

CORPORATE GOVERNANCE AND CORPORATE PROFITABILITY: EVIDENCE FROM SRI LANKA

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ABSTRACT

The poor performance of commercial organizations is frequently attributed to the absence of effective corporate governance. Developed economies with a strong private sector and well-established corporate governance systems consistently post high and steady growth rates. The main purpose of this study is to explore the effect of corporate governance mechanisms on a firm's Return of listed companies in CSE. Data collection was carried out on the 208 companies during the period 2015 to 2020. Size of the board, Board composition, Chief Executive Duality, and Institutional ownership were taken as the explanatory measures and ROA was taken as a proxy of corporate profitability. Furthermore, firm size, and firm age and Debt to Equity Ratio were taken as control measures. To explore the effect of governance mechanisms on a firm's Return, panel data regression was applied. According to the results of the panel data analysis, Board size, Board composition, and firm size have a significant impact on the profitability of the listed companies in Sri Lanka. Moreover, institutional ownership and CEO duality have no impact on Return on Assets. In the normality test, the p-value of the Jarque–Bera value for all models is found to be greater than 0.05. This satisfies the point that the residual has the normality. The findings of this research are vital for policy implications in Sri Lanka.

Keywords: Corporate Governance, Corporate Profitability, Debt to Equity, Board size, Board composition, CEO duality.

1. Introduction

The poor performance of commercial organizations is frequently attributed to the absence of effective corporate governance. Developed economies with a strong private sector and well-established corporate governance systems consistently post high and steady growth rates. As a result, the low levels of corporate governance procedures that characterize emerging countries' economies are sometimes blamed for these countries' poor rates of economic progress (Outa, Nelson & Waweru, 2016). Moreover, the monumental importance of implementing corporate governance practices was simultaneously felt. Corporate governance has been a widely controversial issue for investigators, firm executives, monetary evaluators, academicians, and strategists. Academics, regulators, and governments frequently place a greater emphasis on corporate governance following a financial crisis to increase investor trust and draw in investment (Andrews, Linn and Han Yi, 2017). In countries like Sri Lanka, the implementation of corporate governance practices assumes greater importance because of the globalization of the economy. During the COVID-19 pandemic, the ASPI index plunged by more than 20% and S&P SL20 index

dropped by 10% as at December 2020. Covid-19 outbreak affects the stock prices of the companies and the dividend expectations of the investors at present and future. Accordingly, share price movement affects the financial stability of Sri Lankan economy and, the market value of the companies and decreases investor confidence especially demotivating investors to invest in the shares of listed companies (CBSL 2021). The objective of this study is to find out the impact of the corporate governance mechanisms on the corporate profitability of listed companies in CSE.

2. Literature Review

2.1 Board Size

Advising and monitoring are the main two roles of the board of directors (Shleifer and Vishny (1996). Consequently, the board size has been seen as a crucial governance mechanism for coordinating the benefits of managers and stakeholders of the organization. The two main roles of the board were categorized by Zahra and Pearce (1989). It should supervise company operations and CEO actions, improve the company's reputation, and maintain positive relationships with stakeholders to support organizational culture. It explains that the performance of a firm could be developed by these board functions. The Cadbury Committee recommended an ideal board size of eight to ten members with equal numbers of executive and non-executive directors. However, Rosenstein & Wyatt (1993) argued that seven to eight directors are the optimum board size. As per the findings of Brown and Caylor (2004) board size would be between six and fifteen members. It should supervise company operations and CEO actions, improve the company's reputation, and maintain positive relationships with stakeholders to support organizational culture.

2.2 Board Composition

Based on the Code of Best Practices deployed in Sri Lanka, Board composition is a salient part of the board structure. The existence of a positive relationship between board composition and a firm's performance was inferred by Zahara & Pearce (1989). Agency theory evinces the potentiality of executive directors to proffer substantial performance due to their freedom from the company's management. According to the stewardship theory managers are subtle incentives to derive effective performance of companies and thus to raise the shareholder's return (Donaldson & Davis 1994). Pragmatic evidence on behalf of firms' performance and board composition is assorted. Outside directors, who are assumed to render numerous benefits, present a wide breadth of erudition, know-how, and contacts. In the meanwhile, these may augment the capability of management in safeguarding the meager external resources and their independence from the CEO (Johnson al., (2000). There's the possibility of the CEO being substituted by the firms with a greater share of outside directors after a phase of woeful execution of the company (Brown & Caylor, 2004). To rectify this poor performance, outside directors should adhere to boards during the requirement of novel or further outside guidance for a shift in strategy (Outa & Waweru, 2016; Lee et al., 2004). Rosenstein and Wyatt (1990) recount the significantly deviant returns result because of the domination of boards by independent outside directors.

2.3 CEO Duality

Though mixed effects related to the non-executive directors and firm performance's proportion are elucidated by experiential testimony of past year researches, non-executive directors' appointment is rationally undertaken. According to the research of Chen et al (2008) in China, it is stated that more than a hundred companies owned a non-CEO duality structure while a few companies switched to CEO duality. Nevertheless, due to extreme corporate scandals in USA, most of the China companies paid no heed in the deployment of CEO duality. Thus, the rate of converting to non-CEO duality increased from 55% in 1999 to roughly 70% in 2003. Consequently, 84% of European listed companies altered CEO duality role to non-CEO duality. Niroscha Hewa Manawaduge (2012) affirmed in her research that in Sri Lanka, individuals have unfettered powers of decision due to the authority in a company as evinced in the Sri Lankan mandatory code of practices. Through the agency theory, Fama & Jensen (1983) clarify that CEO duality becomes a shackle for a board's ability to supervise management, which creates agency problems. As an aftermath of this, entrenchment and board independence are enhanced and lessened respectively (Shungu, Ngirande and Ndlovu 2014)

2.4 Institutional Ownership

Bathala et al (1994) declared that conventionally, institutional shareholders don't directly engage in corporate governance, but focus in buying and selling stocks in the capital market by utilizing their power. According to the research findings of Johnson Greening (1999) and Cornet et al. (2007), if a company possesses a greater percentage of institutional ownership, it will raise the remuneration of the board as well as compensation for executive directors, while reducing the likelihood of CEO duality of the board. Institutional owners pressure the company's management to acquire the shareholder's interests dissimilar to the board of directors (Cornett et al. 2007). Monitoring, disciplining, and manipulating managers from passive investors have been recently expanded by institutional ownership role. Besides, the prior studies concluded that institutional ownership had a positive impact on the company's profitability (Bhattacharya, & Graham,2003). On the contrary, Tasi and GU (2007) overshadowed the negative effect of institutional ownership on corporate profitability due to the cost associated with supervising and agency problems. Based on the variables taken in this study, the following hypotheses were developed by the researcher.

H₁: Corporate Governance Mechanism significantly impacts on corporate profitability.

H_{1a}: Board size significantly impacts on corporate profitability.

H_{1b}: Board composition significantly impacts on corporate profitability.

H_{1c}: CEO duality significantly impacts on corporate profitability.

H_{1d}: Institutional Ownership significantly impact on corporate profitability.

3. Research Methodology

3.1 Data Collection

The secondary data that have been utilized for the study were garnered from the annual reports that are available on the official web page of listed companies in Sri Lanka.

3.2 Population and Sample Selection

290 public quoted companies, which are divided into 20 sectors, in the CSE are covered as this study's population. In this research, financial institutions and insurance companies were left out in addition to the companies that don't have the required information because finance institutions have different corporate governance mechanisms which makes the results incomparable with non-financing firms. The data collection was carried out on the 208 companies during the period 2015 to 2020.

3.3 Measurement of Variables

The corporate governance mechanism is measured based on two perspectives such as board structure and ownership structure. Board size, board composition, and CEO duality are considered based on board structure, and institutional ownership is considered as the ownership structure basis.

3.3.1 Dependent Variable

In this study, corporate profitability is to be considered as dependent variable. Return on assets is taken into account in this study.

Return on Assets (ROA): Return on Assets (ROA) is a form of return on investment (ROI) and measures the profitability of a business to its total assets.

3.3.2 Independent Variables

In this study, corporate governance mechanisms are to be considered as independent variables.

- *Board size:* The number of directors on the board is considered as board size.
- *Board composition:* The proportion of non-executive directors on the board is calculated as the number of non-executive directors divided by the total number of directors.
- *CEO duality (CEO):* CEO indicates whether the company's CEO is also chairman of the board, The Dummy variable is equal to 0 if the two persons are separate.
- *Institutional Ownership:* A shareholder owning a large amount of stock, generally an institutional investor.

3.3.3 Control variables

Some other variables can affect the relationship between corporate governance and corporate profitability, thus these variables should be controlled in this study.

Firm size: The size of the firm is an important factor affecting firm profitability. This research used the natural log of a firm's total assets to measure the firm size.

Firm age: Firm age was calculated as each year minus the established date of the company to determine how many years it had been incorporated.

Debt-to-Equity Ratio: The Debt-Equity Ratio helps in determining the effectiveness of the financing decisions made by the company.

3.4 The variance Inflation Factor (VIF)

For measuring multicollinearity problems, the researcher can use the VIF factor. As a rule of thumb, a VIF greater than 10 represents the presence of harmful co-linearity (Gujarati, 2003). According to Table 1 Variable inflation factor for all variables is less than 10. This represents that the variables taken in this study didn't have the multicollinearity problem.

Table 1: Variable Inflation Factor

Variable	Centered VIF
Board size	1.148
Board Composition	1.074
CEO Duality	1.023
Insti.Ownership	1.027
Debt – to-.Equity	1.005
FS	1.121
FA	1.026

4. Data Analysis and Discussion

4.1 Descriptive Statistics

Descriptive statistics are also useful for making general observations about the collected data. A preliminary analysis of the data was carried out for the years 2015 and 2020.

Table 2: Descriptive Statistics of Corporate Governance Mechanism and Return

	BCOM	B_SIZE	CEO	INSO WN	FA	FS	DEEQ	ROA
Mean	0.39	7.84	0.36	68.59	40.26	9.96	75.87	6.03
Median	0.32	8.00	0.00	79.45	31.00	8.34	41.23	5.27
Maximum	0.88	16.00	1.00	99.60	154.00	26.35	801.90	592.30
Minimum	0.08	3.00	0.00	3.00	10.00	5.48	0.03	123.20
Skewness	0.66	0.06	0.56	1.20	1.49	2.81	5.60	29.96
Kurtosis	3.49	2.96	1.32	3.09	4.77	10.43	87.72	10.84

As per Table 2, The means value is found to satisfy the requirements of codes of best practices. The mean value indicates the average board size of listed companies is approximately 8. Yet the minimum and maximum values of board size are found to be 3 and 16. The mean value of CEO duality is found 0.36 and the median is found 0.00. The value of the mean for institutional ownership is 68.59 and the median value is found to be 79.45. The value of the mean for company firm age is 40.26; the maximum and the minimum of company age are 154 and 10 respectively. When the debt-to-equity ratio is observed, the mean value of the debt-to-equity ratio is 75.87. This indicates a higher amount of debt is utilized as the source of capital for the listed companies. Besides the pairs of the maximum and the minimum values of ROA are 592.3 and 123.2.

4.2 Correlation Summary

Table 3: Correlation Summary

Variable	B.comp	B.Size	CEO	DEEQ	INSOWN	FA	FS	ROA
B.comp	1.00							
							
B.Size	0.16	1.00						
	0.00						
CEO	0.05	0.06	1.00					
	0.10	0.03					
DEEQ	0.05	0.06	0.24	1.00				
	0.10	0.04	0.3963				
INOWN	0.06	0.03	0.09	0.04	1.00			
	0.04	0.31	0.00	0.17			
FA	0.07	0.03	0.00	0.10	0.07	1.00		
	0.01	0.34	0.90	0.00	0.02		
FS	0.08	0.29	0.01	0.04	0.08	0.01	1.00	
	0.00	0.00	0.86	0.16	0.00	0.77	
ROA	0.01	0.04	0.03	0.12	0.01	0.01	0.06	1.00
	0.03	0.02	0.28	0.00	0.86	0.85	0.03

To ascertain the relationship between the variables, the correlation analysis was accomplished, and is illustrated in Table 3. As per the results, the independent variables, which are board size and board composition, have a positive relationship with return on assets. Moreover, though CEO duality and institutional ownership have negative coefficient values, they aren't significant. Debt-to-equity and firm size, which are chosen in this research as control variables, have a positive association with profitability. Anyhow firm age's relationship is negative but insignificant.

4.3 Panel Data Analysis

To find out the effect of CG on the ROA of listed companies in CSE, Panel data analyses were carried out. The following Table displays the results of OLS Regression.

Table 4: Ordinary Least Square Regression Results (Model I)

Variables	Coefficient	t Value	P Value
C	5.19	25.43	0.0000
Board Size	0.27	21.72	0.0000
Board Composition	6.77	30.98	0.0000
CEO duality	0.01	0.09	0.9306
Ins.Ownership	-0.003	-3.01	0.2701
Debt to Equity	0.0003	1.10	0.2729
Firm age	-0.004	-3.74	0.0643
Firm size	0.43	50.69	0.0000
R ²			0.72
F Statistics			458.41
Probability			0.0000

Above Table 4 indicates OLS regression results. The beta coefficient of regression is 0.27 for Board size. It indicates that if every board size increased by one then firm profitability will be increased by 0.27 amounts. The P-value for this is less than 0.05. From these results, the researcher concludes that board size has a positive impact on ROA. Therefore, H_{1a} is supported. The beta coefficient of regression is 6.77 for Board composition which is significant since the p-value is less than 0.05. From these results researcher concludes that board composition also has a positive impact on ROA. Therefore, H_{1b} is supported. The beta coefficient of regression is 0.01 for CEO duality which is not significant since the p-value is greater than 0.05. Therefore, H_{1c} is not supported. While the coefficient of institutional ownership is negative in the regression summary, it is -0.003 which is not significant at 5% level as the p-value is greater than 0.05. So H_{1d} is not supported. Further, the beta coefficient of firm age is negative in the regression summary, which is not significant at the 5% level. The coefficient of the firm size is .43 which is also significant at 5% level of significance (p<0.05). From these results, the researcher concludes that firm size has a positive impact on ROA. The value for the R-squared is 0.72 which endorses that 72% of the variation in the dependent variable (ROA) is explained by the independent variables included in the model.

Table 5: Results of Fixed effect Regression (Model II)

Variables	Coefficient	t Value	P Value
C	0.54	3.07	0.0022
Board Size	0.08	7.25	0.0000
Board Composition	0.92	4.92	0.0000
CEO duality	0.20	3.88	0.2761
Ins.Ownership	-0.0003	-0.45	0.6556
Debt to Equity	0.00011	1.45	0.1468
Firm age	-0.03	-2.33	0.1425
Firm size	0.13	17.29	0.0000
R ²			0.73
F statistics			457.05
Probability			0.0000

The coefficient of regression of board size is 0.08 It indicates that if every Board size is increased by one then firm profitability will be increased by 0.08 whereas the t statistic and P-value are respectively 7.25 and 0.000. From these results, the researcher concludes that board size has a positive impact on ROA. So H_{1a} is accepted. The coefficient of regression of board composition is 0.92 and the P value of this is 0.000. From these results researcher concludes that there is a positive impact of board composition on return on assets. H_{1b} is accepted. The coefficient of regression of CEO duality is found to be 0.20 whereas the t statistics and p value are respectively 3.88 and 0.2761. According to the regression results, the researcher concludes that CEO duality is not significantly impact on return on assets of listed companies. H_{1c} is not accepted. The coefficient of Institutional ownership is -0.0003 whereas the t statistic and P value are respectively -0.45 and 0.6556. From these results researcher concludes that there is no impact of institutional ownership on return on assets. H_{1d} is not accepted.

The coefficient of regression of firm age is -0.03. p-value is found to be 0.0564. From these results, the researcher concludes that there is no impact of firm age on ROA. From this table researcher concludes that there is no significant impact of debt to equity on ROA as the p-value is greater than 0.05. The beta coefficient of regression is 0.13 for firm size. P-value is significant at 5% level. From these results researcher concludes that there is a positive impact of firm size on return on assets. The value for the R-squared is 0.22 which endorses that 22% of the variation in the dependent variable (ROA) is explained by the independent variables included in the model.

Table 6: Results of Random Effect Regression (Model III)

Variables	Co.efficient	t Value	P Value
C	0.51	2.93	0.0035
Board Size	0.08	7.31	0.0000
Board Composition	0.94	5.07	0.0000
CEO duality	0.20	3.93	0.0721
Ins.Ownership	-0.0003	-0.31	0.7558
Debt to Equity	0.0001	2.93	0.1220
Firm age	-0.002	7.31	0.0564
Firm size	0.13	5.07	0.0000
R ²			0.22
F Statistics			49.37
Probability			0.0000

According to the regression summary (Table 6), the coefficient of the board size is positive at a value of 0.08 which is significant since the value is less than 0.05. Therefore, H_{1a} is accepted. The coefficient of the board composition is 0.94 which is also significant since the p-value is less than 0.05 which is 0.00. H_{1b} is accepted. The results of the regression, the coefficient value of CEO duality is 0.20, whereas the P value is found to be greater than 0.05 (p=0.0721). So H_{1c} is not accepted. While the coefficient of institutional ownership is negative in the regression summary, it is -0.0003 which is not significant as the value is equal to 0.7558. so H_{1d} is not accepted. The coefficient of debt-to-equity is 0.0001 in the regression summary, which is not significant as the value is equal to 0.1220. Furthermore, the beta coefficient of the firm age is -0.002 whereas the p-value is 0.0564, which is not significant. The beta coefficient value of firm size is 0.13 with a p-value of 0.00. From these results researcher concludes that there is a positive impact of firm size on corporate profitability. The adjusted R² value for the regression model is 22. Therefore it is possible to say that approximately 22% of the variations in the profitability could be explained by the variation in the corporate governance mechanisms included in this study and other control variables taken in this study.

4.4 Residual Normality Test

The table displays the Jarque Beta statistics of the residuals of Model I, Model II, and Model III. In the residual normality test, the p-value of the Jarque Bera value for all models is found to be greater than 0.05. This satisfies the point that the residual has the normality.

Table 7: Results of the Residual Normality Test

Model	Jarque Beta statistics	P Value
Model I	4.68	0.25
Model II	6.37	0.41
Model III	2.23	0.33

4.5 Results of Heteroskedasticity:

In the application of regression analysis, the existence of heteroscedasticity in residual is the major problem since the existence of heteroscedasticity invalidates the results of the regression. The p value of F statistics of all Models greater than 5% significance level means that there can reject the alternative hypotheses and accept the null hypotheses. Hence there is no heteroskedasticity in residuals.

Table 8: Results of Heteroskedasticity

Model	F Statistics	P Value
Model I	9.18	0.162
Model II	0.12	0.731
Model III	0.35	0.707

5. Conclusion and Recommendation

The volatility in capital markets is regarded as the most severe crisis as the vast gloomy and lends some scholars and policymakers to reconsider the weakness of implemented CG practices from a comprehensive perspective. CG has turned into an especially essential context for researchers and policy disclosure in countries all over the world after corporate scandals of large organizations (Johl, Kaur, & Cooper 2015; Hidayat & Utama, 2017; Ghabayen, 2012).

In conformity with the results of the panel data analysis, based on Model I, Model II and Model III, the board size, the board composition, and the firm size have a positive effect on profitability measured by ROA of the companies listed in CSE. This result is consistent with the study conducted by Azeez (2015), Shleifer and Vishney (1997), and Shungu, Ngirande, and Ndlovu (2014), Who found that board size had a positive impact on ROA. Prior research suggests that companies, that own large board sizes, have more expert people. Large board size also supports building up relationships with other corporations and external environments and its guidance leads to powerful and strategic decision-making. In the meanwhile, board composition also positively affects the return on assets. This result is assured in the research findings of Davies (2002), who mentions that the executive directors' active role in guiding the company for the betterment of the shareholders is the cause of the board composition's positive impact on profitability. The findings of this study support the agency theory. As per the findings, Companies can increase corporate profitability by implementing the practices of corporate governance according to the code of best practices available in Sri Lanka.

Since the board size has a positive impact on the ROA of listed firms in CSE. Of the companies taken up for the study the companies that have a board size of less than 6 by

raising the number of directors to the maximum of 13, the profit can be augmented. Furthermore, in the companies that were taken up for the study, what could be observed was that the board compositions of some companies were found to be lower than 0.33. These companies by increasing the independent directors of the total number of board of directors, will serve to enhance the profit through increasing the board composition. On the contrary, the CEO duality and Institutional ownership did not have a significant impact on corporate profitability measured by return on asset.

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