as chairman the performance of organization will be improved with his/her help also he/she is the responsible person holding accountability for the board actions. Brickley, Coles, & Jarrell, (1997) reveal in their research that CEO duality results immense administrative expenses in large firms rather than small firms. Multiple researches conclude that a company is considered to be having a weak legal system if one executive officer serve as both CEO and the chairperson of the board. But according to Ehikioya (2009) the overall performance of the firm is influenced by the duality of CEO. Monitoring and evaluating CEO role will be done ineffectively by board when CEO acts as the chairman. This will lead to lower performance due to agency costs (Brickley, Coles & Jarrell (1997), Core, Hothouse, and Larker (1999)). It is implied that when there is duality in CEO position, a common decision on behalf of the company may not be rational.

Independent and non-executive directors and Corporate Return

The integral role of executive directors is executing the decisions implemented by the board. Studies of Andrews, Linn, & Yi, (2017) depicted that independent directors will be having good relationship with the external environment. Therefore, financial deficiencies can be easily solved the participation of independent directors, which improves the return of the company. Researches of Mak and Kusnadi (2005) deduced that due to the contribution of these external members in the executive committee enhances the value of the firm by employing valuable decisions. Nicholson and Kiel (2007) portrays that insight directors display more concern in governing the firms than the independent directors. In contrary to that Vafeas and Theodorou (1998) proposed that non-executive directors don't have any relationship with the valuation of the firm. Subsequently, the findings of Yammeesri and Herath (2010) also put forwarded that the fluctuation of firms' performance isn't related with the independent directors. However the results of Sri Lankan study denoted that independent directors has positive impact on company's performance through the proper on time decision making and good relationship with financial institutions(Heenetigala,2011 and Balagobei, 2018).

Ownership structure and Corporate Return

Salami (2011) carried out a research on ownership structure on existence of share holders' conflict. Her study reveals that lower ownership concentration creates lower profitability. Bhattacharya & Graham (2009) found that the ownership structure significantly impact on firms' profit in their study. John and Senbet, (2018) concluded from their study that ownership dispersion had impact on cost efficiency. The split ownership encouraged cost-inefficiency relation to companies owned by a single entity was presented by this study using empirical analysis. Owusu, & Weir (2018) showed that extreme equity concentration is positively related with performance to drop agency costs. Kao, Hodgkinson & Jaafar (2019) suggested that the greater the part of autonomous directors, the lessor the board size, together with a dual board system and no chief executive officer duality, the stronger the firm's performance. With regard to ownership structure, block-holders' ownership, institutional ownership, foreign ownership and family ownership are all optimistically related to firm value. Regarding the aforementioned literature review the following hypothesis was developed.

H₁: Corporate Governance Mechanisms have significant effect on firm's return of listed entities in Sri Lanka.

Conceptual Model

The aim of conceptualization is to summarize the idea that the researcher got from past literatures and to bring out the contributions for this study area. Following diagram gives conceptual frame work to explore the effect of CG of firm's return.

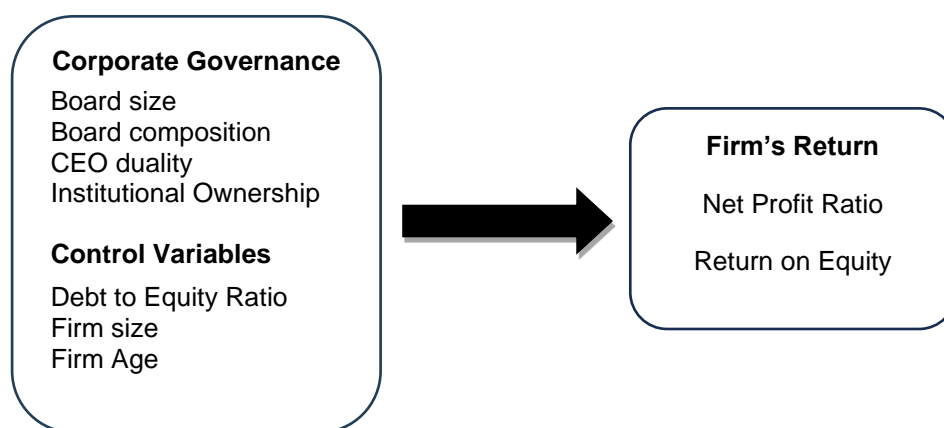


Figure I: Conceptual Model

Source: Developed by Researcher

3. Research Methodology

Population, Sample Selection and Data Collection

In The Colombo Stock Exchange (CSE) companies are divided into 20 sectors and 284 companies are listed within these sectors. Out of 284, 200 companies were selected as sample in this study. The population for this study covered the public quoted companies in the CSE from financial year 2015 to 2020. In this study, financial sectors and insurance organizations were not included because this sector has various corporate governance mechanism which enables the conclusions such that they can't be compared with non-financing organizations.

As a source for this research, secondary data were garnered from the published annual reports, which were collected from the company web page. 1200 observations were analyzed in this study.

Variables and Models used in this study

To measure the corporate governance mechanism, Board size, Board composition and CEO duality and institutional ownership were taken in to account. Furthermore In order to measure the firm's return, Return on equity (ROE) and Net Profit Ratio (NPR) were used as dependent variables. At the same time, firm size(FS), firm age (FA) and debt to equity ratio (DE ratio) were considered as control variables for this study.

The following Models are utilized to find out the impact of corporate governance mechanisms on return. Here the Corporate Governance Variables were considered to be independent variable and the ROE and NPR were considered to be dependent Variables.

$$\text{ROE} = \beta_0 + \beta_1 \text{BS}_{it} + \beta_2 \text{BCOM}_{it} + \beta_3 \text{CEO}_{it} + \beta_4 \text{INSOWN} + \beta_5 \text{DEEQ}_{it} + \beta_6 \text{FA}_{it} + \beta_7 \text{FS}_{it} + E_{it} \text{ Model I}$$

$$\text{NPR} = \beta_0 + \beta_1 \text{BS}_{it} + \beta_2 \text{BCOM}_{it} + \beta_3 \text{CEO}_{it} + \beta_4 \text{INSOWN} + \beta_5 \text{DEEQ}_{it} + \beta_6 \text{FA}_{it} + \beta_7 \text{FS}_{it} + E_{it} \text{ Model II}$$

4. Analysis and Discussion

This section of this paper presents a comprehensive discussion about the analysis and hypothesis testing in an attempt to achieve the research objectives.

Descriptive statistics

According to the table, mean and median values of the board composition are 0.41 and 0.37 respectively. At the same time, board size of the median and mean values are 7.64 and 8 correspondingly. The average board size of the company chosen for the study is 8. Likewise, the average values of the CEO duality and institutional ownership are 0.323 and 64.21 separately. Table 2 presents the descriptive statistics of the dependent and explanatory Variable.

Table 2: Summary of the descriptive statistics

	BCOM	BO_SIZE	CEO	INSOWN	FA	FS	DEEQ	ROE	NPR
Mean	0.41	7.64	0.323	64.21	42.24	9.94	71.61	22.09	20.09
Median	0.37	8.00	0.00	79.41	33.00	8.79	44.23	10.41	9.51
Maximum	0.92	14.00	1.00	99.60	152.00	27.51	112.90	78.03	75.30
Minimum	0.021	3.00	0.00	3.00	6.00	4.98	0.0310	-24	-3.67
Std. Dev.	0.14	2.057	0.47	28.01	7.21	3.63	11.40	19.76.	19.25
Skewness	0.64	0.045	0.571	-1.197	1.41	2.91	3.60	14.23	25.13
Kurtosis	3.39	2.83	1.31	3.12	4.61	11.31	32.72	11.44	12.9
Observations	1200	1200	1200	1200	1200	1200	1200	1200	1200

The variance Inflation Factor

To find out whether the existence of multi collinearity problem, the variance Inflation Factor (VIF) is generally used. Centered VIF values of independent variable used in this study are illustrated in the table 3. All the VIF values of the variables are less than 10, which assures that there isn't multi collinearity problem among the independent variables taken in this study (Gujarati, 2003).

Table 3: Variable Inflation Factor

Variable	Centered VIF
Board size	1.15
Board composition	1.07
CEO duality	1.02
Insown	1.02
DEEQ	1.005
FS	1.12
FA	1.027

Jarque Bera test for Normality

For the regression analysis normality is an essential assumption. T-test and F-test would be violated if the model is not satisfied with the normality test. In this survey, in order to test the normality, Jarque Bera test was conducted and results are displayed in Table 04. As per the results, P value of Jarque Bera test have greater than 0.05 in all models. Based on this, the null hypothesis, which says that residual has the normality, is accepted.

Table 04: Jarque Bera test for Normality

DV Return on Equity	JBStatistics	P value	DV Net profit Ratio	JBStatistics	P value
Model 1	0.169	0.92	Model 4	4.41	0.530
Model 2	0.612	0.56	Model 5	1.40	0.496
Model 3	0.75	0.64	Model 6	4.67	0.235

Breusch-Pagan-Godfrey

In order to test the existence of heteroscedasticity in residual, Breusch-Pagan-Godfrey test was conducted and results were presented in the table 05. For all models P value exists greater than 0.05, which resembles the null hypothesis which says that there's no heteroskedasticity.

Table 05: Heteroskedasticity Test: Breusch-Pagan-Godfrey

Model DV Return on Equity	F statistics	P value	Model D V Net profit Ratio	F statistics	P value
Model 1	2.071	0.149	Model 4	1.981	0.307
Model 2	0.001	0.862	Model 5	0.9228	0.634
Model 3	0.346	0.521	Model 6	0.7231	0.421

Panel data analysis were carried out to find out the impact of Corporate Governance on firm's Return of listed companies in Sri Lanka, Panel data analysis consists of three regression models such as OLS regression, fixed effect regression and random effect regression. In order to measure the firm's return Return on Equity and Net Profit Ratio are used as dependent variables. Based on this the panel data analysis has been carried out separately for both dependent variables (ROE and NPR) and the results and discussion are given below separately.

Impact of Corporate governance mechanisms on Return on Equity

Panel data analysis was performed using Eviews to investigate the impact of corporate governance mechanism on Return on Equity after controlling the factors firm size, firm age and debt to equity ratio. According to the panel data regression results which were presented in Table 6, In all models such as OLS regression, fixed effect and random effect the Board size, Board composition, have positive impacts on firm's return measured by ROE. At the same time the institutional ownership is having negative coefficient values in all these models and significant at 5 percent level. The control variable firm size which was included in this model is having a positive coefficient value where as the firm age has got a negative coefficient value even though both control variables significant at 5 percent level. As per the results hypothesis is supported. That is corporate governance mechanisms significantly impact on firm's return measured by ROE. This results are consistent with the results of Shleifer & Vishny (1997). Furthermore the debt to equity ratio which is another control variable in this models did not impact on ROE. The result from the regression models where the adjusted determination coefficients (R^2) are calculated shows respectively 64.11%, 62.4% and 59.9% of the variations of the Return on equity were explained by the

independent variables which were included in those models. The F- statistics of all these 3 models are significant at 5 percent level as p value are equal to 0.0000, it shows that the models are robust and fits the data well. In order to determine whether fixed effect model or random effect model best suits this study Hausman specification test was carried out and as per the results chi-squad value is 34.21 and P value for this is 0.0000. According to this values fixed effect model is most suitable for this analysis.

Table 6: Results of Panel Data Analysis/Dependent Variable (Return on Equity)

	(OLS Regression)(Model I)			(fixed Effect)(Model II)			(Random Effect)(Model III)		
Variables	Coefficien t	T stats	P value	Coeffi	T stats	P value	Coeffi.	T stats	P value
C	-12.121	--22.26	0.0000	-11.54	-25.165	0.0000	-11.71	-21.24	0.0000
B. Size	0.132	2.421	0.018	0.48	0.202	0.0125	0.2746	21.80	0.0000
Bcom	0.7097	5.66	0.0000	1.147	0.374	0.0000	6.7688	31.02	0.0000
CEO	0.0116	.273	0.786	0.0821	0.1364	0.8915	0.0064	0.10	0.9151
INS OWN	-0.021	-3.04	0.0027	-0.0031	-3.1861	0.0015	-0.0032	-3.20	0.0014
DEEQ	0.095	-0.8540	0.3932	-0.322	-0.912	0.352	-0.0152	0.712	0.3220
FA	-0.005	-3.21	0.0011	-0.0052	-0.3786	0.0021	-0.0041	-3.94	0.0012
FS	0.221	47.21	0.000	0.4337	50.54	0.0000	0.461	5023	0.0000
AdR ²	0.6411			0.624			0.599		
P(Fstatic)	0.0000			0.0000			0.0000		
Dur.WatsStatistic	1.99916			1.6718			1.6428		
Hausman specification test									
Chi squared value							34.21		
Prob>Chi squared							0.0000		

Impact of Corporate Governance Mechanisms on Net Profit Ratio

Table 7 presents these results of panel data analysis via OLS regression, fixed effect and Random effect Regression. According to the panel data regression results, the coefficient of regression of board size, board composition and CEO duality have positive coefficient value in all these three models which were significant at 5 percent level. From this results researcher concludes that there is positive impact of board size, board composition and CEO duality on net profit ratio. Here the hypothesis is supported at 5% significance on the net profit ratio. The coefficient of Institutional ownership in these three models have negative coefficient values which are significant at 5 percent level as p values are less than 0.05 values . From this results researcher concludes that there is negative impact of institutional ownership on net profit ratio. The result from the regression models where the adjusted determination coefficients (R2) are calculated shows approximately from all three models are respectively 35.1%, 88.2% and 76.88%. The F- statistics in all these 3 models are significant at 5 percent level as p value are equal to 0.0000, it shows that the models are robust and fits the data well. Hausman specification test was carried out and as per the results chi-squad value is 24.4 and P value for this is 0.007. According to this values fixed effect model is most suitable for this analysis.

Table 7: Results of Panel Data Analysis/Dependent Variable (Net Profit Ratio)

Variables	(OLS Regression)(Model Iv)			(fixed Effect)(Model V)			(Random Effect)(Model vi)		
	Coefficient	T stats	P value	Coeffi	T stats	P value	Coeffi.	T stats	P value
C	7.43	13.19	0.0000	11.83	19.49	0.0000	7.93	12.8	0.0000
Board. Size	0.042	4.05	0.0001	0.04	3.09	0.0027	0.03	2.46	0.0159
Bcompositi	0.03	2.84	0.0057	1.06	8.26	0.0000	0.00	5.94	0.0000
CEO duality	0.05	2.93	0.0044	0.0069	5.16	0.0000	0.00	2.75	0.0073
INS OWN	-0.03	-14.47	0.0000	-0.046	-5.22	0.0000	-0.01	-8.55	0.0000
DEEQ	2.39	3.15	0.2230	-0.086	-0.14	0.808	-2.94	-2.80	0.1740
FA	-0.004	-3.58	0.0004	-0.0043	-0.38	0.0002	-0.00	-3.61	0.0003
FS	0.43	50.67	0.0000	0.44	50.91	0.0000	0.73	9.04	0.0000
AdR ²	0.351			0.882			0.7688		
Fsatic	12.23			5.19			40.90		
P(Fstastic)	0.0000			0.0016			0.0000		
Dur.WatsSt atistic	1.76			1.47			1.65		
Hausman specification test									
Chi squared value							24.44		
Prob>Chi squared							0.007		

5. Conclusion

According to summary of panel data analysis, Board size and board composition have the positive impact on net profit ratio as well as return on equity even though CEO duality have the positive impact on net profit ratio but not significant on Return on Equity. Agency theory states that the large board size will probably increase the profitability of the firm through monitoring a large group of people in a proper manner also the large board size provides a diversity of expertise with excellent knowledge this will enhance the capability in generating external linkages. Higher the number of members in board will support to improve the performance of the company by improving the quality of the decisions taken by the board (Bhatt and Bhatt 2017 and John 2013). In addition, participation of different members with different background in the board will support the company to improve their networks in accessing finance and other resources. Further the separation of CEO and managing director has a positive impact on return on equity through which it enables the company to install two different persons. Institutional ownership has the negative impact on profitability of listed companies in Sri Lanka. The cause for the institutional ownership having negative impact on return of the firm is that institutional owners have great influence in the company's decision making. Their decisions are not mainly focused on the wealth maximization of shareholders but are concerned of their own benefits. Bhattacharya & Graham (2007), Gugler (2003) Chaganti & Damanpour (1991) and Djankov (1999) concluded that the ownership structure may lead to conflicts of interest between shareholders and management. This conflict can reduce the value of the firm because managers are not willing to work towards maximizing the shareholders 'wealth as they tend to utilize the resources for their personal interests Furthermore the control variables which were included in this research such as firm size which is having positive impact on profitability, firm age which is having negative impact on profitability and debt to equity ratio which is having no impact. Researcher can conclude that implementation of good governance practices will enhance will the profitability of the firms

listed in CSE. These results are found to be consistent with the findings of Akbar Husain, Ahmad, & Hassan, (2019).they found that GCG mechanisms via board size, board composition and CEO duality positively affect firm's Return. Execution of code of governance practices will improve the company's performance through the firm is managed transparently and accountable.

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