

Relationship between Code of Corporate Governance and Corporate Financial Performance (An Empirical Study of Food Companies Listed on KSE)

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Abstract

The crucial role that implementation of Code of Corporate Governance plays on protecting the rights of minorities, shareholders, local as well as foreign investors cannot be denied. Companies all over the world are required to implement their respective Code of Corporate Governance for avoiding agency conflicts between companies' management and stakeholders and for assuring transparency in accountability. This paper aims at exploring the impact of implementation of corporate governance practices (designed by Securities and Exchange Commission of Pakistan) have on the financial position of companies. For explanatory variables of the study, composition of the board as per the Code of Corporate Governance that comprises of presence of independent, executive and non-executive directors has been taken into consideration. Return on equity has been taken as an indicator of firms' profitability i.e. the dependent variable. For this study, companies listed on food producing sector of Karachi Stock Exchange have been screened for excogitation of the relationship. It is an empirical research based on nine years data from 2007–2015. Using Hausman Test for selecting the data analysis technique between Fixed or Random, Fixed Cross Sectional Panel Analysis has been used for analysis of the data collected. Findings indicate that presence of independent, executive and non-executive directors as per the code requirements levies a significant impact on the profitability of companies indicated by return on equity. It is, thus concluded that companies should ensure compliance with code of governance practices to reduce not only the agency issues but also to increase their profitability.

Keywords: Code of Corporate Governance, Fixed Cross Sectional Panel Analysis, Board Composition, Food Producers & Firms' Profitability

Introduction

“What corporate governance means is that people outside looking into the company will see that the people inside who are practicing qualitative governance are making decisions on an intellectually honest basis and are applying care and skill in making business judgments. An example of intellectual dishonesty in the corporate context is Enron.”

(King Report issued by the King Committee on Corporate Governance in South Africa)

Agency conflicts in corporations are subject to contentious debates. Agency theory explains agency conflicts as the issues that occur between companies' management and its shareholders mainly because of lack of separation between ownership and control (Ehikioya, 2009). The need to address these issues arose with the advent of severe organization's collapses such as Enron, Aldephia and WorldCom (Adewuyi & Olowookere, 2013). This is where the role of Code of Corporate Governance arises.

Corporate governance factors are classified as Internal and External Governance Mechanisms as identified by the World Bank (1999). Internal Mechanisms are concerned with providing protection to the shareholders of the corporation by striving at assuring proper board composition, size, independency, remuneration, and ownership structure, etc. (M. Hutchinson, 2009). External Mechanisms on the other hand are associated with

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protecting the rights of external parties such as debtors, lawyers, creditors, financial institutions, compliance with the laws and statutes along with the company's charter and law, etc.

To club both (internal and external factors), Corporate governance mechanisms are aimed at ensuring the protection of rights of all stakeholders associated with the corporations. To achieve this, it encompasses the structure and composition of the board, their independence, technical education, size, presence of human resources and audit committees, etc. (Ehikioya, 2009). Now countries all over the globe have designed codes of corporate governance to assure smooth running of the corporations according to their laws and statutes and are emphasizing them to imbed that code in their operations (Maher & Andersson, 2000; Wu, Lin, Lin, & Lai, 2009). Implementation of the policy rules as defined in Code of Corporate Governance proves to be an effective measure towards reducing agency conflicts and vulnerability of financial distress (Adewuyi & Olowookere, 2013). Further, it also increases corporations' accountability that boasts investments by both local as well as international investors (Shank, Hill, & Stang, 2013).

In Pakistan, Securities and Exchange Commission of Pakistan (SECP onwards) necessitated the need to develop a code ensuring the compliance of policies and measures that are aligned with uplifting company's performance without sacrificing the rights of stakeholders associated. In 2002, Code of Corporate Governance (COCG onwards) was launched and implementation of this code was made mandatory for the corporations. The core areas that this code explains are about the board's structure, size, remuneration, meetings, criteria for directors' selection, their training, presence of audit and human resource committees and many more ("Code of Corporate Governance," 2012). There have been continuous amendments in the Code that are indicative of the fact that governance mechanisms are dynamic and subject to revisions not only due to the necessitated circumstances but also to keep it up to mark with the global environment.

Enormous studies have excogitated the relationship between implementation of corporate governance practices and their profitability (Adewuyi & Olowookere, 2013; Bachiller, Giorgino, & Paternostro; M. Hutchinson, 2009; Maher & Andersson, 2000; Olatunji & Stephen, 2011; Shank et al., 2013). Variables such as board' size, structure, meetings, trainings, etc. have been screened by the

researchers as indicators of COCG. However, this study is aimed towards investigating the impact of implementation of COCG practices specifically regarding the "Composition of the Board" has on firm's profitability. COCG requires corporations to classify their board of directors and to differentiate them as Executive, Non-Executive and Independent Directors. This is primarily because of the varying duties and contributions of each of these directors' category (explained in methodology section of the paper). So far no study has taken this complete component i.e. composition of the board (as per the categories) into consideration and that is the rationale for our study.

The three stock exchanges functioning in Pakistan are Karachi Stock Exchange (KSE onwards), Lahore Stock Exchange and Islamabad Stock Exchange. This study is revisiting the impact of COCG practices on companies listed at KSE and the sector selected for this purpose is Food Producers.

Theoretical Support

The relationship between ownership and control is supported by the Agency Theory. It states that the separation between ownership and control gives rise to the actions in the personal benefits of the managers resulting in agency issues and conflicts (Jensen & Meckling, 1979). It further reduces the ability of corporations to maximize earnings and that hampers stakeholders' interests (Palliam & Shalhoub, 2003). Thus our study is supported by Agency Theory.

Objectives of the Study

SECP has defined the requirements in COCG about the composition of the board with respect to the presence of executive, non-executive and independent directors ("Code of Corporate Governance," 2012). The responsibilities each of these categories of directors performs are distinctive in nature (stated in Methodology section of the paper). So far this entire component of COCG was not taken into consideration by the researchers. Some studies have focused on the board size (Shank et al., 2013; Wu et al., 2009). However, the impact that these three categories of directors of corporations have on profitability were not studied in isolation. This served as the motive for the study.

Hub of this study is to:

- Determine whether there is an association between composition of board and firms' profitability or not.
- Excogitate the direction of impact being positive or negative (if any) that different categories of directors possess on firms' profitability.
- Trace the magnitude/strength by which the presence of varying categories of directors affect the firm's profitability.
- Suggest policy measures in the light of findings of the study.

Literature Review

"A director is bound to take such precautions and show such diligence in their office as a prudent man of business would exercise in the management of his own affairs."

(Trustees of the Orange River Land & Asbestos -Company vs King (1892) 6 HCG 260 285)

Plethora of past studies clearly indicates the predominant role that board of directors' play in uplifting the corporation and in maximizing its worth. Ample studies have explained and shed light on the importance of having executive directors among the panel of board (Heenetigala & Armstrong, 2011; Maher & Andersson, 2000; Palliam & Shalhoub, 2003). However, the presence of independent and non-executive directors along with executive directors is overlooked by researchers. This is where this study looks into. There have been variations among the consensus of scholars regarding the impact that executive and non-executive directors have on firm's profitability. Some have pointed this to be negative (Olatunji & Stephen, 2011) whereas some have revealed that there is a positive significant impact of these directors on firm's profitability (Ehikioya, 2009; Shank et al., 2013).

Olatunji and Stephen (2011) studied the impact of non-executive directors on firm's profitability in Nigeria. Based on a period of three years from 2006-2008, banking sector companies listed on Nigerian exchange were selected for the study. Panel regression analysis was applied to process the data gathered. Number of non-executive directors served as the explanatory variables of the study whereas return on equity was selected as dependent variable. Findings of the analysis indicated that there exists a significant but negative relationship between the non-executive directors and firms' return on

equity. This is likely to be because non-executive directors remain busy with other commitments and thus ignore to play effective role in entity's key decisions. Therefore, the firms' performance is not positively affected by their presence rather it levies a negative impact on the entity.

Another study examining the impact that board composition has on profitability of firm based on analysis of Italian firms listed on S&P/MIB 40 Index excluding financial firms and the firms for which there were no social ratings was carried out (Bachiller et al.). Final sample comprised of 26 firms for the period taken into consideration being 2008. The selected firms were further categorized into family and non-family firms. Entities having 30% ownership and having a family member among the board were considered as family firms and the rest as non-family firms, thus there were 12 family and 14 non-family firms. Dependent variables of the firms comprised ROA, ROE and AEI score which is social rating elaborated by Agenzia Europea degli Investment whereas executive, independent and dimension (number of members on the board) served as independent variables of the study. Using panel data analysis, findings indicated that dimension has a negative impact on profitability whereas board independence has a positive impact on firm's profitability. On the other side, study indicated no significant relationship between executive directors and profitability of firms.

Another study conducted by M. Hutchinson (2009) explored the relationship between profitability of firms and corporate governance practices. It was based on a sample of 200 firms listed on Australian stock exchange for a period of six years from 2000 to 2005. Earnings management measured by absolute value of performance adjusted accruals served as dependent variable of the study whereas presence of independent directors, audit committee and executive directors were taken as explanatory variables of the study. Using fixed effect cross sectional analysis, results showed that audit committees and independence of directors levied a significant but negative impact on company's performance. However, presence of executive directors possesses positive impact on the financial performance of firms selected for the study.

The correlation between the presence of independent directors and the financial performance of companies was studied by Bhagat and Black (2002). To excogitate the impact, degree of independence of directors was taken as the one measured by the fraction of independent

directors less the fraction of inside directors on a firm's board. Tobin's Q, return on assets, return on sales to assets and market adjusted stock price results were taken as independent variables of the study. It was based on a sample of 928 firms listed on American stock exchange for 1988 to 1991. Ordinary Least Square was used to process the data gathered. Overall, the results showed that there exists a significant negative relationship between firms' performance and independent directors. Financial performance of firms decreases as a result of having independent directors on the panel of firms' board.

However, board independence was found to have significant positive impact on firms' performance in a study carried out in Taiwan by Wu et al. (2009). It was aimed to determine the link between firms' performance and corporate governance practices. Return on assets, Tobin's Q and stock returns served as the dependent variables whereas board size, stock pledge ratio, CEO duality, inside and independent directors were the explanatory variables of the study. Sample for the study comprised all companies listed on Taiwan stock exchange from 2001 to 2008 but it excluded banking and insurance industries. Using panel data regression analysis, findings showed that independent and inside directors possess a positive impact on firms' profitability. On the other hand, CEO duality, board size and stock pledge ratio affect firms' profitability negatively.

Another study conducted by Heenetigala and Armstrong (2011) investigated the effect that implementation of corporate governance practices levies on the profitability of companies listed in the country of Sri Lanka. A sample of 37 companies was selected out of the top 50 companies listed on Lanka Monthly Digest 50 (LMD). It was for a period of five years from 2003 to 2007. Using Spearman's correlations and variance analysis, study showed positive relationship between corporate governance practices (being represented by board composition, committees) and firms' performance (being measured by return on equity, Tobin's Q). Meaning thereby that implementation of corporate governance practices levied a positive impact and enhances the profitability of the corporations.

Methodology

(a) Data Analysis Tool

Firstly Hausman Test was used on the panel data to ascertain whether Fixed Effect Regression Analysis

should be used for the study or Random Effect Regression Analysis should be opted.

(b) Scope of Data

Annual data of all selected variables have been collected and considered for the study. It is for the period of nine years from 2007 to 2015. COCG was developed and enforced by SECP from 2002 however, due to the limitation of companies' annual reports for previous years; data for the period of 2007-2015 is used. It comprised total 297 observations.

(c) Choice of Research Design

It is based totally on secondary data. Primary tools such as questionnaires, interviews, focus groups and surveys are not used for the study.

(d) Selection of Sample

Companies listed in Food Producer sectors on KSE have been selected for the study. There are 54 companies listed in this sector. However, due to the non-availability of data for some companies, the final sample used for the study consists of 33 companies.

(e) Data Collection Sources

To collect data from authentic sources is one of the prerequisites of quality research studies. In order to achieve this, data has been collected from reliable websites. It assures that our study is based on actual data instead of un-authentic figures. Selected companies' audited annual reports available on their websites as well as annual reports available on KSE website have been considered for collecting data about the composition of board as to the presence of independent, executive and non-executive directors. However, for the data of financial performance measure i.e. return on equity, Financial Statement Analysis of Non-Financial Corporation published by State Bank of Pakistan has been considered. It is available on State Bank of Pakistan's website.

(f) Explanatory Variables Selection and Validation

Among the various categories of variables representing corporate governance practices, "Composition of the Board" is selected for the study. It is represented by the

presence of independent, executive and non-executive directors. This study is investigating the relationship that this entire category has on financial performance of the firms and is not limited just to a single component of the board composition. The responsibilities and role these directors play are distinctive in nature, therefore to study how these affect companies' performance becomes imperative.

Board of directors can be classified as executive, non-executive and independent directors (Bachiller et al.). Brief introduction of these categories is as follows:

1. Executive Director

Executive directors play vital role in managing day to day activities of the company specially related to the areas in which they have in depth knowledge. Although they are the full time employees of the company but don't have control on the CEO as they have to report to the CEO. Their job responsibilities are well defined.

As per the COCG defined by SECP, executive directors should not be more than one third (1/3) of the total number of directors including CEO. For the study, we have created dummy variable for this variable which has given the value of one (1) for those who comply with this requisite of COCG and a value of zero (0) who fail to comply with this condition.

2. Non-Executive Director

Non-Executive directors are the members of company's board of director but not part of the executive team. They are not responsible for day to day activities of the companies but are involved in the decision making and planning process. Their main responsibility is to monitor executive directors and play their role in the interest of any stakeholder.

As per the COCG defined by SECP, there is no limit for non-executive directors. For the study, we have created dummy variable for this variable which has given the value of one (1) for those companies who have non-executive directors on their board and a value of zero (0) who fail to comply with this condition.

3. Independent Director

Just like non-executive directors, independent directors are also members of a board of directors but don't have

any material relation with the company. They are also known as outside directors. The difference between non-executive directors and the independent directors is that they are not allowed to hold shares of the company.

As per the COCG defined by SECP, it is mandatory for the companies to have at least one independent director and preferably one third (1/3) of the total number of directors. We have created dummy variable for this variable which has given the value of one (1) for those companies who comply with this requisite of COCG and a value of zero (0) who fail to comply with this condition.

(g) Dependent Variable Selection and Validation

Financial performance served as the dependent variable of our study. Financial performance can be measured by either profitability measures or by shareholders' wealth (Bachiller et al.). For this study, we have taken return on equity as indicator of the financial position for the shareholders. It is calculated by dividing the net income earned by corporations with the total number of shares outstanding.

(h) Hypothesis of the Study

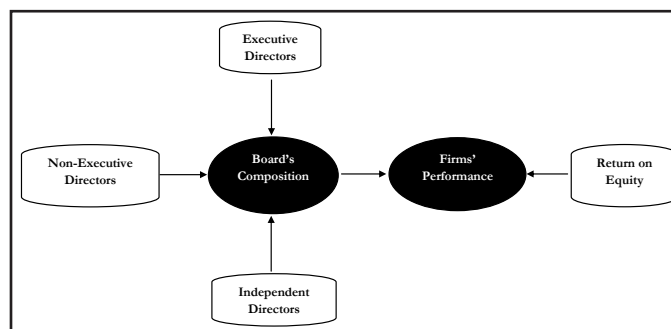
Our study is based on testing the following hypothesis:

H₀: Executive, non-executive and independent directors have no impact on return on equity of companies.

H₁: Executive, non-executive and independent directors possess significant impact on return on equity of companies.

(i) Theoretical Framework

Theoretical framework constructed for the study is as follows:



Where:

Executive, non-executive and independent directors are explanatory/ independent variables of the study and return on equity as dependent variable.

(a) Model Specification

Regression equation formulated for the study is:

$$ROE_{it} = \alpha_i + ID_{it}\beta_1 + ED_{it}\beta_2 + NED_{it}\beta_3 + \varepsilon_{it}$$

Where:

ROE = Return on Equity

ID = Independent Director

ED = Executive Director

NED = Non-Executive Director

ε = Error/disturbance/residual

(b) Data Processing Tool

Statistical software's of "Stata" and "Eviews" have been used to process the data of variables. These are used by many researchers and scholars (Ehikioya, 2009; Hosseini, Ahmad, & Lai, 2011; Mohammad, Hussain, Jalil, & Ali, 2009). Model has been tested using F-test at 5% level of significance.

Data Analysis

Multicollinearity among the explanatory variables is an issue, subject of which is of utmost importance. In the presence of multicollinearity among explanatory variables of the study, results of the study show biased results. To test it, we have used Variance Inflation Factor Test. If it results in values near to 1, it means there is no perfect multicollinearity. On the loop, as this value goes beyond 10, perfect multicollinearity becomes an issue.

It is evident from the values highlighted above that there is no issue of multicollinearity among the explanatory variables of the study.

Due to the limitation of eviews software for performing the test for homoscedasticity of residuals of the model for cross sectional data, this assumption was tested using the statistical software of "Stata". Null hypothesis of this

test states that there is homoscedasticity/equal variance among residuals.

Variance Inflation Factors			
Date: 10/10/15 Time: 10:37			
Sample: 2007 2015			
Included observations: 297			
	Coefficient	Uncentered	Centered
Variable	Variance	VIF	VIF
ID	0.076309	2.779226	1.022659
ED	0.073712	2.555942	1.017951
NED	4.064044	233.1750	1.009416
C	4.082418	235.2476	NA

xttest0		
Breusch and Pagan Lagrangian multiplier test for random effects		
roe[firm,t] = Xb + u[firm] + e[firm,t]		
Estimated results:		
	Var	sd = sqrt(Var)
roe	4.541045	2.130973
e	4.008705	2.002175
u	0	0
Test: Var(u) = 0		
chi2(1) =	1.71	
Prob > chi2 =	0.1906	

Result of this test clearly indicates that this assumption is fulfilled. The P-value (highlighted above) is greater than 0.05 i.e. level of significance so we accept the null hypothesis. Meaning thereby that there is homoscedasticity among residuals.

As our study was based on panel data therefore the first step that needs to be done was to determine whether analysis should be based on Fixed Effect Cross Sectional Panel Data Analysis or it should be based on Random Effect Cross Sectional Panel Data Analysis. For this, firstly we run simple regression. After that Fixed Effect Cross Sectional Panel Data Analysis was conducted. The output is shown below.

Dependent Variable: ROE
 Method: Panel Least Squares
 Date: 10/10/15 Time: 10:46
 Sample: 2007 2015
 Periods included: 9

Cross-sections included: 33

Total panel (balanced) observations: 297

Variable	Coefficient	Std. Error	t-Statistic	Prob.
ID	2.104888	0.600536	3.505015	0.0006
ED	-1.074257	0.525861	-2.042853	0.0424
NED	-8.245676	2.237193	-3.685725	0.0003
C	7.314553	2.222646	3.290921	0.0012
Effects Specification				
Cross-section fixed (dummy variables)				
R-squared	0.251563	Mean dependent var	-0.211479	
Adjusted R-squared	0.117228	S.D. dependent var	2.130973	
S.E. of regression	2.002175	Akaike info criterion	4.368616	
Sum squared resid	781.6976	Schwarz criterion	4.905096	
Log likelihood	-468.5751	Hannan-Quinn criter.	4.584997	
F-statistic	1.872659	Durbin-Watson stat	1.858908	
Prob(F-statistic)	0.004088			

The next step was to perform Random Effect Cross Sectional Panel Data Analysis. The output is shown below:

Variable	Coefficient	Std. Error	t-Statistic	Prob.
ID	0.680824	0.276241	2.464604	0.0145
ED	-0.246494	0.271500	-0.907898	0.3649
NED	-2.725353	2.015947	-1.351897	0.1778
C	2.220094	2.020499	1.098785	0.2730
Effects Specification				
			S.D.	Rho
Cross-section random			0.000000	0.0000
Idiosyncratic random			2.002175	1.0000
Weighted Statistics				
R-squared	0.033588	Mean dependent var	-0.211479	

Adjusted R-squared	0.020816	S.D. dependent var	2.130973
S.E. of regression	2.108677	Sum squared resid	1009.360
F-statistic	2.629788	Durbin-Watson stat	1.706617
Prob(F-statistic)	0.050958		
Unweighted Statistics			
R-squared	0.033588	Mean dependent var	-0.211479
Sum squared resid	1009.360	Durbin-Watson stat	1.706617

The third and the most important step was to conduct Hausman Test. It enables us to decide which particular data analysis technique is appropriate for the study and thus it increases the creditability of the study.

Correlated Random Effects - Hausman Test			
Equation: EQ01			
Test cross-section random effects			
Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	32.713060	3	0.0000
** WARNING: estimated cross-section random effects variance is zero.			

The P-value of this test as highlighted above is less than the level of significance i.e. α therefore we accept that Fixed Effect Cross Sectional Panel Data Analysis is suitable for our study.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	7.314553	2.222646	3.290921	0.0012
ID	-2.104888	0.600536	3.505015	0.0006
ED	1.074257	0.525861	2.042853	0.0424
NED	8.245676	2.237193	3.685725	0.0003
Effects Specification				
Cross-section fixed (dummy variables)				

As per the findings, the p-value of the model is **0.004088** which is less than α i.e. 0.05 (level of significance) thus we reject the null hypothesis and accept H_1 stating that there is significant relationship between the composition of board and companies' profitability.

The p-values of executive, non-executive and independent directors are also less 0.05 i.e. level of significance with values of **0.0424**, **0.0003** and **0.0006** respectively. Meaning thereby that selected variables affect the profitability significantly and that leads to variations in companies' performance.

Executive and non-executive directors affect ROE positively as indicated by the values of regression coefficient. The tendency to increase ROE is 1.07% more in companies who employ executive directors as compared to the companies who do not employ executive directors on their board. This is consistent with the findings of M. Hutchinson (2009). Similarly, ROE of companies increases by 8.24% who have non-executive directors on the board as compared to those who do not have non-executive directors among their board panel.

However, the presence of independent directors has a significant but negative impact of ROE. i.e. companies' performance decreases by 2.10% when they have an independent/outside director among the board of directors as compared to the companies who do not have an independent director. It is consistent with the findings of M. R. Hutchinson et al. (2008) and Bhagat and Black (2002).

Also the standard errors of the coefficients of independent, executive, no-executive directors are very low with values of 0.600536, 0.525861 and 2.237193 respectively.

R-squared	0.251563	Mean dependent var	-0.211479
Adjusted R-squared	0.117228	S.D. dependent var	2.130973
S.E. of regression	2.002175	Akaike info criterion	4.368616
Sum squared resid	781.6976	Schwarz criterion	4.905096
Log likelihood	-468.5751	Hannan-Quinn criter.	4.584997
F-statistic	1.872659	Durbin-Watson stat	1.858908

The explanatory power of the model is **25.15%**. It

indicates 25.15% changes in the financial performance of the companies are explained by the selected variables and the rest is unexplained because of the factors not considered for analysis.

The value of Durbin Watson derived as per the analysis is 1.85. It depicts that there is no auto correlation between residuals and explanatory variables. Thus, this assumption of least square technique is also fulfilled.

Conclusion

Rationale of this study was to explore whether there exists any significant relationship between the three different types of board of directors' categories (independent, executive and non-executive directors) and financial performance of the companies listed on the food producers sectors of the KSE. Analysis clearly revealed that firms who implement COCG practices in their business have improved their financial performance on the whole.

Presence of executive and non-executive directors has positive impact on the financial performance of companies. On the loop, presence of independent directors has significant negative impact on the financial performance of the companies.

Recommendations

In this era of increased competition, corporations should play their active role in taking all possible measures that can increase their profitability. This is because only profitable corporation can eventually sustain the stakeholders associated with it. As per the findings of the study, it is revealed that presence of board composition as mentioned in the COCG designed and implemented by SECP is crucial for the profitability and growth of the companies. Although SECP has made it mandatory for the corporations to implement the COCG properly yet many corporations are not following it. Therefore, it is suggested that SECP should impose penalties on those organizations who are not observing this requirement. It will help in implementation of the COCG practices designed and will ultimately help in improving the financial position of the companies. This will also assure protection of the shareholders right as well as result in reducing the agency conflicts.

Further, companies should design strategies that can

assure proper role of independent directors as well as monitor the responsibilities assigned to them. This will add a value to the companies as studies have proved that their presence improves the performance of companies (Ehikioya, 2009; Wu et al., 2009).

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