

CORPORATE GOVERNANCE IN DETERMINING THE STOCK PRICE IN COLOMBO STOCK EXCHANGE

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Abstract- The impact of corporate governance on firm performance has become a topic of conversation. However there is less attention on how it impacts the share price. The purpose of the study is to determine the impact of corporate governance on the share price of companies listed in the Colombo Stock Exchange (CSE). The research designs, descriptive analysis, regression analysis and correlation analysis, were used in this study and it the period of financial year of 2015–16. A sample of 64 companies was chosen as representative of the population out of 296 companies listed on the Colombo Stock Exchange (CSE), excluding banking and finance sector and data was collected using secondary method. Compliance level of corporate governance have been measured by utilizing self-constructed Corporate Governance Index (CG Index) with five sub-indexes namely Board Structure (BS), CEO and Management(CEO), Transparency and Disclosure (TR), Investor Relation(IV) and CSR Disclosure(CSR). The index contains 40 criteria under the above Sub-Indexes. The study found that there is no significant relationship between overall CG index and the share price. However, transparency demonstrated a significant negative impact on the share price. When the overall sample was clustered in to sub samples as high, medium and low according to firm size, the medium sample demonstrated a significant positive relationship between CG index and the share price. The important key finding that was supported with enough evidence to show lowering the firm size the Board Structure (BS) and Investor Relation (IV) is significant to increase the share price. Unexpectedly Transparency (TR) demonstrated a significant negative impact for smaller firms. Further, it was found that the corporate governance practices generated a long term impact on share price since the same impact can be found in lead share price also.

Keywords- Corporate Governance, CG Index, Share Price

I. INTRODUCTION

Corporate governance has now become the corner stone of corporate sector development (Sarkar & Sen 2012). With the scandals of business corporations recorded during the past years there is an increasing awareness on health of businesses, and it creates an increasing demand on code of best practices on business sector in developed and developing countries(Heenetigala 2011).Corporate governance is a mechanism in which corporation is rationalized, directed, controlled and monitored and the reason for existence of organization is also defines by corporate governance (Dissabandara 2014).Corporate governance provides solutions to align the interest of management to benefit the shareholders of the business and ensures the protection of them. (Javaid and Saboor 2015). The main theoretical argument of this study is based on this agency theory. Rational for this argument suggests that the firms which follow good governance practices in their company conduct, will be benefited by increasing the share price directly by increasing the demand for shares and indirectly by increasing the firm performance. This paper is an attempt to study whether the share price of company gets affected due to corporate governance practices and disclosure.

A.

A. Problem Statement

To compete with dynamic business world, it is required to adapt corporate governance practices and there

should be a demand from investors to follow those provisions in corporations. This demand should be included in the share price. This study agrees that the share price is dependent on so many factors, and the research question of this study is: Does the corporate governance of the firms affect the share price?

B.

A. Objective of The Study

The main objective of this study is to determine the relationship between corporate governance and the share price of companies listed on the CSE.

The sub objective of this paper is to investigate whether the firm size influence the level of governance and stock price.

B. Research Hypothesis

H1: There is a relationship between corporate governance and share price of a firm.

II. LITERATURE REVIEW

There are enough resources that found the relationship between corporate governance and firm performance. Further it affects not only performance but also the survival of the company (Javaid and Saboor 2015). Khan (2016) argued that when investors feels protected they are motivated to participate in the capital market activities more actively, and they are willing to pay a premium for such kind of firms. Companies with better corporate governance structures can earn considerably higher rates of return in the market (Sarkar & Sen 2012). Subsequent paper Ngoc et al. (2013) found that corporate governance has 63.8 percent impact on stock prices and Adjusted R squared value is 0.572 which is close to R squared value. After evaluating almost all the criteria separately such as independency of board and etc., Bistro and Lace (2011) found that most influential factors on the stock performance is information disclosure quality. When reviewing the writings of Gompers et al. (2003) it has been proved that firms with poor shareholder rights have poorly performed in stock market. It has been argued that if governance affect firm performance positively, and if this relationship is fully incorporated by the market, then stock price should adjust. However, it has been realized that it is not immediately incorporated by the market (Drobetz et al. 2003). The difference in

firm specific governance differ the agency costs, and these differences are not incorporated in to stock price at secondary market at the very beginning, but later on with performance or operation statics investors realize differences of these governance and decide to pay either a premium or take discount on the current stock price and ultimately effects share price (Drobetz et al 2003). In other view weak governance leads to poor management and ultimately it lowers the performance (Core et al 2006). As a result, analysts and the market, surprised with weaker performance, and stock price falls (Core et al 2006). However contrasting to the above findings, Owala (2010) discovered that there was no significant difference in stock returns between the good and weak governance portfolios when compared to differences in stock returns (Owala 2010). Later the same kind of study in Egypt found that firms with strong corporate governance have a significant impact on stock prices while no significant impact on trade volume (Mohamed and Elewa 2016).

C. Justification of Research Gap

Plenty of studies and researches have been done on corporate governance both in developed and developing countries. Most of the studies have focused on CG and firm performance, or CG and CSR reporting. In existing literature there is not much evidence to support the relationship between stock prices and corporate governance especially in the case of developing countries. Further the findings contradicted. Most researchers limit to a narrow framework, with the top element of CG; the board of directors when evaluating corporate governance. The intention of the current study is to cover all the aspirations of corporate governance that is directing, controlling, communicating and social character. Therefore, there is a requirement to measure the corporate governance in a broader view and find the impact from governance to share price.

III. METHODOLOGY

A. Conceptualization

Based on the review of literature and from the evidence of empirical studies the conceptual framework was developed as depicted in Figure 1. It indicates governance Index, based on the agency theory and stakeholder theory. It covers the directing by the board structure, controlled by CEO & the management team and communication by

transparency and disclosure, in line with investor relations which will account the agency theory while the CSR to add the stakeholder theory.

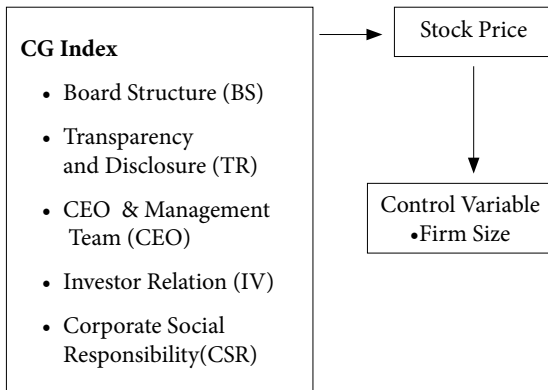


Figure 1. Conceptual Framework
Source: Researcher Developed (2018)

B. Operationalization

The research utilizes a self-constructed CG index as the independent variable by following a number of various CG literature and guidelines of Corporate Governance Code of Best Practices Sri Lanka 2013. The CG index consists of 40 items under given separate areas and it contains weights according to expert opinion. Corporate Governance indexing has been performed using the annual reports of selected listed companies to assess the level of Corporate Governance of each company. Refer Appendix-Table 01 to see the criteria of index. Share Price is considered as a dependent variable and the study incorporated close share price¹ and lead share price² with the intention to find out the timely impact. Details of each variable are provided in Appendix-Table 02. Firm Size is taken as control variable and the study is performed in two steps. First the overall sample is taken in to consideration and as a second step to fulfil the second objective of the paper, the overall sample is divided in to sub samples according to size and regression analysis done separately for each sub category to find whether there is any impact over the share price when the size is controlled.

¹ The share price at the end of the financial year (2016/3/31 or 2016/12/31)

² The average share price of the following year (Average of beginning and the end share price of 2017)

C. Population and Study Sample

Population consists of all public listed companies which are registered in the Colombo Stock Exchange. The study sample consists of at least one listed company from each business sector. Bank finance and insurance sector were considered as a special type of company that require several other mandatory requirements in relating to CG. Therefore, considering it as an exceptional situation which can mislead the results, bank, finance and insurance sector were reasonably be excluded from the sample. Expected sample size is 64 public listed companies representing all business sectors excluding the banking and finance sector. This sample counts about 28 percent of the total population. Sample was selected according to the sector wise market capitalization. Top few companies were selected on equal proportion of 28 percent.

D. Collection of Data

Data collection was done according to the secondary source through annual reports of listed companies of financial year 2015–16 which were provided in the website. The share price was collected through CSE publication in electronic form.

IV. DATA ANALYSIS & DISCUSSION

The research utilizes a self-constructed index, and should ensure the validity and reliability. Content and consistency are crucial for the validity of the index. When considering the content, the index covers five wider governance elements under four major areas namely direct, control, communication and social character. The construction of index was guided by CG literature and regulations of best practices issued as joint initiative by Institute of Chartered Accountants of Sri Lanka (ICASL) and the Securities and Exchange Commission of Sri Lanka (SEC) with the Colombo Stock Exchange, to cover all important areas. The weights for each sub index have been decided using expert opinion which ensure the comparative importance of each index. Using this CG index, the level of corporate governance of listed companies can be measured in more advanced way. In order to find out the relationship between CG Index and stock price the correlation

analysis had been performed. By performing the regression analysis the overall model validity, degree of explanatory power and significant variables and mainly the impact of independent variables was identified.

A. Descriptive Analysis

The CG Score has been designed by allocating 20 percent weight to CSR which is to represent the ethical character and board consideration on responsibility towards society based on stakeholder theory. The rest of the 80 percent of the CG score is more towards agency theory which is more favor on shareholder. Descriptive statistics demonstrated that except CSR all other Sub indexes are averagely at higher level. Refer Table 03 for details. Which means that Sri Lankan company social character is considerably at lower level. This suggest to encourage CSR in company conduct for better governance. However, the overall CG is at higher level which is more than 76 percent. It may due to mandatory requirements which should be followed by the listed companies in Sri Lanka. Further the companies are focusing to come in to an international standard to attract foreign investments. Internationalization of companies had redefined corporate conduct aligned with global investor interests and had emerged standardization in corporate governance (Heenetigala 2011).

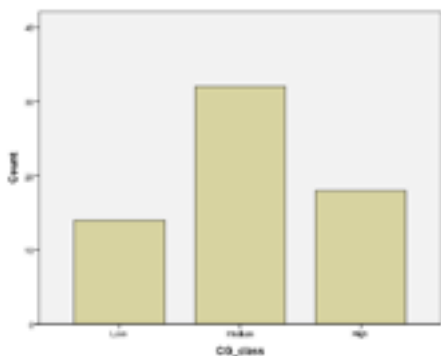


Figure 2. Firm classification according to CG class.

Source: Calculated using researcher developed CG Index based on Annual Reports (2015-16)

Note: CG class have been classified as Low, Medium, and High according to the deviance from the mean value. Low CG class represents the range 45 percent to 65 percent and Medium class represents the range 65 percent to 87 percent and above 87 percent is considered as high CG class.

J. The Figure 2 demonstrated that more than 76 percent of companies are clustered in high CG class. And Table 4 also demonstrate that the sample shows 67 percent of companies out of total selected companies have disclosed more than the mean level of CG index. Therefore it can be denoted that Sri Lankan firms have identified the importance of good governance practices.

B. Correlation Analysis

The Table 5 presents Spearman’s Correlation for all the variables in the study. It examines the association between CG index and share price and the strength of relationship. It was found that the findings do not support to conclude that there is a relationship between CG index and share price. Only transparency demonstrated a significant negative impact on the share price.

A. Regression Analysis

The study aims to answer its main research question which is whether better governed firms (high level of compliance and disclosure with CG standards) tend to have higher share price than those of poorly governed counterparts (lower level of compliance and disclosure with CG standards). The regression analysis was performed to find out the relationship between CG Index and share price. It was analyzed using two models. First to find whether overall CG index effects on the share price and the model two was an extension of model one, which divided the overall CG Index in to Sub Indexes and found whether those Sub Indexes effect the share price. Therefore, the study was performed in two steps as overall sample and sub samples.

The Share prices were not normally distributed and Quadratic relationship was identified among the share price and CG Index. The study intended to build a linear relationship between the CG index and share price. A linear relationship can be built by converting the share price in to log form. It makes share price a normal distribution. Further R2 value was increased by converting the CG index in to log form for the linear regression model. Therefore, for further analysis of the CG Index, Sub-Indexes and the share price were converted in to Log form.

Table 05. Correlation analysis of dependent and independent variables

	Log_BS	Log_CEO	Log_IV	Log_TR	Log_CSR	Log_CG	Log_Cprice	Log_Lprice
Log_BS	1							
Log_CEO	.634**	1						
Log_IV	.253*	.413*	1					
Log_TR	.312*	.520*	.633**	1				
Log_CSR	.351**	.237	.018	.297*	1			
Log_CG	.833**	.740**	.511**	.605**	.634**	1		
Log_Cprice	.226	-.005	-.226	.246	.178	.121	1	
Log_Lprice	.231	-.001	-.233	-.246*	.178	.123	.998**	1

Source: Calculated using researcher developed index based on annual reports and CSE publications (2015-16)

$$\text{LOG_SPRICEI} = B_0 + B_1 \text{LOG_CGII} \dots \dots \dots (1)$$

$$\text{LOG_SPRICEI} = B_0 + B_1 \text{LOG_BODI} + B_2 \text{LOG_CEOI} + B_3 \text{LOG_TRI} + B_5 \text{LOG_IR} + B_5 \text{LOG_CSRI} \dots \dots \dots (2)$$

N. Where,

O. SPRICE = Share price

P. β = Parameters to be estimated

Q. i = Listed Company

R.CGI = Aggregate score of Corporate Governance Index as a percentage

S.BOD = score of sub-index _ board structure

T.CEO = score of sub index 2_ CEO and Management

U.IV = score of sub index 3_ Investor Relation

V.TR = score of sub index 4 _Transparency & disclosure

W.CSR = score of sub index 5 _Corporate Social Responsibility

Note: All the dependent and independent variables were converted in to log form.

X. Table 6 and 7 present the findings of multivariate regression which depict the impact of CG Index to the share price using two models separately. F-statistics is much lower and insignificant since the model contains a single independent variable, moreover the share price is not solely determined by Corporate Governance. This study only focused to build a relationship with CG and share price, and not the determinants of share price. Therefore, F-Statistic

Table 6. Findings of regression for CG index and Share price for overall sample

Model 01

Independent Variable: LOG_CG Index

Dependent Variable	Relationship	Statistical significance	Conclusion	R2
Log-Close share price	1.032	Insignificant	Do not support	1.50 percent
Log-Lag share price	1.022	Insignificant	Do not support	1.50 percent

*** Correlation is significant at the 0.01 level (2-tailed).

** Correlation is significant at the 0.05 level (2-tailed).

* Correlation is significant at the 0.10 level (2-tailed).

Source: Calculated on researcher developed CG Index based on Annual Reports 2015/16 and CSE publication

Table 7. Regression of CG Sub Indexes and Share price for overall sample

Model 02

Dependent variable: LOG_Close Share Price

Independent Variables	Relationship	Statistical significance	Conclusion	R2
Log_BS	1.457	Insignificant	Do not support	
Log_CEO	-0.025	Insignificant	Do not support	
Log_IV	-0.622	Insignificant	Do not support	
Log_TR	-4.048	Significant*	Support	18.20 percent
Log_CSR	0.465	Insignificant	Do not support	

was intentionally ignored to consider the model validity. It was hypothesized that the CG index and each and every sub elements of CG Index has positive impact on share price. By performing the regression analysis for overall sample it was found that there is no significant impact from CG index to current share price or lead share price. This finding is in line with Owala(2010), but contradicted with other researchers findings. Further model 02 was performed to find out the impact of Sub Indexes.

The Sub Indexes also do not support the hypothesis, however only transparency had demonstrated a significant negative impact. When transparency increases the company disclosure level is high. The disclosure may effect positively or negatively for investors according to the information revealed. This

may be due to the nature of information revealed this year. As per Bistрова and Lace (2011) the most influential factors on the stock performance is information disclosure quality. The current study also is in line with that argument. The R2 showed a slight increase when comparing the current CG practice with next year average share price (Lead Price). It showed the long term impact from CG. However, the intended results were not found by overall sample. For deeper analysis the overall sample was clustered in to three sub samples as high, medium and low according to the firm size.

The results derived are provided in Table 8. CG is not significant for low and high firm size clusters to determine share price. CG level had become a ground factor over firm size for these two sub samples to

Dependent variable: LOG_Lead Share Price

Independent Variables	Relationship	Statistical significance	Conclusion	R2
Log_BS	1.441	Insignificant	Do not support	
Log_CEO	0.016	Insignificant	Do not support	
Log_IV	-0.694	Insignificant	Do not support	
Log_TR	-3.866	Significant*	Support	18.60 percent
Log_CSR	0.443	Insignificant	Do not support	

*** Significant at the 0.01 level (2-tailed), **Significant at the 0.05 level (2-tailed), * Significant at the 0.10 level (2-tailed).

Source: Calculated on researcher developed CG Index based on Annual Reports 2015/16 and CSE publication

Table 8. Regression for CG Index and Share price for sub samples

Firm Size	Low		Medium		High	
Dependent Variable	Log_CPrice	Log_LPrice	Log_CPrice	Log_LPrice	Log_CPrice	Log_LPrice
Constant	6.128	5.799	-2.366	-2.627	5.401	5.098
Log_CG	-2.293	-2.274	2.180*	2.165*	-1.787	-1.785
R2	18.80 percent	19 percent	6.10 percent	6.40 percent	2.90 percent	2.90 percent

Note: The low size is representing total assets range below 45,197,548.28 and medium size represent the total asset range of 45,197,549 to 17,080,310,671 and above had been considered as high size firms.

N (Low = 6, Medium=45, High=13)

Source: Calculated on researcher developed CG Index based on Annual Reports 2015/16 and CSE publication

determine the share price. The overall CG does not act as hypothesized, may be due to two extremes of companies. Medium size firms demonstrated significant positive relationship as intended. Most of listed companies are included in medium size cluster (70 percent). Therefore it can be generalized that the share price is affected by CG Index with enough evidence under 10 percent significant level. When the CG Index is sub divided, using the model two the outcomes demonstrated an important finding in low size firms. For detail refer to Table 9.

Board structure (BS) and investor relation (IV) demonstrated a significant positive impact on both close share price and lead share price for smaller firms indicating the importance of those sub elements for smaller firms to be successful in the stock market. The CEO and Management (CEO) and Transparency (TR) showed a significant negative impact on the share price. It can be explained that the stock price had declined by decreasing the demand on shares due to the nature of information disclosed by the companies. As previously mentioned overall CG Index had significant effects on

Table 9. Regression for CG Sub Indexes and Share price for sub samples

Firm Size	Low		Medium		High	
Dependent Variable	Log_CPrice	Log_LPrice	Log_CPrice	Log_LPrice	Log_CPrice	Log_LPrice
Constant	21.498	20.923	6.523	6.109	7.359	7.027
Log_BS	4.598*	4.555*	1.489	1.489	0	0
Log_CEO	-1.84	-1.804*	-0.2	-0.154	0.058	0.057
Log_IV	3.965**	3.898**	-0.739	-0.898	0.019	0.019
Log_TR	-16.126**	-15.906**	-3.289	-3.09	-0.12	-0.12
Log_CSR	-0.398	-0.405	0.47	0.444	-0.004	-0.004
R2	99.90	99.90	10.70	11.10	62.10	62.20

*** Correlation is significant at the 0.01 level (2-tailed).

** Correlation is significant at the 0.05 level (2-tailed).

* Correlation is significant at the 0.10 level (2-tailed).

Source: Calculated on researcher developed CG Index based on Annual Reports 2015/16 and CSE publication

both share prices for medium size sample, however Sub Indexes did not depict any significant impact over share price. When studying the High Size cluster number, the overall CG Index nor the sub-indexes of CG had demonstrated any significant relationship. It is obvious that investors are attracted to high asset base rather than other ground factors. An important observation can be found by holistically viewing the beta values of the outcomes and that is, the higher the firm size, lower the coefficients of the independent variables. It means that the impact of governance on share price had decreased when the size increased. It can be generalized since high size firms are well established in the market. Their share prices are less likely to change with governance elements. When compared the coefficients and R2 among current share price and lag share price the coefficients were lower and R2 was higher for lag share price. By this it can be identified that the current CG practice has a long term impact. When compared the R2 of the overall CG model, share price could be highly explained by the CG compliance in low size class which was about 20 percent and when the size increases the R2 tend to decrease. It also supports the view that when the size increases the CG matters less in determining the share price. A remarkable R2 was recorded in model two in lower size class which is 99 percent almost 100 percent indicating that the findings are more important. R2 of high size firms was more than 60 percent .It demonstrates the view that when the firm size is larger the corporate governance level is a ground factor over high assets base. When one excludes those two extremes high and low, it can be concluded that the CG index (CG compliance level) significantly effects share price positively. Since more than 70 percent of listed companies were medium size it can be generalized for most of the companies.

V. CONCLUSION

The main purpose of the study was to find out the relationship between CG compliance level and the share price and the results of the analysis is utilized to explain the importance of the corporate governance to perform well in the share market. For that a self-constructed CG index was built to measure the level of compliance consisting of 40 provisions with five sub-indexes and relevant weights. Utilizing the CG Index the level of CG compliance of the selected firms were assessed by considering the 2015–16 annual reports. The study found that there is no significant relationship between overall CG index and share price. However, transparency had

demonstrated a significant negative impact on share price. When the overall sample had clustered in to sub samples as high, medium and low the medium sample demonstrated a significant positive relationship between CG index and share price. Another key finding of the current research is that current governance practices highly impact the next year share price, implying that the results of current governance practices make long term results. The important finding that were supported with enough evidence is that, lower the firm size, specially Board Structure (BS) and Investor Relation (IV) is significant to increase the share price. Therefore, small size firms should consider more CG practices compared to large size firms since, when the firm size is lower, higher the impact of governance elements on share price. The other way round it had been found that when larger the firm size CG level becomes ground factor over larger asset base.

VI. FUTURE RESEARCH

The current study used binary coding but it is more accurate to measure the level of CG compliance in liquored scale. It will provide expected outcome if the extent of compliance is assessed by comparing financial and nonfinancial firms.

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