
Board Structure and Financial Performance: A study of state-owned service enterprises in Ethiopia

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Abstract

Corporate governance is concerned with holding the balance between economic and social goals, and between individual and communal goals. Different sources indicated that despite extensive privatization over the past 20 years, state-owned enterprises (SOEs) remain important in many developing countries and globally SOEs account for 20 percent of investment, 5 percent of employment, and up to 40 percent of output in some countries. Ethiopia as developing country is invested in most strategic sectors that can assist the ongoing development by attracting private investment. Studying their corporate governance and financial performance is very critical for sustainable economic performance of the country. Corporate governance is there to encourage efficient use of resources and equally to require accountability for the stewardship of those resources. This study indicated the relationship between the most common corporate governance variables included in board structure of board size, board composition, board committee and board leadership structure and the accounting based performance measures of ROA and ROE for the year 2000 to 2014 in state-owned service enterprises in Ethiopia. The dataset is panel type and the descriptive statistics, ANOVA, correlation and regression is analyzed using stata software package. The findings showed, separate leadership, percentage of non-executive directors and board size has significant relationship with both ROA and ROE performance variables. On the other hand, board committee has significant relationship with ROE but not with ROA. Therefore, this study concludes that there is a positive relationship between corporate governance variable of board structure and financial performance but the relationship between the financial performance and corporate governance indicators mentioned above remains mixed.

Keyword: Board structure, corporate governance, Ethiopia, financial performance and state-owned service enterprises.

Introduction

Corporate governance has become a popular discussion topic in developed and developing countries. The widely held view that corporate governance determines firm performance and protects the interests of shareholders has led to increasing global attention. However, the way in which corporate governance is organized differs between countries, depending on the economic, political and social contexts. Firms in developed countries have dispersed shareholders and operate within stable political and financial systems, well developed regulatory frameworks and effective corporate governance practices (Kumudini, 2011). The reverse is true for developing countries.

Corporate governance has become an issue of global significance. The improvement of corporate governance practices is widely recognized as one of the essential elements in strengthening the foundation for the long-term economic performance of countries and corporations (Ibrahim et al., 2010). It has received new urgency because of global financial crisis and major corporate failures that shock major financial centers of the globe (Imam & Malik, 2007). Hence, corporate governance has become an important factor in managing organizations in the current global and complex environment. Corporate governance can be defined as a frame work that protect stakeholders rights by illustrating an effective board of directors, efficient internal control and audit in addition to reliable financial reporting and disclosure (Hassn, n.d.). Melvin and Hirt (2005) described corporate governance as referring to corporate decision-making and control, particularly the structure of the board and its working procedures.

Opportunities and competitive threats created by the global economy make instituting good corporate governance practices key to developing a strategy for the company to prosper. Improving corporate governance allows companies to attract greater investment at lower cost, strengthens corporate strategy and its implementation, clarifies accountability, enhances shareholder protection, and helps to attract and retain quality employees. This is true not only for large publicly-listed multinationals but for other types of companies as well. For controlling shareholders, corporate governance clarifies roles and improves accountability, enhances senior executives' professionalization, and increases company value. Crucially, for society as a whole, corporate governance minimizes the occurrence of corruption, reduces the risk of devastating systemic crises, and improves productivity (John, Andrew and Anna, 2013)

Corporate governance is the set of processes, customs, policies, laws and institutions affecting the way a company is directed, administered or controlled and defines the relationships among the various stakeholders. In the real world, all enterprises, irrespective of size and ownership structure, need some principles and guide to conduct a business. However, firms of different size and ownership structures (small size firms, share companies, government owned companies, commercial banks and microfinance institutions) may require different sets of complexities of

governance (Tilahun and Kibre 2007). Board structure is the indicators of corporate governance and the importance of good corporate governance for overall financial performance is stated below diagrammatically for better understanding. Board structure as corporate governance variable plays a vital role in monitoring of the overall organizational activities to promote transparency and enhance sustainable profitability.

Corporate governance is becoming the great concern of practitioners, academicians and political leaders due to its importance in maintaining healthy economic development. Good corporate governance plays a vital role in the smooth movement of resources in working units and this makes management, boards, investors and stakeholders to have mutual understanding on the objectives of the companies.

1. Objective and Methodology

The objective of this paper is to examine the relationship between board structure variables of board size, board composition, and board committee and board leadership on financial performance. Board size is measured by total board members sitting in the board meeting; board composition indicated the proportion of independent or non-executive directors from total directors. Similarly, board committee measures the availability of audit, remuneration and nomination committees in the board and board leadership measures the separation of board chairman and chief executive officer (CEO).total six state-owned service enterprises are selected due to their strategic importance to the economy and mostly secondary data is collected from 2000 to 2014 from different sources.

2. Result and Discussion

This paper shows the results of the data collected from the sample state-owned service enterprises and clearly indicated the relationship between board structure as corporate governance variable and financial performance variables of ROA and ROE. Variables included under board structure of in this study are board size, board composition (ratio of non- executive directors in the board), board committees (presence of audit, remuneration and nomination committees), and board leadership structure (separate and combined leadership) corporate governance variables and accounting measures of financial performance of ROA and ROE.

3.1. Summary descriptive statistics of variables

The table 3.1 below displays the summary of descriptive statistics like mean, standard deviation, minimum and maximum of the value of all the variables included in the study in the study.

Table 3.1

Summary of statistical results of the study

Variables	Observations				
		Mean	Std. Dev.	MIN	Max
Return on Asset (%)	90	4.326	4.54	.31	18.5
Return on Equity (%)	90	16.97	16.67	1.5	77.71
Board Composition (%)	90	0.47	.1393712	.2	.7
Board committee	90	0.59	.4947919	0	1
Board size	90	7.7	2.255829	4	12
Separate leadership structure (%)	90	.8222222	.3844675	0	1

Source: STATA summary of descriptive statistics, 2017

3.1.1. Analysis of Board Leadership structure

As shown in table 3.1 above summary of statistics, the mean results of leadership structure for the year 2000 to 2014 shows that all of the state owned service enterprises under this study are separated the executive and monitoring role of directors (in 2014) but cumulative result from 2000 to 2014 is 82%. This indicates the sample organizations are aware of the advantage of separate leadership roles on the performance of their business affairs. According to different researchers and best practices of corporate governance guidelines separating the position of chairman and CEO are complying with the code of best practice recommendations like issued by Cadbury 1992 and is stated as follows. A given the importance and particular nature of the chairman's role, it should in principle be separate from that of the chief executive. If the two roles are combined in one person, it represents a considerable concentration of power. They recommended, therefore, that there should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board. This shows the importance of separating CEO and board chairman and all the sample state-owned service enterprises are going in line with the recommendation of best practices. This is also supported by different theoretical and empirical literatures. Agency theory clearly argued the importance of separating CEO and board chairman to make businesses more accountable and to run in transparent manner.

3.1.2. Analysis of Board Composition

Board composition shows the proportion of external (non-executive) to total directors sitting in the board room. The number of non-executive directors ranged from a minimum of 20% to

a maximum 70% and average percentage of non-executive to total board members is 47%, and this is below the recommendation of best practices and by different scholars.

Furthermore, the number of non-executive directors on the board ranged from 4 to 12 and the average number of non-executive directors was 8 for the period 2000 to 2014. The advantage of non-executive directors also stated in the recommendation by Cadbury (2000) as follows. Non-executive directors should bring an independent judgment to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct. The committee recommend that the calibre and number of non-executive directors on a board should be such that their views will carry significant weight in the board's decisions.

3.1.3. Analysis of Board Committee

Regarding the availability of board committees, as per the recommendations of best practices and from different scholars there must be committees to control the overall aspect of companies. The most common committees that are expected to present in good established board environment is remuneration, audit and nomination committees were recommended by code of best practices of Cadbury committees. The mean value of the availability of these members shows 59% for the last 15 years. The sample companies under study had audit, remuneration and/or nomination committees and this is expected to some extent to promote the overall internal controls. The availability of board committees to encourage for establishing of good corporate governance is stated below by Cadbury committee's recommendations and other empirical studies is clearly explained as follows. Nomination committee is one approach responsible for board appointments. which makes clear how these appointments are made and assists boards in making them, is through the setting up of a nomination committee, with the responsibility of proposing to the board, in the first instance, any new appointments, whether of executive or of non-executive directors. A nomination committee should have a majority of non-executive directors on it and be chaired either by the chairman or a non-executive director. Internal Controls Directors are responsible under s.221 of the Companies Act 1985 for maintaining adequate accounting records. To meet these responsibilities directors need in practice to maintain a system of internal control over the financial management of the company, including procedures designed to minimize the risk of fraud. Therefore, implicit requirements on directors to ensure that whether proper system of internal control is in place or not. Since an effective internal control system is a key aspect of the efficient management of a company, the Cadbury committee recommended that the directors should make a statement in the report and accounts on the effectiveness of their system of internal control and that the auditors should report thereon.

3.1.4. Board Size

As shown in the table 3.1 above, the mean of the number of board is near 8 (7.7), minimum is

4 and maximum number of board in the observation is 12. The importance of limited number of board is clearly defined by different researchers. According to Yenesew (2012), He defined the number of directors sitting on the board cited from different authors as follows. According to agency theory limiting board size to a particular level is generally believed to be improving financial performance. The reason is that the benefit of larger boards is outweighed by the poor communication and decision making when the board size is too large. Previous studies found negative effect of board size on performance. Therefore, large board size makes communication difficult in situations where there is no coordination and mutual understanding between the board members. Conflict between board members may be rise and this can negatively affect the performance of a company. On the other hand, medium number of board members can make communication easy and this in turn has positive contribution for company's performance and when we come to the Ethiopian context mean of board size is about 8 for the sample state-owned service enterprises which is in line with the recommendation of best practices.

3.1.5. Return on Asset

As shown from the summary of descriptive statistics in table 3.1 above, The average of Return on Asset (ROA) for the period 2000 to 2014 years sample is 4.326 percent, min 0.31 percent and the maximum value is 18.5 percent. The standard deviation is 4.54 percent from the average value.

3.1.6. Return on Equity

As stated in the table 3.1 summary of the descriptive statistics above, the minimum value of ROE was 1.5 percent, with a mean value of 16.97 (approximately 17) percent and a maximum of 77.71 percent from the year 2000 to 2014. The standard deviation is 16.67 percent from the average value of sample firms. By comparing the two accounting based financial performance measures of ROA and ROE, it's possible to conclude that the sample service enterprises are relatively doing better on the return on equity performance measures. While the mean value of return on equity is 16.97 percent whereas return on asset is 4.326 percent. That indicates that the sample state-owned service enterprises are better in utilizing shareholders equity capital. From the two accounting based indicators of financial performance summarized in table 3.1 above, return on equity and return on asset are ranked as first and second based on their percentage amount from highest to lowest percentage.

3.2. Correlation Analysis of board structure and financial performance

Based on the correlation output, board structure; board composition, board committees and board leadership structure are positively correlated with return on asset at 5 percent significance level and board size is negatively correlated with firm performance variable (ROA).

The Pearson correlation coefficients of board composition, board committee, board size and board leadership structure have the value of 48 percent, 9 percent, -28.13 percent, 11.68 percent and 27.42 percent respectively.

From this it can be concluded that board composition (percentage of non-executive to total directors in the board) has relatively better positive association with return on asset. In contrast, board size has negative correlation with financial performance variable of return on asset (ROA).

Similarly, the Pearson correlations among return on equity and board structure variables, the coefficients of Pearson correlation on board composition, board committee, board size and board leadership structure shows positive association to the performance variable of return on equity (ROE) and the Pearson correlation coefficient values of board composition, board committee, board size and board leadership structure are 22.47 percent, 34.01 percent, 26.46 percent, 51.67 percent and 20.28 percent respectively. There is no multicollinearity problem. All the corporate governance variables of board structure in this study are positively correlated to return on equity at different rates starting from strong positive significant to weak but still positively associated to it. The result indicated board committees (34.01%), board leadership structure (20.28%), board composition (22.47%) and board size (26.46%) associations to return on equity.

The results suggested that all the board structure of corporate governance variables are positively associated to both performance variables of ROA and ROE except board size it shows negative associated with the value of ROA.

3.2. Analysis of Variance (ANOVA)

Analysis of variance investigated the interaction between board structures; board composition, board committees, board size and board leadership structure with firm financial performance of ROA and ROE. F-statistics is used to measure the relationship between board structure and financial performance.

3.3.1 Analysis of variance for Leadership Structure and Firm Performance

Board leadership structure is about separation of CEO and board chairman and/ combined of both posts to the same person. Separating the role of CEO and Chairman has positive relationship with both financial performance variables. CEO has the executive role and chairman has the monitoring role of the organizational activities. Combined these positions to the same person is useful to take corrective actions immediately and to have sufficient information about the company for decision making process. However, segregation of duties is violated because doing and monitoring by the same person is not practically possible. The results of the analysis of variance conducted to find the interaction between leadership structure and firm performance is reported a direct relationship between board separate

leadership and both ROA and ROE financial performance variables in Table 5.5 below. The relationships between the corporate governance variable leadership structure (separate leadership structure) and both performance variables of (ROA & ROE) were significant for the year 2000 to 2014. Means the null hypotheses (H_0): was Separate leadership structure is not associated with firm performance and the alternative hypotheses was (H1a: separate leadership structure is positively associated with firm performance is accepted according to the ANOVA results and the null hypothesis is rejected. Meaning, there is significant relationship between separate board leadership structure and financial performance. This is also supported by empirical study like by Hanoku Bathula (2008), in his study put the findings of CEO duality and financial performance as follows. The findings of the study show that board characteristics of CEO duality was positively related with firm performance in all firms listed on New Zealand stock exchange as on November 2007 for the study period of 2004 to 2007.

From the table below, it can be concluded that there is a direct relationship between separate leadership structure and firm performance. This is supported by different literatures as follows. According to an article published by Global corporate governance forum and OECD (2011), states that the separation of CEO and Chairman should be regarded as best practice to promote transparency. The OECD's Principle VI.E recommends that in different countries with single tier board systems, the neutrality of the board and its independence from management is possible to strengthen by the separation of the role the executive body (chief executive) and the monitoring unit (board chairman).

This Principle adds that separation of the two posts can help to achieve an appropriate balance of power and this in turn has its own contribution to increase accountability and improve the board's capacity for decision making independent of management and can also help to ensure high quality governance of the enterprise and the effective functioning of the board. This creates fertile condition for the company to increase its market share and to have sustained profit even under volatile and difficult business environment.

Table 3.2

Separate leadership structure and firm performance

ROA				
Analysis of Variance				
Source	SS	df	F	Prob > F
		MS		
Between groups	137.33818	1	7.15	0.00
		137.338		
Within groups	1689.89458	88		
		19.20335		
Total	1827.23276	89		
		20.5307		
ROE				
Between groups	1016.57719	1	3.78	0.05
		1016.577		
Within groups	23696.5479	88		
		269.2790		
Total	24713.1251	89		
		277.6756		

Source: Statistical output of ANOVA from sample data, 2017

3.3.2. Board composition and financial performance

Analysis of variance was also performed to find the interaction between board composition and firm performance stated in the table 5.6 below. Results show that there is significant relationship with performance indicators and F-statistics reported that board composition was significantly related to ROA, with F-statistics 4.59 ($p = 0.000, < 0.05$), and ROE with F-statistics 2.01 ($p = 0.0101, < 0.05$). Therefore, the researcher can conclude that boards dominated by non-executive directors are positively associated with firm performance.

Board composition is about the representation of non-executive directors on firm financial performance in the study sector and area. The alternative hypothesis developed to test the relationship is a majority of non-executive directors on the board is positively associated with firm performance. A total observation of 90 (6 firms 15 years' data each) Ethiopian firm-years is used in the study. Analysis of variance (ANOVA) is used to test the hypotheses. Results witnessed that the independent directors add potential value to the firm's financial performance to both accounting measures of ROA and ROE in for the sample firms of the country. The logic behind the percentage increase of independent directors has benefits for encouraging transparency,

accountability and to establish sound internal control.

Table 3.3

Board composition and financial performance

ROE					
Source	Analysis of Variance			F	Prob > F
	SS	df	MS		
Between groups	14818.3762	38	389.957267	2.01	0.01
Within groups	9894.74892	51	194.014685		
Total	24713.1251	89	277.6755		
ROA					
Between groups	1413.52613	38	37.1980562	4.59	0.00
Within groups	413.706627	51	8.11189465		
Total	1827.23276	89	20.5307052		

Source: Statistical output of ANOVA from sample data, 2017

3.3.3. Availability of board committees and financial performance

Analysis of variance also reported an interaction between board committees and firm performance (see table 3.4 below). Results showed that there is significant relationship between board committees and financial performance. Therefore, the results showed a significant relationship for ROE with F-statistics 11.51 ($p = 0.0010, < 0.05$) and from the table below the relationship between board committees and ROA is insignificant with F-statistics 0.66 ($p = 0.4186, > 0.05$). From different literatures availability of audit, remuneration and nomination in the board is very important to establish accountability, transparency and strong internal control to overcome issues related with misuse of firms resources. But, only their presence cannot have positive contribution to their financial performance rather it needs exercising the principles of corporate governance is very important. The aim of corporate governance is to assure transparency, accountability and control in mobilizing resource and every committee has to work for the realization of the specified objectives.

Table 3.4

Analysis of variance of board committees and financial performance

ROA					
Source	SS	df	MS	F	Prob > F
Between groups	13.612318	1	13.612318	0.66	0.41
Within groups	1813.62044	88	20.6093232		
Total	1827.23276	89	20.5307052		
ROE					
Between groups	2858.18109	1	2858.18109	11.51	0.00
Within groups	21854.944	88	248.351636		
Total	24713.1251	89	277.675563		

Source: Statistical output of ANOVA from sample data, 2017

3.3.4. Board size and financial performance

The results of the analysis of variance conducted to find the interaction between board size and firm performance reported mixed results. The relationships were significant for board size with both ROA and ROE performance variables. Therefore, board size was significant for ROE with F-statistics 3.68(p = 0.0011, < 0.05) and ROA was significant with F-statistics 5.89(p = 0.0000, < 0.05). Based on the statistical result there is significant relationship between board size and both performance variables. Therefore, board size influences financial performance measures of both ROA and ROE.

Table 3.5

Analysis of Variance on board size and performance

ROA					
Analysis of Variance					
Source	SS	df	MS	F	Prob > F
Between groups	672.037014	8		5.89	0.00
			84.0046267		
Within groups	1155.19575	81	14.2616759		
Total	1827.23276	89	20.5307052		
ROE					
Between groups	6583.56335	8		3.68	0.00
			822.945418		
Within groups	18129.5617	81	223.82175		
Total	24713.1251	89	277.675563		

Source: Statistical output of ANOVA from sample data, 2017

3.4. Regression results of ROA, ROE and board structure

Base on the regression results, the R-squared-within, R-squared-between, and R-squared-overall are reported 13.84 percent, 67.75 percent and 47.72 percent respectively. This indicated that the variables considered in the study explain about 13.84 percent of the variation within a given firm’s performance, 67.75 percent of the variation between the firms’ performance and 47.72 percent of the variation among all the firms’ performance included in the study.

The relationship witnessed that the level of influence of the independent variables to dependent variables. Board composition has coefficient value of 16.49, standard error values of 3.21 and p-value is 0.000. In the same manner board committees has the coefficient 1.09, standard error of 1.29 and p-value of 0.399. The value of -0.64, 0.31, and 0.037 belongs to board size for the value of coefficient, standard error and p-value of the regression output respectively. The values of coefficient are -2.14, standard error 1.40 and p-value 0.127 represents the variable of board leadership structure (separate leadership structure).

The independent variable with the greater coefficient explains to the dependent variable well.

If p-value is less than the confidence interval the alternative hypothesis is accepted. Accordingly, the p-value of board composition and board size variables has significant relationship with the financial performance of ROA.

On the other hand, board composition and board committees, positive coefficient with ROA. In contrast, the coefficient of board size and board leadership structure variables showed negative relations with the financial performance variable of ROA.

Similarly, the corporate governance variables of board composition and board committees have a positive coefficient value of 16.49 and 1.09 respectively. However, there are also some variables that have negative coefficient value of -0.64 and -2.14 for board size and board leadership structure respectively. In the variables with positive coefficients, board composition has the highest influence to the firm performance with the value of (16.49) and board committees has the lowest coefficient value of (1.09). From the variables with negative values board size (-0.64) and board leadership structure (-2.14) are ranked from highest to lowest value respectively.

The negative relationship between ROA and board size is also supported by empirical study of Shobod et.al (2015), found a negative and significant relationship between board size and firm performance and the study recommends smaller but representative board size is acceptable to increase profitability companies even though this research is failed to define smaller because size is relative.

The regression analysis related with the second performance variable of ROE also indicates the R-square as follows. R-squared-within, R-squared-between, and R-squared-overall are reported 59.96 percent, 20.65 percent and 36.55 percent respectively. This indicated that the variables considered in the study explain about 59.96 percent of the variation within a given firm's performance, 20.65 percent of the variation between the firms' performance and 36.55 percent of the variation among all the firms' performance included in the study.

Similar with the result that showed the relationship ROA and board structure also shows the level of influence of the independent variables to dependent variables. Board composition has coefficient value of -7.21, standard error values of 12.5 and p-value is 0.566. In the same manner board committees has the coefficient -7.84, standard error of 2.89 and p-value of 0.008. The value of -1.25, 1.09, and 0.255 belongs to board size for the value of coefficient, standard error and p-value of the regression output respectively. The values of the coefficient of -2.88, standard error 3.17 and p-value 0.366 represents to the variable of board leadership structure.

Therefore, one can conclude that there is significant relationship between the accounting measures of financial performance of ROE and board structure variables.

3.5. Conclusion

Results of the summary of the descriptive statistics, Pearson's correlation and analysis of variance and regression results are discussed in this section. The discussion integrates the results to support the overall relationship between corporate governance and financial performance of state-owned service enterprises in Ethiopia.

The accounting based firm performance indicators used in this study were ROE and ROA and board size, board composition, board committees, firm size and board leadership structure are considered as corporate governance variables. This study investigates the influence of board composition, board committee, board size and board leadership structure on financial performance of state-owned service enterprises in Ethiopia.

Therefore, based on the results obtained from all the tools of analysis it's possible to conclude that there is significant relationship between corporate governance variables of board structure considered in this study and the accounting based performance measures of ROA and ROE.

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