Corporate Governance and Firm Value: Evidence from Colombo Stock Exchange

Samarakoon SMRK[1]*, Priyadarshanie WAN[2], Jayendrika WADK[3]

Department of Accountancy, Faculty of Business Studies and Finance, Wayamba University of Sri Lanka[1,2,3]

ABSTRACT

Corporate governance is considered as having significant implications for the growth prospects of an economy. The association between corporate governance and firm value has been extensively studied at Colombo stock Exchange in this study. The natural logarithm of market value, Tobin's Q ratio and market to book value ratio were used as the dependent variables to indicate the market value while percentage of shares held by the largest shareholder, square of percentage of shares held by the largest shareholder, aggregate percentage of shares held by the second to fifth large shareholders, percentage of shares held by directors, percentage of total emoluments of directors to total sales, natural logarithm of the number of directors on the board, CEO duality and ratio of non-executive directors to total directors in a firm were employed as independent variables. Gearing ratio and firm size had been utilized as control variables. Data were collected from the annual reports of randomly selected Public Listed Companies in Colombo Stock Exchange during the period of 2010 – 2014. Panel data pooled regression is used to estimate the regression model. The findings indicate that, corporate governance behavior has a significant effect on market value. The evidence reported has practical significance for investors in Sri Lankan firms.

[1]* Corresponding Author: Samarakoon SMRK: ruwankithsirisamarakoon@yahoo.com

Introduction

Corporate governance (CG) is an evolving area in developed and developing countries. The Organization for Economic Corporation and Development (OECD) (1999) provides the following elaborate functional definition on corporate governance as the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in a corporation, namely board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. It is provided the structure through which the objectives of the company are set, and means of attaining those objectives and monitoring performance. And also the way in which CG is organized differs between countries, reliant on the economic, political and social contexts.

Corporate governance reflects in which ways companies should be governed. The legal procedure of the company is set out in its written constitution. Apart from the main legal documents, other procedures are embedded in the code of best practice.

In the UK and USA there were a number of companies, which collapsed unexpectedly in the 1980s and 1990s (Kariyawasam, 2010). Financial reporting irregularities or inadequate internal controls and risk management were analyzed as the causes of these corporate failures. Sri Lanka is not immune from these problems. There had been a few incidents of corporate failures in the past such as the collapse of finance companies in 1980s, the bankruptcy of Pramukha Bank in late 1990s and down fall on Vanik incorporation, which was a well performed company once. These corporate failures have serious repercussions on depositors and investors of these organizations, which ultimately led to erosion of public faith in the finance sector of the country. With these scandals interest in corporate governance has been heightened in the world, not to discuss about a grim future, but to discuss about a sanguine future of the economy in the world. Therefore; the concerns about corporate governance have developed rapidly during the past decades and the outcome has taken an important part in business as well as in the economy and society.

In general, corporate governance is considered as having significant implications for the growth prospects of an economy, because of the proper corporate governance practices reduce risk for investors, attract investment capital and improve performance of companies (Spanos, 2005). Therefore Sri Lanka is looking forward to many investors to come to the country; the companies must seriously take action to implement corporate governance practices.

Securities and Exchange Commission (SEC) of Sri Lanka as the apex regulator of the Sri Lankan capital market is committed to maintain a higher standard of corporate governance in order to maintain the market integrity. In view of the broader objective, the SEC Sri Lanka together with the Institute of Chartered Accountants of Sri Lanka (CASL) published the "Code of Best Practices on Corporate Governance" in the year 2008 in order to establish good corporate governance practices in Sri Lankan capital market.

The objective of the study is to investigate whether corporate governance practices such as board size, non-executive directors on the board, CEO duality, directors' ownership and ownership concentration affect the performance of Sri Lankan firms. In particular, it was investigated firms that possess CG mechanisms have better operational performance as results of following CG mechanisms. It is a contribution to CG research by offering new evidence on the association between CG and firms' financial performance for Sri Lankan firms.

The findings of this study will add value to the companies in the sample and with that they will encourage to continue their best practices in CG. The existing and potential investors of these companies can get better understanding regarding the implications of the best practices of CG and thereby they will be encouraged in their future investment decisions on these companies which have best practices in CG. Further, the findings will be benefited to the future research studies in CG and path for the academic and scholars who are in the field of accountancy and finance.

Review of Literature

Theoretical Background of Corporate Governance

According to the Code of Best Practices on Corporate Governance published by CASL following can be elaborated as five aspects of CG.

CEO Duality

There are two key tasks at the top of every public company conducting of the business of the board and facilitating executive responsibility for management of the company's business. There should be a clear division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.

Board Balance

It is preferable for the Board to have a balance of executive and Non-Executive Directors such that no individual or small group of individuals can dominate the Board's decision-taking.

The Board should include Non-Executive Directors of sufficient caliber and number for their views to carry significant weight in the board's decisions. The Board should include at least two Non-Executive Directors or such number of Non-Executive Directors equivalent to one third of total number of Directors, whichever is higher. In the event the Chairman and CEO is the same person, Non-Executive Directors should comprise a majority of the Board.

Appointments to the Board

There should be a formal and transparent procedure for the appointment of new Directors to the Board. A nomination committee should be established to make recommendations to the Board on all new Board appointments. The nomination committee, the Board as a whole should annually assess Board – composition to ascertain whether the combined knowledge and experience of the Board matches the Strategic demands facing the company.

Directors' Remuneration

Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual Directors. No director should be involved in deciding his/her own remuneration.

Level of remuneration of both Executive and Non-Executive Directors should be sufficient to attract and retain the Directors needed to run the company successfully. A proportion of Executive Directors' remuneration should be structured to link rewards to corporate and individual performance levels of remuneration for Non-Executive Directors should reflect the time commitment and responsibilities of their role, taking into consideration market practices. The company's Annual Report should contain a statement of remuneration policy and details of remuneration of the Board as a whole.

Shareholders

Institutional shareholders have a responsibility to make considered use of their votes and should be encouraged to ensure their voting intentions are translated into practice. Individual shareholders, investing directly in shares of companies should be encouraged to carry out adequate analysis or seek independent advice in investing or divesting decisions.

Empirical Evidence on CG and Financial Performance

There are several studies made around the world which are country specific or cross-border to examine the impact of corporate governance on firm performance. These research studies have been made valuable contributions to the literature of corporate governance, as they given an insight on the impact of firm performance.

Duc Vo and Thuyphan (2013) reported a positive relationship between elements of CG such as the presence of

female board members, the duality of the CEO, the working experience of board members, and the compensation of board members and firm performance as measured by the return on asset (ROA). Sheikh et al. (2011) revealed that board size is positively, whereas outside directors and managerial ownerships are negatively related to the return on assets, earnings per share and market to book ratio by using the data of Pakistani firms. Further, ownership concentration is positively related to all measures of performance. CEO Duality is positively related to earnings per share only.

Cheng and Leung (2013) observed different effects of the aggregate ownership of other large shareholders and the remuneration of top executives on firm value.

Mouselli and Hussainey (2010) used multiple regression model to examine the associate between CG, analyst coverage and firm value for a sample of UK firms listed in London Stock Exchange for the period of 2003 to 2008. They found that the overall level of CG quality is positively associated with the number of analysts following UK firms.

Fallatah and Dickins (2012) found that corporate governance and firm performance (measured as ROA) are unrelated, but corporate governance and firm value (measured as Tobin's Q and market value of equity) are positively related.

Velnampy (2013) examined the relationship in between corporate governance and firm performance with a sample of 28 manufacturing companies using the data representing the periods of 2007 -2011. Board structure, board committee, board meeting and board size including executive directors, independent non-executive directors and non-executive directors were used as the determinants of corporate governance whereas return on equity (ROE) and return on assets (ROA) were used as the measures of firm performance. This study found that determinants of corporate governance are not correlated to the performance measures of the organization. It has been concluded that corporate governance has no effect on companies' ROE and ROA.

Zhaoyang and Udaya Kumara (2012) found that board size and proportion of non-executive directors in the board have a marginal negative relationship with the firm value, the firm size and director share holdings have a significant impact on firm performance of listed firms in Sri Lanka.

Achchutan and Kajananthan (2013) explored the significant difference between corporate governance practices on firm performance using data from a sample of manufacturing firms listed on Colombo Stock Exchange (CSE) for the period 2007 – 2011. They revealed that there is no significant mean different between the firm performance among corporate governance practices as board leadership structure, board committees, board meetings and proportion of non-executive directors.

Heenetigala (2011) also examined the relationship between corporate governance practices and firm performance in Sri Lanka. This study was a comparative analysis to gauge the changes to corporate governance practices from 2003 – 2007. This study provides evidence in support of a positive relationship for separate leadership, board composition, board committees and firm performance based on return on equity. A sample of 37 companies had been selected from the top 50 listed companies in the Lanka Monthly Digest 50 (LMD) for the years 2003 and 2007.Both board composition and board committees also had a significant relationship with performance measured by Tobin's Q in 2007.

Although there is an abundance of research which aims to explain the relationship between corporate governance and firm performance, empirical evidence yields contradictory and inconsistent results.

Methodology

Data & Sample

Data relevant to corporate governance practices and performance measures were taken from the annual reports of companies listed on the Colombo Stock Exchange (CSE) during 2010 – 2014. Every listed company is responsible to prepare its financial statements in accordance with Accounting Standards (LKAS and SLFRS) issued by CA Sri Lanka. The final sample set, after deleting firms with incomplete data, consists of 125 observations for 25 firms over a period of five years.

Variables

On the basis of research objectives, variables were selected in this study and their definitions are largely adopted from existing literature. Notably, firm value measure Tobin-Q (TQ), natural log of market capitalization of the firm and market to book value were used as the depended variables. Key independent variables include percentage of shares held by the largest shareholder, aggregate percentage of shares held by the second to fifth large shareholders, percentage of shares held by directors, percentage of total emoluments of directors to total sales, natural logarithm of the number of directors on the board, CEO duality. Moreover, some control variables such as gearing and firm size were also included in the estimation model in order to control the firm specific characteristics that may affect firm performance. Definitions of these variables are listed in Table 1.

Table 1. Variable Descriptions

Variable	Definition
Dependent Variables	
TQ	Tobin-Q value as ratio of the market value of equity of a firm to the book value of its total assets.
MV	Natural logarithm of the market capitalization of the firm
MTBV	Ratio of market price per share at the end of the year to book value per share
Independent Variables	
TOPSHARE	Percentage of shares held by the largest shareholder.
TOPSHARE^2	Square of TOPSHARE
SHARE $_{2-5}$	Aggregate percentage of shares held by the second to fifth large shareholders.
TOPDIR_ SHARE	Percentage of shares held by directors.
DIR_REM	Percentage of total emoluments of top executives to total sales of the listed firm.
ln BOD	Natural logarithm of the number of directors on the board.
SEP_CAP	Dummy variable that takes the value of 1 if the chairperson of the board and the CEO are two separate persons and 0 otherwise.
NONEx	Ratio of non-executive directors to total directors in a firm's board.
Control Variables	
ln (TA)	Natural logarithm of the total assets.
Gearing	Percentage of total long term loans to the total assets.

Regression Model

Panel data methodology was used since the sample contained data across firms and overtime. The pooled ordinary least squares (OLS) method is used to estimate the relationship between the corporate governance mechanisms and the measures of performance.

$$TQ_{it} = \beta_0 + \beta_1 TOPSHARE_{it} + \beta_2 TOPSHARE^2_{it} + \beta_3 SHARE_{2-5_{it}} + \beta_4 DIR\_SHARE_{it} + \beta_5 DIR\_REM_{it} + \beta_6 lnBOD_{it} + \beta_7 SEP\_CAP_{it} + \beta_8 NONEx_{it} + \beta_9 ln(TA)_{it} + \beta_{10} GEARING_{it} + \varepsilon_{it} \quad (1)$$

$$MV_{it} = \beta_0 + \beta_1 TOPSHARE_{it} + \beta_2 TOPSHARE^2_{it} + \beta_3 SHARE_{2-5_{it}} + \beta_4 DIR\_SHARE_{it} + \beta_5 DIR\_REM_{it} + \beta_6 lnBOD_{it} + \beta_7 SEP\_CAP_{it} + \beta_8 NONEx_{it} + \beta_9 ln(TA)_{it} + \beta_{10} GEARING_{it} + \varepsilon_{it} \quad (2)$$

$$MTBV_{it} = \beta_0 + \beta_1 TOPSHARE_{it} + \beta_2 TOPSHARE^2_{it} + \beta_3 SHARE_{2-5_{it}} + \beta_4 DIR_{SHARE_{it}} + \beta_5 DIR_{REM_{it}} + \beta_6 lnBOD_{it} + \beta_7 SEP_{CAP_{it}} + \beta_8 NONEx_{it} + \beta_9 ln(TA)_{it} + \beta_{10} GEARING_{it} + \varepsilon_{it} \quad (3)$$

Where ε is the random error term of the model; i is the ith firm and t is the year.

Table 2. Correlation Analysis

Correlation
t-Statistic
Probability

	TQ	LNMV	MTBV	DIR_REM	GEAR	LNBOD	LNTA	NONEX	SEP_CAP	SHARE_2	TOPSHARE_5	TOPDIR_SHARE	TOPSHARE_2
TQ	1.000000												

LNMV	0.517997	1.000000											
	3.733004	-----											
	0.0006	-----											
MTBV	0.992550	0.500146	1.000000										
	50.21891	3.560412	-----										
	0.0000	0.0010	-----										
DIR_REM	-0.117218	0.121035	-0.149859	1.000000									
	-0.727597	0.751636	-0.934341	-----									
	0.4713	0.4569	0.3560	-----									
GEARING	-0.128942	-0.082729	-0.127014	-0.204102	1.000000								
	-0.801544	-0.511732	-0.789357	-1.285222	-----								
	0.4278	0.6118	0.4348	0.2065	-----								
LNBOD	-0.062869	-0.161804	-0.090212	0.236271	-0.229771	1.000000							
	-0.388317	-1.010748	-0.558379	1.498910	-1.455339	-----							
	0.6999	0.3185	0.5799	0.1422	0.1538	-----							
LNTA	0.193815	0.892051	0.190144	0.191352	-0.073153	-0.320312	1.000000						
	1.217848	12.16760	1.193911	1.201781	-0.452159	-2.084359	-----						
	0.2308	0.0000	0.2399	0.2369	0.6537	0.0439	-----						
NONEX	-0.327708	-0.203450	-0.350155	-0.203203	0.402664	-0.004784	-0.074143	1.000000					
	-2.138204	-1.280940	-2.304387	-1.279317	2.711742	-0.029491	-0.458312	-----					
	0.0390	0.2080	0.0268	0.2085	0.0100	0.9766	0.6493	-----					
SEP_CAP	-0.125541	-0.192706	-0.129383	-0.344097	0.108448	0.022806	-0.081384	0.650352	1.000000				

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Correlation matrix (lower triangular; each cell shows correlation, t-statistic, and probability). The top row's correlation values are cut off at the top of the page.

	1	2	3	4	5	6	7	8	9	10	11	12	13
(label cut off)	-0.780061 / 0.4402	-1.210612 / 0.2335	-0.804328 / 0.4262	-2.259111 / 0.0297	0.672484 / 0.5053	0.140624 / 0.8889	-0.503355 / 0.6176	5.277595 / 0.0000	---- / ----				
SHARE_25	-0.245526 / -1.561315 / 0.1267	-0.590137 / -4.506174 / 0.0001	-0.237772 / -1.509001 / 0.1396	0.251695 / 1.603161 / 0.1172	-0.136648 / -0.850334 / 0.4005	0.503866 / 3.595862 / 0.0009	-0.671747 / -5.589946 / 0.0000	-0.339693 / -2.226402 / 0.0320	-0.528535 / -3.837984 / 0.0005	1.000000 / ---- / ----			
TOPDIR_SHARE	-0.197403 / -1.241303 / 0.2221	-0.686706 / -5.823274 / 0.0000	-0.200863 / -1.263961 / 0.2139	-0.014330 / -0.088345 / 0.9301	-0.108182 / -0.670818 / 0.5064	0.679609 / 5.710927 / 0.0000	-0.786822 / -7.858792 / 0.0000	0.102244 / 0.633593 / 0.5301	0.170320 / 1.065492 / 0.2934	0.649066 / 5.259553 / 0.0000	1.000000 / ---- / ----		
TOPSHARE	0.336434 / 2.202296 / 0.0338	0.592427 / 4.533091 / 0.0001	0.344088 / 2.259043 / 0.0297	-0.424774 / -2.892395 / 0.0063	0.069690 / 0.430647 / 0.6692	-0.402539 / -2.710740 / 0.0100	0.607409 / 4.713452 / 0.0000	0.277586 / 1.781156 / 0.0829	0.550906 / 4.069193 / 0.0002	-0.947472 / -18.26119 / 0.0000	-0.549812 / -4.057604 / 0.0002	1.000000 / ---- / ----	
TOPSHARE_2	0.428035 / 2.919555 / 0.0059	0.613042 / 4.783294 / 0.0000	0.441109 / 3.029881 / 0.0044	-0.474312 / -3.321213 / 0.0020	0.019154 / 0.118096 / 0.9066	-0.359113 / -2.371942 / 0.0229	0.579357 / 4.381683 / 0.0001	0.195813 / 1.230900 / 0.2259	0.485512 / 3.423466 / 0.0015	-0.890295 / -12.05168 / 0.0000	-0.516154 / -3.714885 / 0.0007	0.985943 / 36.37580 / 0.0000	1.000000 / ---- / ----

Regression Results

Impact on Tobin's Q Ratio

There is a significant negative relationship between percentage of shares held by the largest shareholder and Tobin's Q ratio. Aggregate percentage of shares held by the second to fifth large shareholders also indicates a significant negative relationship with Tobin's Q ratio. Results demonstrate an insignificant positive relationship between percentage of directors' shareholding and Tobin's Q ratio. Directors' remuneration, Board size, CEO duality also positively correlated with Tobin's Q ratio

Table 3. Regression Model 1

Dependent Variable: TQ Method: Least Squares				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	47585.52	9876.107	4.818247	0.0000
TOPSHARE	-103249.4	26771.44	-3.856697	0.0006
TOPSHARE_2	72784.36	16091.85	4.523057	0.0001
SHARE_25	-43093.11	11727.39	-3.674571	0.0010
DIR_SHARE	613.3101	3392.920	0.180762	0.8578
DIR_REM	74174.91	52648.16	1.408879	0.1695
LNBOD	1125.737	1596.650	0.705062	0.4864
SEP_CAP	392.2972	2454.537	0.159825	0.8741
NONEX	-3651.249	2340.989	-1.559704	0.1297
LNTA	-389.9093	298.4833	-1.306302	0.2017
GEARING	9.245060	7.936893	1.164821	0.2536
R-squared	0.717425	Mean dependent var		1839.228
Adjusted R-squared	0.619985	S.D. dependent var		2531.152
S.E. of regression	1560.337	Akaike info criterion		17.77161
Sum squared resid	70604915	Schwarz criterion		18.23605
Log likelihood	-344.4322	Hannan-Quinn criter.		17.93954
F-statistic	7.362762	Durbin-Watson stat		1.550793
Prob(F-statistic)	0.000011			

Impact on Market value

Percentage of shares held by the largest shareholder, aggregate percentage of shares held by the second to fifth large shareholders and number of non-executive directors in the board indicate an inverse relationship with the market value.

Directors' shareholding and directors' remuneration are positively correlated with market value, while board size is significantly positively associated with market value. CEO duality shows significant negative relationship with market value of the firm.

Table 4. Regression Model 2

Dependent Variable: LNMV				
Method: Least Squares				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	13.76857	4.938528	2.787992	0.0093
TOPSHARE	-7.139638	13.38701	-0.533326	0.5979
TOPSHARE_2	9.738596	8.046699	1.210260	0.2360
SHARE_25	-9.167397	5.864257	-1.563267	0.1288
DIR_SHARE	0.263669	1.696623	0.155408	0.8776
DIR_REM	35.78716	26.32661	1.359353	0.1845
LNBOD	3.280515	0.798402	4.108852	0.0003
SEP_CAP	-4.347644	1.227387	-3.542197	0.0014
NONEX	-0.768502	1.170607	-0.656499	0.5167
LNTA	0.528566	0.149256	3.541338	0.0014
GEARING	0.005111	0.003969	1.287852	0.2080
R-squared	0.946519	Mean dependent var		21.78284
Adjusted R-squared	0.928078	S.D. dependent var		2.909369
S.E. of regression	0.780244	Akaike info criterion		2.569995
Sum squared resid	17.65462	Schwarz criterion		3.034437
Log likelihood	-40.39990	Hannan-Quinn criter.		2.737923
F-statistic	51.32528	Durbin-Watson stat		1.891719
Prob(F-statistic)	0.000000			

Impact on Market to Book Value

In line with the above models, Percentage of shares held by the largest shareholder and aggregate percentage of shares held by the second to fifth large shareholders are significantly negatively related with Market to Book Value. Directors' shareholding, Directors' remuneration, Board size and CEO duality positively correlated with Market to Book value.

Table 5. Regression Model 3

Dependent Variable: MTBV				
Method: Least Squares				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	114.7763	24.81198	4.625844	0.0001
TOPSHARE	-255.7302	67.25853	-3.802197	0.0007
TOPSHARE_2	184.4660	40.42794	4.562834	0.0001
SHARE_25	-96.78788	29.46299	-3.285066	0.0027
DIR_SHARE	1.853156	8.524114	0.217402	0.8294
DIR_REM	193.2884	132.2692	1.461326	0.1547
LNBOD	0.872950	4.011301	0.217623	0.8292
SEP_CAP	2.262085	6.166592	0.366829	0.7164
NONEX	-10.06396	5.881322	-1.711173	0.0977
LNTA	-0.813921	0.749887	-1.085393	0.2867
GEARING	0.026419	0.019940	1.324926	0.1955
R-squared	0.725450	Mean dependent var		4.168392

Adjusted R-squared	0.630778	S.D. dependent var	6.451341
S.E. of regression	3.920072	Akaike info criterion	5.798514
Sum squared resid	445.6420	Schwarz criterion	6.262955
Log likelihood	-104.9703	Hannan-Quinn criter.	5.966441
F-statistic	7.662738	Durbin-Watson stat	1.517935
Prob(F-statistic)	0.000008		

Conclusion

In this study, the impact of corporate governance mechanisms on firm value was examined. Firms of which high percentage of shares held by the largest shareholder experience a reduction of their share value. Firms with high aggregate percentage of shares held by the second to fifth large shareholders also experience the same results. Firms that have higher director's shareholding, high directors' remuneration and large board size experiencing an increase in the market value.

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