Impact of Corporate Governance on Performance of Banking Sector in Malaysia

Mahboubeh Bahreini* Mazlina Mat Zain[2]

1. Faculty of Management, Multimedia University, Jalan Multimedia, Cyberjaya 6300, Malaysia
2. Faculty of Management, Multimedia University, Jalan Multimedia, Cyberjaya 6300, Malaysia

* E-mail of the corresponding author: b_mahboubeh@yahoo.com

Abstract

The purpose of this paper is to examine the impact of corporate governance characteristics specially board of directors and audit committee on performance of Malaysian banking sector. In this study sample includes one set of original data, financial information was obtained from the annual reports of thirty banks in Malaysia in period of 2005-2009, and data analyzed by panel data model. Based on the finding in this research, it's appear that three out of six corporate governance characteristics variables were discussed in this study such as board size, audit committee size, and audit committee meeting have positive relationship with performance of bank. Percentage of independent non executive board of director and percentage of independent non executive audit committee members have negative correlation with performance of bank. The result show that corporate governance mechanisms do influence the bank performance, by referring to this result, we hope that banks try to implement the right corporate governance system and policies until they can reduce probability of failure and bankruptcy and can also increase reliability for investors and investments.

Keywords: Corporate governance, Board of director, Audit committee, Bank performance, Malaysia

1. Introduction

After financial crisis of (1997) in Asia, most of the Asian countries especially Malaysia was badly affected by this crisis. They tried to find the main reasons for this crisis which causes different opinions about the reason of this financial crisis. One of the most important reasons was lack of corporate governance practices in Malaysian banks and companies. There were some structural weaknesses in the banking sector during the crisis; the most important weakness and issue was weakness in corporate sector of banking institutions that leads to many losses and too much risk. From the samples of annual reports of some main banks in Malaysia such as Bank Negara Malaysia, we found out that the key issues in banking sectors are related to inefficacy in the corporate system during the financial crisis 1997 in Asia. As a result of this inefficiency there was no proper disclosure and transparency of financial information system. So, the accuracy of the financial statement was not clear for share holders and stakeholders, and bankruptcy in many large banks and companies made the investors to lack of confidence to invest. This lack of protection of investment was the result of poor corporate governance in this country, so companies tried to improve the corporate governance sectors such as improvements in the board of directors and Audit committee that is responsible for the accuracy of financial reports and statement and accountability of the company. Theses bankruptcies, not just in Malaysia, also in many large companies in other parts of the worlds such as HIH (the second largest insurance company) in Australia during 2002 caused a loss of investor confidence about the integrity of financial reports, so the liquidity of asset dropped and impacted the rate of return. This research study will try to examine corporate governance mechanisms on bank performances in Malaysia. Some elements that will be examine are audit committee structures including (audit size, audit meeting, audit independent members) and also board composition including (board size, board independent directors and percentage of female in board composition) along with bank performance for the period of five years (2005-2009) and the data was obtained from the annual reports of thirty banks.. The measurements for performances are return on equity and Tobin's Q. The result shows that board of directors and audit committee structures have impact on bank performance. Therefore, by improving the corporate governance, board of directors and audit committee standards and adoption of fairness, accountability, responsibility and transparency in running the banks, companies and organizations, investors have more trust and confidence about investing in Malaysia.

This paper is structured as follows, literature review on corporate governance and banking system, review of empirical studies on board of director and audit committee, we will have a discussion on development of hypotheses which includes the relationship between corporate governance and performance, the third section explains research methodology and data collection to satisfy the objective of this study, at the end results will be announce, then leading to a conclusion.

2. Literature review

2.1 Review of empirical studies

2.1.1 Board of Director

Board structure and effect of board on firm performance in one of the important debated problems in today's literature. According to an investigation by Lorsh & Lipton (1992) showed that there is an inverse link between board size and company value. They concluded that when board size is larger, problems will arise in group management and ability to process problems will increase and so they recommended restraining the membership of boards to ten members, by choosing a size of eight or nine. The study by Bryd & Hickman (1992) showed that boards with above 60% foreigner composition produced negative shareholders value effects. The boards' composition has variety of duties and responsibilities and so requires a variety set of talents to carry them out effectively. The study by Weisbach & Hermalin (1992) found that there is no important relation between composition of boards and performance. They argued that one good explanation is board composition does not simply matter, and also they supported their findings that there is no association between outside directors and company performance. In one survey by Yermak (1996, it was found that there is a negative relationship between board size and firm's value, in this study he chose a sample of 452 large manufactures in USA between 1984 and1991. Here, the firm value was represented by return on asset, Tobin's Q, and return on sales. This study also supported the study that was carried out by Lipton & Irosh in 1992 and Jensen in 1993. Based on the study by Mac (1998), he found that the percentage of outside directors have a small impact on the performance. This results may be understood because the companies in New Zealand are small and don't have overall size. Another similar study by peck and Conyon (2002) investigated the relationship between board size and firm performance. The company's performance was measured by ROE and they reached to this result that board size is negatively related to firm performance. They also suggested that the role of board should be a matter for resolution for agency problem. The study by Bhagat (2002) found negative relationship between independent non executive audit committee members with performance; decrease in audit committee independence led to increase in unusual accruals which say that there is no significant correlation between independent non executive of audit members and company performance. The study by Renee B. & Hamid Mehran (2004) investigated the association between board size and composition and firm performance. They used the sample of banking firms during 1959-1999 and found that banking firms with larger board size performed better as measured by Tobin's Q and also their findings suggested that constrains on board size in the banking industry may be counter–productive.

The recent study by David A. Carter, Frank D Souza, Betty J. Simkins and W.Gary Simpson, (2010) showed that there is no significant relationship between gender and ethnic diversity of the board and financial performance; the measurements were based on return on asset and Tobin's Q in this research and samples was just US corporations.

2.1.2 Audit Committee

Audit committee is a committee of the board of directors. One of the important roles of this committee is focused on all aspects of financial reporting. The committee should have at least three members or directors who are independent or non executive directors. Results from some audit committee meetings show that small groups of audit committee are better able to solve issues and problems and also dealing with issues more effectively. In every meeting of audit committee, other directors are allowed to attend even though they are not member of the audit committee. Evidence by Berlin & Bromilow (1993) showed that about 92% of audit committee meetings are held at least four times a year and about 76% are held more than four times in year. They also argued that in every meeting instead of discussion about financial report, they should cover all committee duties and responsibilities and also focus more on more efficient meetings and keep sufficient time for more discussions on key problems and issues. Study by Coopers & Lybrand (1994) showed that for having the right financial report, the audit committee must have three or four times meeting during a year. This frequency of meetings helps the committee to have more control on accountability of the company; usually the meetings are held every quarter. In a study by Raghunandan & McMullen (1996), empirical evidence showed that Audit committee can play an important role in improving the quality of financial statement and reporting. They also concluded that 40 percent of firms without financial statement problems held meetings three times yearly at least and twenty three firms with financial problems met more than four times yearly. In a survey by Raghunandan & McMullen (1996) on audit committee effectiveness between firms without and with financial reporting problems has found that problem firms were less likely to have audit committee. As determined in Malaysian code of corporate governance an Audit committee should have at least three members or directors; the majority of them are independent directors who have special duties and authority to do. Usually the chairman of the audit committee is an independent non executive director. One of the important mechanisms of corporate governance is the appointment of independent non executive directors. Their duties are to ensure that the financial statement of the company is properly done and another role and duty of the audit committee is to protect the interest of shareholders. So these roles sometimes need the committee to take on a probing attitude or manner, questioning management's decision. In a study by Dan & Vic Niker (2007), it showed that when the members of an audit committee are professional in three types of financial expertise such as accounting, finance and supervisory then the probability of accuracy of financial statements are high and the quality of results are more accurate.

3. Hypothesis Development and Research Methodology

Hypotheses are developed based on the research on literature review that is focused on board of directors and Audit committee structures such as board size, board independent, percentage of female in board structure, audit committee size, audit committee meeting and percentage of independent audit committee members. Based on the literature review which focused on the above mentioned Audit committee and board of director structures, a hypothesis model and a conceptual framework was developed to direct the study, involving explanations and definitions, measurement and selection of the variables. This part goes on to discuss the selection of samples, collection of data, and the statistical analysis was used in data analysis.

3.1 Hypothesis Development

Here, we have six hypotheses tested and discovered relationship between these hypotheses and bank performance.

3.1.1 Board Size

For best control and lead of a company there should be an effective board. Board should be inclusive of executive and non executive directors. Researches show that in a small board communication and coordination is more effective than large sized board and also decision making process needs less time and is more accurate. The studies by Lorsh and Lipton (1992), Jensen (1993), Peck, Conyon and Yermack,(1995), Phan, Yoshika and Trevor (2004) showed that there is a negative or inverse relationship between board size and performance. A study by Firstenberg & Malkeil (1994) showed that a board size by eight or fewer members have more focus on duties and also board and members have more participation and the results are more accurate. They concluded that when board size becomes bigger, problems in communication and coordination are more effectiveness because functions become low or decreased. In a study by Abdulah (2004), it revealed that the average number of board size in Malaysia is eight person and companies that want to be more effective prefer to select eight or nine member for board size.In some report by Yermack (1996), Wells and Eisenberg (1998), Rosenstain and Barnhat (1998) shows a negative relationship between board size and performance, in study by Yermack (1996) that analyzed about 452 large company in U.S.A between period of 1984 and 1991 shows inverse association between board size and firm performance, Base on these results the first hypothesis can be as follow;

Hypothesis 1

H1: performance of the bank is negatively related to the board size

3.1.2 Independent directors

Based on many literature reviews there are positive and negative relationship between company performance and independent director. In studies by Hickman & Bryd (1992), Lott & Karpoff (1993), Tery & Coles (1994), it showed that a positive relation between performance and independent directors. They added that the presence of outside directors in board structure have more effects on the decision making process which results in better decisions and shareholders have more safeguard of interest. On the other hand, Hickman & Bryd (1992), Mace (1998), Black & Bhagat (2004) found that there is no relation between company performance and independent directors. They argued that independent directors have the important role in the decision making process and it is not easy for outside directors to control the daily actions and operations of company. Also they believed that directors on the inside have more knowledge and better skills in developing the company and play a more effective and important role in running the business and developing strategies.

Hypothesis 2

H2: Performance of banks is positively related to the percentage of independent directors.

3.1.3 Audit Committee size

According to a study by Berlin & Bromlow (2005), it showed that when audit committee size is smaller, effectiveness of the audit committee is more and it helps the members of audit committee to solve and discuss issues more effectively.
Arguments supported by Lipton and Lorsh (1992), Trevor (2004), Jensen (1993) showed that problems in communication, solving of issues, coordination and decision making will increase when board size is larger. Here in this study, we want to investigate the effectiveness of audit committee on the performance of banks and where the majority members of audit committee are independent directors. By referring to hypothesis one that bigger board size is related to performance of firms due to diversity and larger size in business. Thus, we expect that there is a positive relationship between audit committee and performance of firms.

Hypothesis 3
H3: Performance of companies is positively and directly related to the audit committee size.

3.1.4 *Number of Meetings*
The audit committee meetings held for controlling both internal and external auditors. In every meeting, members should provide a summary of all actions. The duration of meetings is not important but the effectiveness and quality of every meeting is very important. Based on the literature review on Mc Mullen (1996), the number of meetings in problem companies is less common rather than meetings in companies that don't have problems. Usually meetings are held three or four times during one year, and in another study by Rubarsky & Pincus (1989), it showed that audit committee in larger companies have more oversee on the financial reporting process. By refer to the functions and responsibilities of audit committee members and also based on the findings of McMullen and Pincus, it was expected that the performance of bank is expected to have positive and direct relationship with number of audit committee meetings.

Hypothesis 4
H4; the performance of bank is expected to have positive and direct relationship with number of audit committee meetings.

3.1.5 Independent audit committee members
In the study by Tiras (2004), it showed that independence of members of this committee improved the quality of reports. He argued that reported earnings and stock returns when audit committee members are independent are lower.

Hypothesis 5
H5; performance of bank is negatively related with percentage of audit committee independent members.

3.1.6 Number of Female in board structure
The study by Gary Simpson (2010) showed that the number female in board composition did not have significant relationship on performance.

Hypothesis 6
H6: performance of bank is negatively related to number of female in board composition

3.2 Selection and measurement of variables (performance)
3.2.1 Dependent Variables
Using the panel approach (panel data model) for analysis data and considering the
Impacts of two dependent variables were used for performance measurement, includes (Return on equity, and Tobin's Q) on independent variables

3.3 Sample selection and data collection
The sample of banks consists of a random sample of 30 bank holding companies. The data was found from 150 annual reports during the period of 2005 to 2009. The annual report provided information on corporate governance, board of directors and audit committee. In addition some of the date was found from balance sheet of every bank and the expressed financial statement of each bank.
3.4 Conceptual framework

Board of director structures such as board size, board independent, number of female in board composition and Audit committee structures such as audit committee size, audit committee meeting, Independent audit committee members are investigated based on its relationship with bank performance. The returns on equity and Tobin's Q have been used as a measurement to bank performance. Total asset, total equity, leverage ratio and firm's age was used as control variables.

3.5 Data analysis

The results of this study achieved in two main statistics analyses including Descriptive analysis, regression analysis**.**

4. Results

The following results will be presented in two sections; the first part is the descriptive statistics and the second part is the Multivariate analysis. In this section, the results of the two models will be considered and also hypothesis testing is included in this part. This section will describe the key terms and characteristics of measurement of every variable. While this study have focuses on board of director characteristics such as board size, board independent, and percentage of female on board composition and also audit committee structure such as audit committee size, audit committee independent, and number of meeting as independent variables and, return on asset, return on equity and Tobin's Q are performance indicators which included to the regression analysis to provide a wider perspective on the association between corporate governance variables and performance.

Table 1- Provide descriptive statistics for all of the variables used in this study.

Descriptive statistic shows mean values in most of variables is above 2.50, this value gives a positive answer to objective of this research and indicate that corporate governance characteristics have importance role on the banks performance, and it conducted that banks should have excellent practice on improvement of corporate governance.

Table 1-Variable used in this study

Descriptive Statistic					
Variable	Minimum (Actual)	Maximum (Actual)	Mean	Standard Deviation	Median
ROE	-0.020	68.200	1.271	6.481	0.260
TQ	0.240	31.330	2.638	4.562	1.690
TA	5.000	12.000	7.352	1.216	7.000
TE	3.000	11.000	6.40	1.221	6.000
LR	0.000	1.000	0.747	0.281	0.910
FIRM'S AGE	4.000	77.000	20.241	15.977	15.000
AC SIZE	3.000	9.000	4.214	1.174	4.000
AC MEETING	2.000	30.000	7.676	5.550	5.000
AC INDEP	28.570	100.000	79.181	19.389	75.000
BOD INDEP	20.000	90.000	52.418	14.463	50.000
BOD SIZE	5.000	14.000	9.490	2.069	10.000
FEMALE	0.000	33.330	13.872	9.156	12.500

Remarks:

TQ= Tobin'sQ
ROE=Return on asset
ACIND=Audit committee independent

ACMEET=Audit committee meetings
ACSIZE= Audit committee size
BODIND=independent directors
FMALE=Percentage of female in board composition
FAGE=Firm's age
LR=leverage ratio
TA=Total asset
TE=Total equity

4.1 Multivariate Analysis

Regression analysis was used to test the impact of independent and control variables on the dependent variables. The regression performed between ROE dependent variables with audit committee and board of director structure as an independent variables and the third regression was performed between Tobin's Q as a dependent variable with audit committee and board of directors structure as an independent variables. Control variables in this research were total asset, total equity and leverage ratio, analysis was performed using Panel data model for evaluation of assumption.

MODLE 1 = **β0** + **β1** ACSIZE + **β2** ACMEET + **β3** ACIND + **β4** BODSIZE + **β5** BODIND + **β6** TA + **β7** TE + **β8** LR + **β9** FAGE + **β10** BODF
MODEL2 = **β0** + **β1** ACSIZE + **β2** ACMEET + **β3** ACIND + **β4** BODSIZE + **β5** BODIND + **β6** TA + **β7** TE + **β8** LR + **β9** FAGE + **β10** BODF

Hypotheses1

performance of the bank is negatively related to the board size.

Hypotheses2

Performance of banks is positively related to the percentage of independent board directors.

Hypotheses3

Performance of companies is positively and directly related to the audit committee size.

Hypotheses4

the performance of bank is expected to have positive and direct relationship with number of audit committee meetings.

Hypotheses5

performance of bank is negatively related with percentage of independent audit committee.

Hypotheses6

performance of bank is negatively related the number of female in board composition

4.2 Result of Model 1 (Hypotheses 1, 2, 3, 4, 5, 6)

By concern to table 2- the coefficient for board size is significant at the one percent level of significant and it's near to (0.03) so it doesn't support hypothesis 1and the direction is positive and the result is different by my predicted, this result say that there is positive relationship between board size and return on asset thus when the size is larger the return on equity is also bigger.

The result reported at table 5.5 Shows that the coefficient for percentage of independent board of director members is not significant at the five percent level of significant and it's about (0.09) so the result shows that there is no association between board non executive and return on equity. So the hypothesis 2 is rejected.

Hypothesis 3 indicate there is positive relationship between audit committee size with return on equity the level of significant is five percent and this variable is significant at (0.00). So the result strongly support hypothesis 3 and the direction is positive as predicted.

By concern to table 5.5 can conclude that there is significant relationship between number of audit committee meeting and return on equity, the coefficient for this variables is (0.03), so the result support hypothesis 4.

The result shows that the coefficient for audit committee independent is not significant, at the five percent level of significant and its (0.09). The result indicates there is not positive relationship between percentage of independent audit committee members and return on equity so the result support hypothesis 5.

By concern to finding there is no significant relation between the number of female in board composition and ROE, and there is negative relation between them, so the hypothesis 6 is accepted.

Table 2-Regression Results for Return on Equity

Variables	Coefficient	Std.E	T	Sig.
Constant	*5.005*	*8.533*	*0.586*	*0.5*
Control				
TA	0.767	0.863	0.889	0.3
TE	-2.405	0.815	-2.948	0.0
LR	-2.905	2.404	-1.208	0.2
FAGE	0.033	0.036	0.916	0.3
Experimental Variables				
AC SIZE	0.300	0.522	0.574	0.00
AC IND	0.003	0.032	0.118	0.09
AC MEE	-0.003	0.116	-0.028	0.03
BODSIZE	-0.740	0.719	-1.020	0.03
BODIND	0.003	0.040	0.095	0.09
FEMALE	-0.060	0.073	-0.86	0.30

R Square: .35
Adjusted R Square: .30
F-statistic: 2.17
Prob(F-statistic) : .019

Remarks: TQ= Tobin'sQ
ROE=Return on equity
ACIND=Audit committee independent
ACMEET=Audit committee meetings
ACSIZE= Audit committee size
BODIND=independent directors
FMALE=Percentage of female in board composition
FAGE=Firm's age
LR=leverage ratio
TA=Total asset
TE=Total equity
Std.E=Standard error
Sig=Significant
T=T-value

4.3 Result of Model 2 (Hypotheses 1, 2, 3, 4, 5, 6)

By concern to table 3- the coefficient for board size is significant at the one percent level of significant and it's near to (0.00) so it doesn't support hypothesis 1and the direction is positive and the result id different by my predicted, this result say that there is positive relationship between board size and Tobin's Q thus when the size is larger the return on equity is also bigger.

The result reported at table 5.6 Shows that the coefficient for percentage of independent board of director members is significant at the five percent level of significant and it's about (0.00) so the result shows that there is positive association between board non executive and Tobin's Q. So the hypothesis 2 is rejecting.

Hypothesis 3 indicates there is positive relationship between audit committee sizes with Tobin's Q the level of significant is five percent and this variable is significant at (0.05). So the result strongly support hypothesis 3 and

the direction is positive as predicted.
By concern to table 5.6 we can conclude that there is significant relationship between number of audit committee meeting and Tobin's Q, the coefficient for this variable is (0.05), so the result support hypothesis 4.The result shows that the coefficient for audit committee independent is not significant, at the five percent level of significant and its (0.4). The result indicates there is negative relationship between percentage of independent audit committee members and Tobin's Q .so the result support hypothesis 5.
By concern to finding there is significant relation between the number of female in board composition and Tobin's Q, and there is positive relation between them, so the hypothesis 6 is not accepted for this variable.

Table 3-Regression Results For Tobin's Q

Variables	Coefficient	Std.E	T	Sig.
Constant	*-9.635*	*4.238*	*-2.273*	*0.0246*
Control				
TA	1.968	0.428	4.589	0.00
TE	0.574	0.405	1.417	0.10
LR	-0.649	1.194	-0.543	0.50
FAGE	0.067	0.018	3.676	0.00
Experimental Variables				
AC SIZE	0.141	0.259	0.544	0.05
AC IND	0.032	0.016	2.014	0.40
AC MEE	-0.036	0.057	-0.633	0.05
BODSIZE	-1.089	0.357	-3.046	0.00
BODIND	0.019	0.020	0.946	0.00
FEMALE	0.069	0.036	1.921	0.05

R Square: .57
Adjusted R Square: .54
F-statistic: 16.55
Prob(F-statistic) : 0

Remarks: TQ= Tobin'sQ
ROE=Return on equity
ACIND=Audit committee independent
ACMEET=Audit committee meetings
ACSIZE= Audit committee size
BODIND=independent directors
FMALE=Percentage of female in board composition
FAGE=Firm's age
LR=leverage ratio
TA=Total asset
TE=Total equity
Std.E=Standard error
Sig=Significant
T=T-value

Table 4 :Pearson Correlation Coefficient for this study

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
TQ(1)	1.00												
ROE (2)	-.022**	1.00											
ROA (3)	-.023	.275	1.00										
AC IND (4)	.167	-.092	.022	1.00									
AC MEET(5)	-.209	.072	.167	-.010	1.00								
AC SIZE (6)	-.086	-.031	.029	-.176	-.109	1.00							
BOD IND (7)	-.122	-.015**	.004*	.019*	-.166	.277	1.00						
BOD SIZE (8)	-.292	.048	.044	-.410	.293	.245	.028	1.00					
FEMALE (9)	.142	-.189	-.069	.318	-.178	-.007	-.013	.245	1.00				
FAGE (10)	.336	.015	.018*	.142	.061	-.176	-.262	.057	-.065	1.00			
LR (11)	.128	.009	-.093	.135	.066	.025*	-.105	.028*	-.109	.293	1.00		
TA(12)	.652	-.177	-.162	.188	-.055	.160	-.244	-.109	-.100	.290	.324	1.00	
TE (13)	.612	-.307	-.152	.163	-.203	.027*	-.029	-.183	.057	.148	-.091	.737	1.00

Correlation is significant at p<0.05 level** * Correlation is significant at p<-0.01 level**

Remarks: TQ= Tobin'sQ
ROE=Return on equity
ACIND=Audit committee independent
ACMEET=Audit committee meetings
ACSIZE= Audit committee size
BODIND=independent directors
FMALE=Percentage of female in board composition
FAGE=Firm's age
LR=leverage ratio
TA=Total asset
TE=Total equity
Std.E=Standard error
Sig=Significant
T=T-value

5. Conclusion

By concern to the summary of findings in this research, it was appeared that three out of six corporate governance characteristics variables that discussed in this study such as board size, audit committee size, audit committee meeting have positive relationship with performance of bank and percentage of independent non executive board of director and percentage of independent non executive audit committee members have negative correlation with performance of bank, the result shows that corporate governance mechanisms influence the bank performance, by concern to this result we hope that banks tries to implement right corporate governance system and policies until they can reduce probability of failure and bankruptcy and also can increase the reliability of investments and the investor's confidence.

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