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THE INFLUENCE OF CORPORATE GOVERNANCE ON DIVIDEND POLICY

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ABSTRACT

Master thesis

The influence of Corporate Governance on Dividend Policy

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Corporate governance is an internal system which is intended to work for the interests and needs of the shareholders and stakeholders by directing the company actions to the right direction and also controlling the management activities in a way that meets the overall expectations of the company's shareholders and stakeholders.

In the last 20 years, the corporate governance became a topic of debate between the world scholars, in which different scholars have varying views and definitions regarding the corporate governance. The main aim of this study is to find if there is an influence of corporate governance on dividend policy in Turkey. So, the study to be effective, the data that will be used in the analysis will be collected from ISE 100 and also from the financial data available in the public and from their personal websites.

In this first chapter of this study, the definitions, actors and mechanisms of corporate governance was discussed in detail; also the importance, categories and principles of the corporate governance was discussed in brief. In this first chapter, the history of corporate governance was also talked about in brief, as well as the history of Turkish corporate governance.

In the second chapter, the dividend payout ratio and dividend policy was discussed as well as its procedures and payment methods. Dividend is part of the net income of the company that is being aimed at given to its shareholders; this amount of money is usually a topic of debate in the management system of any firm. So, here the researcher will give highlight about the ways it is divided, the decisions taking when giving to the shareholders and etc.

In chapter three, the empirical analysis of the study was done, and SPSS 18 has being used in the data analysis, the fourth chapter is the results of the analysis and the fifth chapter is the conclusion.

ÖZ

Yüksek Lisans Tezi

Kurumsal Yönetişimin Temettü Politikası Üzerindeki Etkisi

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İşletme Bölümü

Kurumsal yönetişim hissedarlar ve paydaşların çıkarlarını ve gereksinmelerini gözetmek için oluşturulmuş bir iç sistem olup, şirketin faaliyetlerini doğru yöne yönlendirerek ve aynı zamanda yönetim faaliyetlerini şirketin hissedarları ve paydaşlarının genel beklentilerini karşılayacak biçimde kontrol altında tutarak bu amaca hizmet eder.

Son 20 yılda, kurumsal yönetişim dünyada bilimadamları arasında bir tartışma konusu olagelmiştir, öyle ki farklı bilimadamları kurumsal yönetişim konusunda farklı görüşler ve tanımlar ortaya koymuşlardır. Bu çalışmanın ana amacı kurumsal yönetişimin Türkiye’de temettü politikası üzerinde bir etkisi olup olmadığını belirlemektir. O nedenle, çalışmanın geçerli bir sonuç ortaya koyabilmesi bakımından, analizde yer verilecek veriler İMKB 100 endeksinden alınan veriler ve kamuya açıklanmış mali verilerin yanı sıra şirketlerin kendi kişisel web sitelerinden alınmıştır.

Çalışmanın ilk bölümünde, kurumsal yönetişimle ilgili tanımlar, aktörler ve mekanizmalar ayrıntılı olarak irdelenmektedir; ayrıca kurumsal yönetişimin önemi, kategorileri ve ilkeleri de kısaca irdelenmektedir. Bu ilk bölümde, kurumsal

yönetişimin tarihçesinin yanı sıra, Türkiye'de uygulandığı şekliyle kurumsal yönetişimin tarihçesine de kısaca yer verilmiştir.

İkinci bölümde, temettü verme oranı ve temettü politikasının yanı sıra, temettü sürecinin işleyişi ve ödeme yöntemleri de irdelenmiştir. Temettü şirketin elde ettiği net kardan şirket hissedarlarına verilmesi amaçlanan dilimi oluşturur; bu ödemenin meblağı ekseriya her firmanın yönetim sisteminde bir tartışma konusu olmaktadır. O nedenle, burada araştırmacı temettü ayrımının nasıl yapıldığı, hissedarlara temettü verme kararların nasıl alındığı vs konular üzerinde ağırlıkla durmaktadır. Üçüncü bölümde, çalışmanın ampirik analizi yapılmış ve veri analizinde SPSS 18 kullanılmış olup, dördüncü bölümde ise analiz sonuçlarına ve beşinci bölümde ise çalışmanın genel sonucuna yer verilmektedir.

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CHAPTER ONE
CORPORATE GOVERNANCE

1.1 Definition

Corporate governance exists to provide checks and balances between shareholders and management and thus to mitigate agency problems. Hence, firms with better governance quality should incur less agency conflicts. In such firms, managers should be less likely to adopt a sub-optimal dividend policy. As a result, the quality of corporate governance should have an impact on dividend policy (Jiraporn, S. Kim, J.C, Kim, 2010).

In other words, corporate governance is an important and well recognized concept or topic in today's economy. Investors, creditors and all of other stakeholders of companies give more importance and attention to corporate governance than past; this is a new concept that has joined to the world of business. Especially, recent corporate scandals have created high interest on corporate governance term.

As corporate governance is topic of debate among the scholars and business man it is mostly explained in differing ways as institution or mechanism that exercises power over decision making within a firm (Macey, Corporate Governance, 2008). If we look at the other said, it can be defined as the as measures, processes, structures, and a well-defined line of accountability to ensure effective governance and performance of corporate entities (Kyereboah, 2007).

The divergence of the stockholders' interests from the managers' interests due to separation of ownership and management of the firm is first emphasized by Adam Smith (1776), as a matter to the fact, most stockholders need a lot of dividend from the retained earnings at the yearend while the management want to make investments in other projects which they think that it will be more profitable to the company. Due to the poor performance that led to major losses in the shareholder value in U.S. companies (e.g. General Motors, IBM, Amex, and Westinghouse), corporate governance concept gained public attention in these types of countries. In other words, Good governance has been a long time issue in public and corporate governance, today there is a very strong interest in corporate governance, and this interest is driven by the frequency of high profile corporate scandals beginning with those of Enron, WorldCom (Iwu-Egwuonwu, 2001).

Corporate governance also gained public attention because of the failure and fraud in U.K. companies such as Polly Peck, Mirror Group, and BCCI. U.S. companies such as Enron and World Com are recent examples to the corporate governance issues. Due to the massive participation of U.S. households in equity markets poor performance of U.S. companies attracted public attention also. Institutional investors are said to be, in the case of U.K. firms that they are the major actors in the corporate governance system. In other words, the governance practices of these financial institutions led to the fraud, pay disparities between the directors and the employees, and failures that attracted public attention in U.K.

Similar unethical organizational behaviors are also very common in Turkey, it can be said that it is not only in Turkey but also around the world specially the developing and undeveloped countries. Due to this type of issues many articles and books have been written about corporate governance in the world. Besides, as the culture and ethical behaviors of the countries are vary, most of the countries declared their own corporate governance principles. OECD (1998; 2003; 2004) published reports regarding this issue. United Nations Environmental Program (UNEP) developed an index for measuring the economic, environmental, and social performance of firms, which is also closely related with the corporate governance, and can be more beneficial to the institutional investors around the world which has become today a global village. In these days non-governmental organizations (NGOs) and some of the governmental institutions also declared the principles and processes of corporate governance in Turkey. For example, Capital Markets Board of Turkey (2003) and Turkish Industrialists' and Businessmen's Association (2002) published reports about corporate governance.

Therefore, all of these books, articles and reports show the importance of corporate governance phenomenon in the world, and also there are a lot of articles printed and published by Turkish banking sectors about the corporate governance, such as Seker Bank which are available in the internet and other data base areas in the Turkish systems. Thus, Tricker (2000) stated that nineteenth century was the century of entrepreneurship, twentieth century was the century of management, and the twenty-first century will be the century of corporate governance, because the twenty-first century is century in which the world came to a global village and the owner of the business and management are to be segregate so that there will be a control and accountability in the business.

As you look at the theories, there is no unity about corporate governance that explains theoretically or empirically how the modern corporation is run (Pettigrew, 1992), because the business scholars have different views about the corporate governance and it will also hard for us to solve the corporate governance conundrum. Although Philip Stiles attempted to form corporate governance theory (Clarke, 1998b), there is still a quest for an optimal or superior theoretical model of corporate governance (Gunay, 2007).

If we look at the other sides, the American organization of corporate governance itself has just moved in the direction and the system of liberal market economies in the 1980s, driven, in part, by economic recession and increased competition from abroad. In the 1990s, there was a shift or a change in the opposite direction as U.S. corporations included more takeover defenses in their charters, because in that time the takeover rates were higher in number. The economic literature reflects a tendency to presume that value based market arrangements allocate wealth more efficiently than coordinated systems (Herrigel, Sept, 2007).

Recent literature has shown that as the countries' developments differ the patterns of corporate dividend payout policies vary tremendously between developed and transition equity markets because as the country is undeveloped or developing it is not easy to compare that of a developed country. Glen *et al.* (1995) find that payout ratios in developing countries are only about two thirds that of developed countries, but one thing to remember are that the payout ratio has a direct contact with the country's development, as long as the country is undeveloped or developing it is not possible to pay a higher payout ratio to its investors. Similar results are observed by

(Ramcharran, 2001), who report lower dividend yields for emerging markets. However, a scarce body of the literature has not provided a uniform explanation for these existing differences.

In this section we examine the determinants of corporate dividend policy in transition economies. The equity markets in transition countries are quite young and underdeveloped, have less information efficiency and are more volatile, they may be newly established or the system in use is less developed. In addition, they also differ from those developed markets in such characteristics on firm levels as the ownership structure and corporate governance standards.

In developed countries, firms decide to be listed as they grow in size and need additional capital in order to grow because if the firms are not opened to public it will be that the capacity of investment of the firm will be lower or insufficient. So, the ownership of these companies tends to become more diffuse and passes from a single entrepreneur or his family to other investors. In order to attract outside investors family firms need to enforce corporate governance standards, which provide protection of the interests to the new shareholders, today in the world of business as the management and ownership of business are not classified, it will be harder for an outside investor to buy the shares of a firm which will not protect his/her interests. This trend of companies and stock market development is relative new in transition countries. Till recently the formation and the creation of listed companies and stock markets was related mainly to the privatization process of state owned companies.

In the first decade of the transformation, the governments used stock markets and other institutions to transfer ownership of state owned companies through privatization, which placed ownership of shares in the hands of domestic and foreign investors and then helped companies find foreign and domestic investors which then helps the company make other profitable investments in the future or at that time. At this time, the legal environment was weak and the corporate governance mechanisms were practically non-existent. Under such situations, shareholders were from beginning at risk because of the non-existing and practical corporate governance standards and as they were often too dispersed to take action against non-value maximization behavior of insiders (Jensen and Meckling, 1976). As a result, the dispersion of ownership and the weakness of corporate governance mechanism leaded to substantial diversion of assets by managers of many privatized firms in Russia and other transition countries, in any business there must be a set of standards to be used and accountability among the management and shareholders, otherwise it will be difficult for shareholders to know whether their assets are used in the right way at the right time.

Despite the early dispersion following privatization programs, in many transition countries – Poland being one of them - ownership has turned out to be significantly concentrated. The increased concentration of ownership and control in listed companies is the result of substantial foreign investments, because as the ownership and management are separated there is usually a possibility for foreign investment. One of the set of laws requires that investors who are passing from a certain threshold must offer to buy either more shares or even the entire company. The mandatory bid rules have been introduced with the aim and purpose of protecting and keeping the interests of minority shareholders from an unwanted investor who are not mostly considered. Yet, the result is an increase of foreign ownership in listed companies in most of the transition countries.

Actually the concentrated ownership is not only a feature of transition countries but is also something that is genuine and present in developed Continental European countries. In some other studies it shows that concentrated ownership is the distinguishing feature of the listed and unlisted companies across Continental Europe. The literature suggests that minority shareholders may be at risk or we can say that they are more risky than those who are majority of shareholders in companies controlled by strategic stakeholders. Additionally, with the lack of board independence, many companies are open to potential expropriation. (Yurtoglu, 2003) claim that the power of the largest equity holder reduces the dividend payout ratio in Germany, whereas the power of the second largest shareholder increases the dividend payout. Accordingly, in transition countries, the main conflict lays the interests of between a large, foreign controlling owner and small, domestic minority shareholder, which have little voting share. Hence, we assume that the preference for dividends should be even stronger in transition countries as shareholders encounter a great risk of expropriation by insiders, because in the transition countries, the management system and auditing system are little bit weak, and even the legal environments so that they can make any fraud and mismanagement which can lead the firm to greater losses.

As professional managers have yet to come forward in transition economies and the management in any case cannot be expected or may not be possible for the management to be independent in countries with weak legal environment and protection laws and heavily concentrated ownership structures, the main conflict in many listed companies is currently between controlling owners and minority shareholders, so if there is a system or environmental protection rules that gives their rights to the minority owners it will be better for the business to grow in fast, but when the owners have the most voting shares, they are able to manipulate any dividend payout ratios and investment projects. Given the weak legal environment and the low protection of minority shareholders' interests in transition countries, the question arises if shareholders are able to extract from listed companies some returns in the form of dividends (Easterbrook, 1984).

Present that dividend payouts are higher, on average, in countries with stronger legal protection of minority shareholders, and even as the rights of minority shareholders are protected, the number of minority investors will increase in the stock exchange markets. Therefore, if the protection of minority shareholders has a positive impact on dividend payouts, then shareholder protection represented by the corporate governance standards should help explain differences in dividend payouts on firm-level and give the minorities their rights. Indeed, while country-level investor protection is an important factor in preventing expropriation, firm-level corporate governance could carry equal or greater importance. Furthermore, corporate governance practices can vary widely even among firms in the same country operating under the same legal regime, really it happens sometimes that the same firms under the same conditions with the same legal environment protections act differently, and we can say that this depends on the management system, accountability, segregation of duties, and the ownership interests of the firm, and also how the management considers the social responsibility.

The existing studies for developed countries even don't succeed to find statistically significant effects of corporate governance on firm performance in developed countries, in most studies, it is said that corporate governance and its application in the business environment doesn't affect the financial performance of the firms. Even when significant results are reported, they are often economically small. In contrast, transition economies may offer more fertile ground for study. Sometimes scholars argue that considerable effects are likely and possible to be found in emerging economies, which often have weaker rules and applications and wider variations among firms in corporate governance practices. For the above reasons, a study on the determinants of dividend policy and its association to corporate governance in a transition economy both offers an interesting subject of application and considerable complements to the existing corporate governance literature. The agency theory points that dividends may mitigate agency costs by distributing free cash flows that otherwise would be spent on unprofitable projects by the management, it is meant that any payout ratios that are supposed to be invested in less net present value to be paid as dividend to the shareholders. It is argued that dividends expose firms to more frequent scrutiny by the capital markets as dividend payout increase the likelihood that a firm has to issue new common stock more often (Easterbrook, 1984).

Alternatively, scrutiny by the markets helps alleviate opportunistic management behavior, and, thus, agency costs. Agency costs, in turn, are related to the strength of shareholder rights and they are associated with corporate governance. Furthermore, agency theory suggests that shareholders may prefer dividends, particularly when they fear expropriation by insiders.

The corporate governance term has been investigated and used for a few decades only specially in twenty-first century. But corporate governance was always in life from ancient times and practices. Governance issues arise whenever a corporate entity acquires a life of its own, whenever ownership of an enterprise is separated from its management, and the rights of minority shareholders are protected. The Merchant of Venice, in Shakespeare's play (Act 1 Scene 1), feared for the safety of his commercial ships sailing out of sight on the high seas, because at that time, the control of his business has separated from the owner and transmitted to the captain of the ships.
(Colley, 2003) gives details how corporate governance term got developed smoothly from past to today. According to him; the developed countries' economies have created high living standards and rich people who are working for these systems in the

twenty first century. Main reasons for this economic development are free enterprise, capitalism and high competition among corporations; these are to be considered first. Free enterprise gives sustained energy of competition to economies of developed countries in which many people are willing to pursue their own interests and make any profitable projects and opportunities that they forecast it will be highly achievable. Because of the scare resources (human capital, raw resources, customers and investment capital) the competition among corporations have increased and the weakest rivals have closed and the strongest corporations have continued their business, because there are no well-set legal environment rules that protects the interests of the weaker rivals, and usually the stronger rivals use the dumping strategy to pull out the weaker rivals from the market. It promotes the survival of the most successful. The development of capitalism also promoted this economic development. With the development of capitalism, many investors could be united and bring together to provide and enhance the large amounts of investment capital needed to fund extensive projects and massive enterprises (Dirim, 2008).

The enterprises became to very huge sizes and their management complexity increased, with the development of economic system. The most important thing for the investors of these enterprises is the economic value of the company. So managing the company in the best interest of the shareholders is a vital for the company. This situation brings the corporate governance term. Corporate governance is 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 the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs.

Corporate governance as an objective and as a subject should be looked and followed for the good and existence of shareholders, employees, customers, bankers and indeed for the reputation and standing of our nation and its economy" (Maw *et al*. [1994:1]) Corporate governance specifically explains and describes how companies ought to be run, directed and controlled towards the interests of shareholders regardless of whether a majority or minority shareholders. It is about supervising and holding to account those who direct and control the management. Gabrielle O'Donovan describes corporate governance as an internal system encompassing policies, processes and people, which serves the needs of shareholders and other stakeholders, by directing and controlling management activities with good business saw, objectivity and integrity, addition to that, management and the owner of publicly owned companies should be segregated. According to O' Donavan perceived quality of corporate governance can affect company's share price and its cost of capital, as the company's reputation and image among the society is good, the possibility of new minority shareholders will increase, but if the company's image is on the lower side in the stock market and doesn't apply the corporate governance properly, it means that it is too rarely to have foreign or domestic investors because it doesn't succeed the loyalty of its future investors. In this point, the perceived quality is determined by all market forces and international organizational environment, how policies and processes are implemented and how people are led.

Consequently, it is obvious that corporate governance shows the best way of directing and managing the overall assets and interests of the company shareholders and stakeholders. Also, it sustains the regulation of the corporate actions towards its stakeholders as well as the interests of minority shareholders. Corporate governance cares about all stakeholders of the corporations and it regulates the relationships between them (Dirim, 2008).

In another interesting topic about the corporate governance, is that Globalization also poses both opportunities and challenges to corporate governance reforms in developing countries, which is said today that the corporate governance is mostly practiced in that area. On the one hand, globalization can accelerate the union and the convergence of corporate governance to international standards (Khanna, Kogan, and Palepu); on the other hand, however, globalization can also increase competition for a large number of inefficient domestic firms, and thus may create high pressure for them to try to apply the corporate governance so that the company may get an external financing and attract outside investors, and for the company to grow and compete with the international and multinational firms(Wu, 2005).

Corporate governance is consistent with the practices and philosophy of a free market and a democratic culture all over the world, as the world becomes a global village, the need for corporate governance increases which enhances the trust ship among the society of different nations. It gives the final authority and complete responsibility to a board of directors whose decision-making responsibility is mutually respectful and participatory where independent and outside views are valued. The corporate governance mechanism suggests that board maximizes shareholder value through fairness, accountability and transparency (Aksoy& Bozkus, April, 2009).

In other research views, corporate governance could be understood as a set of processes, not only set of process but also customs, policies, rules, procedures, and institutions that are used to administer, control and direct a corporation and also protect the rights of its stakeholders. It also involves the relationships among many players and the owners of the corporation. Generally, the main players in corporate governance are managers, shareholders, and the board of directors.

Much of the recent interest, concentration, and understanding in the field of corporate governance has been driven by corporate scandals in the USA, which has been highlighted by the OECD: "Recent corporate scandals have focused the minds of governments, regulators, companies, investors and the general public on weaknesses in corporate governance systems and the need to address this issue'' (OECD, 2004). As a result, financial market regulatory bodies and governments have put in place or projected various changes relating to directors' responsibilities, the role of independent directors, new and/or more stringent external reporting requirements and minimum disclosure levels at least at the end of each financial year. A dominant focus of the changes is on strengthening the role and function of the board. The overall goal is an attempt to significantly reduce opportunities for corporate mismanagement and instances of corporate collapse, and thereby provide better protection for shareholders and other business stakeholders (Perek, 2009).

Scholars have made various explanations and definitions about corporate governance. According to Freeman and Evan (1990), corporate governance is about how voluntary agreements and promises are carried out in the business environment (Freeman, R. E., W. M., 1990). According to Tricker (2000), it is about the exercise of power and control over corporate entities via board of directors (Tricker 2000). MacMillan and Downing (1999) defined this concept as a system by which companies are directed and controlled to produce the right results, which is high financial performance. (Donaldson, 1990) defined this phenomenon as a structure whereby managers at the organizational apex are controlled through the board of directors, executive incentives, monitoring and bonding. In other words it is the segregation of the rights of minority shareholders and ownership.

As it can be seen in the definitions above, corporate governance has different meanings and theories for different scholars around the world. So, there is no generally accepted meaning for corporate governance, this result is simply related with the scholar's perception about corporate governance. In other words, relativism and ethnocentrism will be effective in the perception of the scholars. Therefore, it is very normal to encounter different definitions for this concept but it is a new concept to the business world. Corporate governance is an open system which is said to be created and initiated by corporate governors via forming a belief system or a corporate credo by the help of vision, mission statements, strategies, and policies. This system is then made operational by the direct and indirect interactions of stakeholders of the firms, which produce desired or undesired business results for the governors of the firm. In other words, corporate governance is a system that emerges as a result of the relationships among the variables of principles, processes and business results at the level organization, which is shaped by factors such as culture and economy at the level of society, in the past it is something usually practiced but not knowing and effectively, but the concept has got to known after years of discussions of the business scholars.

This open system, corporate governance is dominated into two different models which are the stockholder governance or stakeholder governance models. The premise of self-interest generally leads to the implementation stockholder governance model specially those which are mostly owned and operated by small number of people, and the premise of public-interest generally leads to the implementation of stakeholder governance model in the corporate governance system which guards the interests of all stakeholders as the employees, shareholders, management and etc. Conducting a pure stockholder governance model and a pure stakeholder governance model is very difficult in our contemporary age. Therefore, these two corporate governance models converge and different corporate governance structures emerged as a result of this convergence and the impact of macro level factors. These corporate governance structures will be described in detail and given explanations as far as possible in the presentation and explanation of universal corporate governance model. The emergence of mutual-interests principle is closely related with the convergence of these two opposing corporate governance models (Gunay, 2007).

In practice the concept of "corporate governance" should be seen as a procedure and any kind of process in which the organization is involved; it refers to all the internal parts and components that work together, which will eventually be subordinated to a single and accepted management structure. It is a concept with very wide connotations, which includes the following elements: responsibility for the accuracy of the information in financial statements; the existence of tight deadlines for financial reporting; communication and full transparency on financial results; transparency of internal and external audit processes (Constantin, Anca, Doina, Caciora, Simona, 2000). If all these are put in efficient way, then mostly the corporate governance is applied and there will be an environment of trust ship and confidence between the company and the current and potential investors.

1.2. Importance of Corporate Governance

Corporate governance has evolved over years in reaction to more important and significant economic crises and corporate failures in the world of business. Maxell Corporation (1991), Barings Bank (1995), Enron (2001), Worldcom (2002) and Parmalat (2003) are examples of high corporate scandals and they created high financial loss for their investors and their financial markets were damaged. This situation decreased the confidence of investors, and as far the confidence of investors reduces, the possibility to go private firms to public reduces. So, these failures in the world's history created demand for high quality corporate governance standards. It shows the importance of corporate governance.

Enron (2001) scandal is one of the most important corporate scandals which have reduced the confidences of a lot of potential and present minority shareholders. At the end of 1990s Enron was in a perfect position in American financial market. Business area of Enron was natural gas pipeline. In the mid-1990s Enron as a well-known company was making and creating most of its profit from its intermediary function in natural gas business. Enron was selling to its valuable customers a long term gas contracts to its but it was buying the natural gas from spot gas market at volatile prices. So, Enron was a more risk taking company and was taking price risk from its customers by making high profit. In order to offset this price volatility risk, Enron took positions in derivative contracts in high amount. This increased off balance sheet entries of the company. Also, at the same time, Enron entered into new business areas overseas.

Another change of Enron which caused to be internationally recognized corrupted business firm was the adoption of illegal accounting practices. Enron created an off-balance-sheet company whose profits were double counted for both the company and Enron itself. This double counting hid the true financial situation from investors, who had the right to get fairly prepared financial statements. The auditing firm of Enron, Arthur Andersen, also didn't succeed in its auditing role and ignored the warning signs in Enron's financial statements. Enron's new business areas and activities also failed and it made loss from these new business activities. When this problem was finally understood, Enron was required to take a $1.4 billion write down. (Neal and Cochran, 2008:1- 2) Enron is a very dramatic corporate governance deficiency. There are both management and auditing problems, and any business with management and auditing failure could go out of the market with a lot of loses as that of Enron. High corporate governance codes are employed to overcome these deficiencies.

First reaction to Enron case was the Sarbanes-Oxley Act in 2002 in USA. This law was very necessary because corporate failures cost too much for corporations in USA. For example, the NASDAQ Composite Stock Index increased 180% from March 1998 to its maximum point in March 2000. Only in 2 years, all of the gains disappeared. In 2001 and 2002, 446 publicly traded firms with assets of $628 billion went bankrupt. (Neal and Cochran, 2008: 2) According to Sarbanes-Oxley Act,

- CEOs (Chief Executive Officers) and CFOs (Chief Financial Officers) have to personally try to verify the accuracy of financial statements.
- SEC (Security Exchange Commission) has to review financial statements in every 3 years.
- Off-balance-sheet disclosure requirement increased.

- Firms must usually try to disclose corporate governance ethics and assess internal audit of the company as much as possible.
- Criminal and civil penalties for senior management are established in the case of cheating shareholders.
- Generally as it happen CEOs and CFOs may be called for to sacrifice their compensation if firm has to restate its financial statements.

As a result, the concept of corporate governance has made a good development especially in the last decade as a response to recent corporate scandals which reduced the confidence of the investors. Before these scandals people didn’t know the significance of corporate governance but after these scandals Importance of corporate governance was realized by public when they lost their investment in the companies in these scandals.

First, governments and its regulatory bodies issue and present every time new laws in order to regulate and control the companies and draw guidelines for corporate governance. Secondly, firms follow these rules and regulation and prepare their own corporate governance codes and principles in order to protect the all stakeholders of the company and do their business in best way. This is the way that corporate governance follows from top to bottom, from government to public.

1.3. Main Actors in Corporate Governance

Corporate governance systems are mainly influenced and affected by its actors. Corporate governance actors are consisting of the mechanisms and parties that have direct or indirect relationship with the corporations; these actors can be of different types such as employees and shareholders. (Aguilera, Yip 2004) states that the main interior corporate governance actors are; shareholders, governments, employees and the board of directors, these actors are the representatives of different interests on corporate governance in the company.

1.3.1. Employees

Employee’s which are considered to have direct impact on corporate governance in the company varies according to corporate governance regime on that company’s home country; they are the people who can enhance the image of the firm and the quality of its services or goods. On the other hand; employees can influence corporate governance by some mechanisms such as; equity ownership, consultation rights on working conditions and job security, work councils, unions and board representation. A strong role for employees in corporate governance, affects global market participation positively. But as far as the employees are more satisfied and their rights are protected. This situation increases global sales and consequently with increasing profits of the company, employment in the home country is affected positively again.

However, it is also said that employees' high participation on corporate governance may have also negative effects especially in Multinational companies (MNCs). First of all, MNCs' global investments of different projects with potential benefits may decrease due to home country employees' strong voice in corporate governance. Home country employees actually try not to lose their jobs while MNC is investing on a different country around the world. Secondly, for MNC it may be difficult to relocate and spread its business branches globally outside the home country. Lastly, strong home country employees may prefer marketing that retains national identity, so global marketing may be affected negatively. As a result, employees' strong role on corporate governance has both positive and negative effect on the corporation. (Aguilera and Yip, 2004)

1.3.2. Shareholders

Shareholders' role varies from country to country. In USA and England, there are mostly neutral shareholders among big institutional shareholders. Their role is mostly passive and they are focused on shareholder wealth maximization only, and don't give any consideration other factors in the business, But in Japan, big institutional shareholders are mostly active and they act as part of a network ('keiretsu') that supports the role of the company within the network and, hence, incumbent management. In Germany, there are many different corporations where different stakeholders, especially banks and institutional shareholders influence the corporate governance of the corporation.

According to (Aguilera, Yip, 2004)**,** there are three major types of different shareholders which are; neutral shareholders, partial interest shareholders and employee shareholders. Neutral shareholders' main desire and ambition is to get the maximum shareholder value and wealth. Employee shareholders have partial interest bias between maximizing shareholder value and employment conditions, level and pay. Banks and big institutional investors are said to be partial interest shareholders. They have many additional interests in addition to shareholder value maximization. In Japan, institutional shareholders hold maintenance of the overall keiretsu as a major objective. In Germany, institutional shareholders typically have close relations and loyalty to management. In all countries, state shareholders have some other macroeconomic objectives such as maintaining national security, employment, competitiveness and prestige. Family shareholders also tend to be concerned with the family's legacy, loyalty to employees and tradition, and can also be risk averse. (Aguilera and Yip, 2004).

1.3.3. Board of Directors

The Boards of directors are different importantly in terms of their structure, composition and activeness and the way of decision making and taking. German boards have a dual structure, with a supervisory board above a management board. The supervisory board has various statutory duties, especially the right and power to appoint the members of the management board and supervision of their actions and activities. Among German companies, taking the form of GmbH is very rare and difficult. Only GmbHs can operate with only one board. In the UK, most boards adhere to the Cadbury Report's recommendation of having a non-executive chairman; in the other countries, the roles of chief executive (CEO) and chairman are often combined, especially in the USA. Another aspect of board structure is the role of committees, which varies depending on the strategic leadership of the board (Aguilera&Yip, 2004).

Compositions of boards among OECD countries are usually different from one country to country by customs and law and even their culture. In British companies, the boards have mostly internal directors and outsider chairmen. In contrast, US boards have mostly external directors and insider chairmen like past or current CEO.

French boards are becoming Anglicized owing to foreign institutional investor pressures like US and UK. German supervisory boards are required by the Co-Determination Laws to have employee representatives, their number and proportion depending on the size of the company.

In the other countries, labor representation and participation in firm decision making is rare especially in the undeveloped or transition countries, except where they are significant shareholders. State owned firms also tend to have higher labor representation. Japanese boards usually include representatives of other keiretsu members (Aguilera and Yip, 2004:62). Major shareholders' board representation is different in each country. In USA and UK, large institutional shareholders are represented on boards for only a few years. Before, they were not represented on boards usually. In contrast, German and French boards mostly have members from their major institutional investors and financing banks(Dirim, 2008, p. 5).

On the other hand, Directors who are not employees of the corporation (independent or outside directors) are considered by some commentators and many institutional investors to be the crucial corporate governance mechanism for monitoring managers.11 Congress and the stock exchanges, under the shadow of the SEC, have codified this notion of the directors' role by mandating, respectively, appointment of independent directors to all of the audit committee positions, and to all of the compensation and nominating committee positions and a majority of the board.12 In addition, investor organizations identified most closely with public pension and union funds have outlined best practices, the central component of which is a board that consists principally of independent directors, including the board chair (Bhagat, Bolton, Romano, Dec. 2008).

1.3.4. Governments

Governments, which is one of the major external factors of the business environment affect business environment highly. Governments set general rules and regulatory regimes that apply to all companies in a country or all companies in a specific sector which can have negative impact on some business or positive effects. Also, government can set rules or regulation for a specific case of a company in the country.

Corporation must operate according to the rules that are established by governments otherwise there will be fines and forfeits for the firm which doesn't accept the issues presented by the government. So governments are one of the main actors in corporate governance. Companies adopt their corporate governance policies towards governments' regulations and rules. There are big differences between the governing styles of the governments. These differences are also creating different corporate governance regimes across different countries (Dirim, 2008, pp. 9-10).

1.4. Two Categories of Corporate Governance

Scholars of today generally divide the world's systems of corporate governance into two categories but the terminology which is now used to describe these categories varies each other. While Cheffins employs the outsider/arm's length and the insider/control-oriented terms, Moreland chooses market-oriented systems and network-oriented systems to describe the two poses of corporate governance systems. Additionally, there are two models utilized to illustrate the division: the Anglo-American model and the German-Japanese model (Jamal 2010).

1.5. The Evolutionary Theories of Corporate Governance

The pattern and the configuration of the board structure has become a topic of increased attention in the disciplines of economy (Jensen and Meckling. 1976), finance (Fama, 1980). Numerous and different corporate governance theories have been developed (agency theory, stewardship theory, resource dependence theory and stakeholder theory), which will be briefly discussed.

1.5.1. Agency Theory

Agency theory has been the dominant approach in the last years in the literature of economics and finance. (Fama and Jensen, 1983) and describes the relationship between two parties with conflicting interests; such as the majority owners and minority shareholders: the agent and the principal (Jensen and Meckling, 1976). For agency theorists, the role of the board is to authorize and monitor the decisions of the top management team (Fama, Jensen, 1983).

Agency theory is concerned with aligning the interests of owners and managers and it is based on the assumption that there is an inherent conflict between the interests of a firm's owners and its managers (Fama and Jensen, 1983; Fama, 1980; Jensen and Meckling, 1976), generally the management wants to make an investment for the retained earnings of the year while the shareholders mostly want to get high dividend payout ratio that can increase the conflict of interest among them.

Agency theory underlines and describes in a suitable way the importance of monitoring and the governance functions of boards (Zahra and Pearce, 1989); and the need for establishing mechanisms in order to protect shareholders from any management conflict of interests (Fama and Jensen, 1983). It finally suggests that boards should have a majority *of outside and independent directors* and that the position of *Chairman and CEO should be separate* (Daily and Dalton, 1994a).

1.5.2. Stewardship Theory

In contrast to agency theory, stewardship theory suggests that there is not a way that can create a conflict of interest between managers and owners and any successful organization wants to get structure that allows the coordination of both parts (Donaldson and Davis, 1991, 1994), if both parts have share common standards and communications that enhance the well-being of the company it increases the productivity and the financial performance of the company. Stewardship theorists argue that executives serve both their own but also their shareholders' interests. They argue that superior corporate performance is associated with there being a majority of *inside directors* because, firstly, they ensure more effective and efficient decision-making and secondly, they contribute to the maximization of profits for shareholders (Kiel and Nicholson 2003).

1.5.3. Resource Dependency Theory

Resource dependency theory proposes that actors lacking in essential resources will seek to establish relationships with others in order to obtain needed resources or we can say simple if actors didn’t get sufficient resources it finally brings them to be dependent upon other actors which they can get the needed resources. The corporate board is a kind of mechanism for managing external dependencies, reducing environmental uncertainty and the environmental interdependency. It also views outside directors as a critical link to the external environment (Pfeffer and Salancik, 1978). This perspective advocates the appointment of representatives of significant numbers of external voters as outside board members. This is considered as a strategy for managing an organization's environmental relationships. *Outside directors* can provide access to valued resources and information (e.g., Bazerman and Schoorman, 1983; Pfeffer and Salancik, 1978; Steams and Mizruchi, 1993). For instance, outside directors who are also executives of financial institutions may contribute to the securing of favorable lines of credit.

1.5.4. Stakeholder Theory

Finally, stakeholder theories include all the necessary actors for a firm to operate and its consistencies in its governance mechanisms and stress their fundamental importance. In defining stakeholder theory, Clarkson (1994) states that: a "Firm is a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firm's activities, these are the resources which makes the firm operating in the business environment it exists (Clarkson 1994). The purpose of the firm is to create wealth for its stakeholders by converting their stakes into goods and services". Since the stakeholders (i.e. employees, owners, investors, customers, government, community) of the firm provide the essential inputs and infrastructure in order to be achieved, it follows that *stakeholders should be included* in the government mechanism, so any firm going to be successful should give considerations to its stakeholders, and as far as they are dissatisfied it is difficult for the firm to achieve its established goals. Their inclusion, however, in the corporate governance mechanisms should be limited to the extent that their interests are threatened because they usually lack the managerial knowledge and long-term experience to take strategic decisions.

In this context, the corporate governance theories emphasize that the government structure, the inclusion of outside directors, stakeholder participation, the board configuration and its independence are of great significance.

1.6. Corporate Governance Mechanisms

According to (Jensen, 1993) and (Denis, 2001), corporate governance has historically been achieved and seen using a combination of four mechanisms which are to be considered and are:

1.6.1. Legal and Regulatory

Legal and regulatory mechanisms are externally imposed on organizations and that is necessary to be implemented so that the business goes smoothly, and it encompasses rules and regulations put in place by governments, stock exchanges and other regulatory bodies.

1.6.2. Product and Market Competition

Product and market competition, as the world became global village, is perhaps potentially more effective today than in the past due to the impact of globalization and relatively low or non-existent tariffs on the import/export of many manufactured goods and services, in the past fair competition was very rare due to tariffs and lack of good market standards and rules. Therefore, in the current business environment, few firms have the luxury of serving a local, protected marketplace. External control and product market competition are strongly free market orientated in their operation.

Reliance on these mechanisms is based on the firm belief that the disciplines of the market-place can achieve effective corporate governance. However, these are relatively weak and reactive rather than proactive tools of corporate governance (Jensen, 1993).

1.6.3. External Control (Capital Markets)

External control occurs when outsiders gets and acquires a large blocks of shares or most of the shares of the firm and impose a more disciplined approach on company operations and corporate governance procedures because they are majority of the shareholders. In this way, non-executive owners can exert a high degree of external (and also internal) control by closely scrutinizing the actions of senior management.

1.6.4. Internal Control

Internal control is one of the most important mechanisms of delivering accountability and enables organizations to monitor and control their operations, and it enables the segregation of duties and description of each person’s duties and responsibility so that the accountability becomes active and controllable. Legal, regulatory and internal control mechanisms have more and more been the focus of governments and regulatory bodies as a response to the corporate scandals and collapses of recent years.

The primary thrust of corporate governance is increasingly toward legal and regulatory and internal control mechanisms as these are in order according to the set rules, it easier to apply any standards required within the firm. Reliance on external control and competitive markets is seen as more risky and problematic due to its generally lagging and reactive nature. The aim of legal and regulatory and internal control mechanisms is more proactive corporate governance.

A company's board of directors functions as the highest internal corporate governance mechanism (Jensen, 1993). Internal control, which is also subject to external regulation, is largely concerned with board decisions about the *size*, *composition* and *function of the board of directors.* In this study the responsibilities of the board, a prime topic of firm's internal control mechanism is discussed in detail and is used as a central point to design the framework (Perek, 2009).

1.7. The Principles Of Corporate Governance

In this section, principles and guidelines in corporate governance are discussed in detail that can be applied to any organization. In the world, there are some big organizations that publish new guidelines and principles of corporate governance in every year in order to guide companies and governments in corporate governance field and always make them update. OECD is one of the most accepted organizations in corporate governance field in the world. In this section, OECD corporate governance principles will be investigated. The *OECD Principles of Corporate Governance (2004)* report will be used. The summary of the main principles are:

- **Principle 1: Ensuring the Basis for an Effective Corporate Governance Framework**

The corporate governance framework should facilitate transparent and efficient markets that can be benefited by the firm and other firms within the market. It should be consistent with laws and supervisory, regulatory and enforcement authorities that has been set and in order and should be separated efficiently and each authority should fulfill its own duty efficiently.

- **Principle 2: The Rights of Shareholders and Key Ownership Functions**

Shareholders should have right to get and transfer their shares easily and safely and their rights must be kept and protected. They should easily get relevant information about the company they have dedicated their assets that they had invested and they should participate and vote in shareholder meetings. The most importantly, they should have right to get profit with dividend payments for the shareholder at least to get some return for his/her investments in the firm.

Also shareholders should have right to participate in and get information about meetings in order to change business field of the company or some other extraordinary fundamental corporate changes because they are the people who invested the business and they have the right to get transparent information. Any capital structure change that increases the wealth of someone or another shareholder should be disclosed. And lastly, ownership rights should be exercised for all shareholders.

- **Principle 3: The Equitable Treatment of Shareholders**

All shareholders of the same class of share should be treated equally without making any bias. Minority shareholders should be protected, and their rights must be considered. Insider trading and abusive self-dealing should be prohibited. Members of the board and key executives should be required to disclose whether they have any material interest in the company.

- **Principle 4: The Role of Stakeholders in Corporate Governance**

The rights of stakeholders that are established by law or through mutual agreements should be protected as long as the company guards their privileges and rights the confidentiality between the stakeholders and business increases. Stakeholders should easily access information about the corporation at any time they demand on time and whenever they participate in any process of the corporation. The employees and other stakeholders should be able to freely tell their concerns about illegal practices of the company to the board. More employee participation in corporate governance should be facilitated (Dirim, 2008).

- **Principle 5: Disclosure and Transparency**

The corporate governance framework should try to make sure that accurate and timely information on governance structures and policies, objectives, ownership and voting rights, financial performance, foreseeable risk factors and issues regarding the employees and other stakeholders of the corporation, the information should be fairly prepared without making any manipulations to the original data to be used for preparing the information. This disclosed information must be in accordance with internationally accepted high quality standards of accounting and other financial and non-financial fields. An annual audit should be conducted by an independent and qualified auditor in order to get assurance about the financial performance of the corporation. Accessing to the required information by users should be easy and cost efficient (Dirim, 2008).

- **Principle 6: The Responsibilities of the Board**

Board members should act on a fully informed basis in the interest of the company and the shareholders not according to their interests and benefits. The board should care for the stakeholders and apply high ethical standards that can protect the rights of any stakeholder and as well as enhancing the company productivity and profits. The board should treat equally for the all shareholders. When the boards are established, their composition and working procedures should be identified and disclosed clearly so that the boards get to know which standards and systems they are to work in. Board members should exercise their duties carefully. In order to exercise their duties efficiently, the board members should have accurate and timely information access. Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgment to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration (Dirim, 2008).

1.8. The Definition and Theories that Constitutes Corporate Governance Paradigm.

A paradigm is defined as the framing and shaping a set of concepts, beliefs, and practices that guide the human action in an orderly and pattern way. There are twelve theories that contribute to the corporate governance paradigm. Different theories are developed to explain the different aspects of corporate governance paradigm. Thus, it is understood that there is a need to examine all the relevant theories about corporate governance. As a result of the process of induction, it is found that agency theory, resource-dependence theory, transaction cost economics theory, stakeholder-agency theory, instrumental stakeholder theory, traditional stewardship theory, corporate social performance theory, corporate social responsibility theory, integrative social contract theory, modern stewardship theory, resource based theory and normative stakeholder theory contribute to the corporate governance phenomenon. All these theories will be Explain d and some of them will be compared with each other in this section of chapter two.

1.8.1. Agency Theory

Agency theory emerged as a result of separation of ownership and control, and as these are separated conflicting interests arises. This separation led to conflicting interests between managers/agents and stockholders/principals which causes the business to get sick. In other words, agency theory emerged as a result of opportunistic behaviors by managers. The intellectual development of agency theory starts with the seminal papers of Ross (1973) and Jensen and Meckling (1976). Adam Smith is the first person who understood the agency cost problems between management and owners because of the varying and conflicting interesting. The roots of the agency theory can be found on the work of Coase (1937). Moreover, agency theory is the first theory that made fundamental contributions to the corporate governance phenomenon.

The fundamental issue in corporate governance is whether stockholder interests can be effectively protected or not and mostly as the power is transferred to the management there is possibility to manipulate the interests of the shareholders. According to agency theory, stockholders/principals delegate the control of the firm to the managers/agents. This fact generates a potential risk that managers/agents may serve their own interests at the expense of stockholders/principals, and this can cause a loose of confidentiality between the management and shareholders which can finally cause business to fail. Agency theory is built to solve this issue (Jensen and Meckling, 1976).

The premise of agency theory is positive distrust on the corporate behavior (Swift 2001). The assumption of agency theory is that humans are self-interested (Shankman 1999) and they are prone to opportunism (Eisenhardt, 1989), and however you trust a person it is an easy for that person to act according to your own interest by leaving his or her interests. Therefore, keep in mind that there will be conflicts of interests when people engage in cooperative endeavors (Jensen, 1994). Maximization of short-term wealth, emphasis on short-term perspective, and managerial motivation on preserving self-interest are the assumptions of agency theory (Caldwell and Karri, 2005). The roots of agency theory lies in the field of organizational economics, which contrasts with more humanistic and ethically centered fields such as organizational theory and strategy (Barn y, 1990). As a result, the main assumption in the agency theory, which is supported by some of the scholars above, is the premise of self-interest.

1.8.2. Transaction Cost Economics Theory

In the neoclassical perspective, the firm is seen as an automatic transformer of inputs of the firm like human efforts, raw material and information into outputs or as a black box. In this regard, it is advocated by Ronald Coase (1937) that market transaction costs are the reason for the existence of the firm and it should be given special attention accordingly. It is argued by Coase that the reason for the emergence of the firms is the transaction costs involved in entering markets, negotiating for goods and services, and enforcing contracts.

In transaction cost economics theory, there are two main problems which is to be fully cared about. One of these problems is related with asymmetric information and the other is related with resource dependence between the buyer and seller. For example, when suppliers and/or employees, has more information over a resource than the firm these stakeholders can misrepresent the value of the resource opportunistically (e.g. poor quality of a product or propensity to shirk). According to transaction cost economics theory, hold-up problem, which is related with asset specify, is the second issue.

For example, when a firm is hold-up by a supplier or customer due to the specialized investment in the assets there is a threat of buyer's or supplier's renege on the pricing agreements, which would make the investment on specialized assets a sunk cost for the firm. Therefore, firms prefer to exchange hostages, negotiate, monitor and enforce over contracts in order to prevent these problem related with asymmetric information and resource in/dependence. These two problems may also be solved by the use of hierarchy, viz., merging with suppliers or customers. Both of these solutions also come up with governance costs Therefore, the premise of self-interest is also the underlying reason for the emergence of transaction cost economics theory.

1.8.3. Traditional Stewardship Theory

According to the traditional stewardship theory, managers are the stewards who are required to protect and enhance the interests of stockholders (Grossmann and Hart, 1980; Linn and McConnell, 1983), because managers (stewards) perceive greater utility in substituting their self-interested behavior with cooperative behaviors, which is based on rational perspective (Davis, Schoorman, and Donaldson, 1997). Traditional stewardship theory is based on utilitarian ethics. In other words, maximizing stockholders' utility is expected to maximize the utility of stakeholders

(Caldwell and Karri, 2005). Traditional stewardship theory is based on the assumption that the interests of managers and stockholders are expected to be reconciled because it is believed that this is the rational behavior, and in this concept it is argued that both managers and owners should make possible standards which accepted by both of them to develop their way of understanding and cooperation. In other words, this myopic view is based on the assumption that managers will cooperate with the stockholders because their interests converge but it does not cover the interests of non-stockholders. Therefore, traditional stewardship theory does not tell the whole story about the corporate governance system. In other words, this theory illuminates only one aspect of the corporate governance paradigm.

1.8.4. Resource-Dependence Theory

Resource dependence theory focuses on how stakeholders within the business environment affect a focal firm and how the firm can respond to these stakeholders (Oliver, 1991; Rowley, 1997), in addition to that, if an actor cannot stand alone or may be difficult to do special task and to do that requires an extra help or resource from another actor it can be said a dependence. Anything that is perceived as valuable by an actor can be defined as a resource. If one actor relies on the actions of another to achieve particular outcomes, this kind of relationship can be defined as dependence. When one actor supplies another with a resource, this kind of relationship can be defined as resource dependence. In other words, unequal dependence between the parties to an exchange relationship creates power differentials (Emerson 1962), and the one which is more powerful than the other will always be independent while the other becomes dependent. Power arises from the dependencies of two parties. Suppose that there are two parties such as A and B. If party B is more dependent on party A relative to party A's dependence, party A has asymmetric power over party B. This is a typical example to the resource dependence theory. Specific examples can also be given to the resource-dependence theory. For example, management may enhance its asymmetric power over its suppliers via vertical integration or cooperative agreements among the different firms such as joint ventures, purchasing alliances, price leadership agreements and interlocking directorates. Management may also enhance its asymmetric power over customers via product and market diversification or horizontal mergers and acquisitions. Financial methods such as stock buybacks and new stock issues may also be used to increase the asymmetric power of management over stockholders.

Finally, management may use bureaucratic mechanisms to increase its asymmetric power over employees (Pfeffer and Salancik, 2003). All these explanations about resource-dependence theory implicitly show the existence of the self-interest principle.

1.8.5. Stakeholder Theory

The philosophical background of stakeholder theory can be said to be seen in the 19th century where it has been practiced. In other words, stakeholder theory is put an emphasis via cooperative movements and mutuality almost 200 years ago but it has been marginalized and forgotten periodically (Clarke, 1984). It is not possible to determine the precise origins of the stakeholder theory (Sturdivant, 1979). Edith Penrose is shown as a pioneer of stakeholder theory because she is one of the first scholars who examined the internal environment of the firm and included the firm's human resources and stakeholders to the theory of the firm (Pitelis and Wahl, 1998). Stakeholder theory became popular after the integration of stakeholder concepts in a coherent construct by Freeman (1984). Stakeholder construct is treated as a foundation for the theory of the firm and as a framework for the corporate social performance theory. Recently, it became a theory of its own right (Rowley, 1997). Some of the purposes of stakeholder theory are about integrating stockholder and organizational interests and treating people with fairness and equity and even guarding the rights of each individual in the company (Caldwell and Karri, 2005) or identifying and evaluating the stakeholders' legitimate stakes in the corporation or creating a better world and advancing the human condition (O'Higgins, 2001) or enabling managers to understand and strategically manage the stakeholders of the firm (Frooman, 1999) or determining the nature of the relationships between the firm and its constituents in terms of both processes and outcomes for the firm and its stakeholders.

Running a firm not only in the interests of its stockholders but also in the interests of all its stakeholders is a matter of development and keeping the business on track

(Aggarwal and Chandra, 1990; Arthur, 1987; Blair, 1998) is the definition of stakeholder theory. According to stakeholder theory, the legitimate interests of all stakeholders should be given simultaneous attention in stakeholder management (Donaldson and Preston, 1995). In other words, the premise of mutual-interests is the main assumption in stakeholder theory; companies are run for the interest of the company and its stakeholders not for specific interest which can put into bad side of the business.

In other words, the premise of public-interest is another main assumption in stakeholder theory, because the public are the people who are without care the business cannot be successful and reach its goals. Therefore, stakeholder theory emerged as a result of the mutual interests and public-interest that served as the main principles of this theory. The derivatives of stakeholder theory are instrumental stakeholder theory, stakeholder agency theory, corporate social performance theory, integrative social contract theory, modern stewardship theory, resource-based theory, corporate social responsibility, and normative stakeholder theory. These theories will be defined in the following sections.

1.8.6. Instrumental Stakeholder Theory

The instrumental stakeholder theory establishes and tries to find out a framework for examining the connections between the practice of stakeholder management and corporate performance goals. In other words, the instrumental stakeholder theory treats the stakeholders of the corporation as a mean (Donaldson and Preston, 1995).

Instrumental stakeholder theory is also expected to explore how organizations can succeed in the current business environment and which methods are necessary to be used to be successful (Freeman, 1984). The studies in USA show that adherence to stakeholder principles and practices help firms to achieve conventional corporate performance objectives. If managers view the interests of stakeholders as having intrinsic value and pursue the interests of multiple stakeholders, their firms will achieve better financial performance than the firms which pursue the interests of a single stakeholder group, because as far as the interests of the stakeholders are combined the chances of everyone to participate the development of the organization will increase and thus can succeed the confidentiality of all stakeholders (Donaldson 1999).

This is the proposition of instrumental stakeholder theory. Thus, instrumental stakeholder theory posits an empirically testable link between the organizational behavior and its financial outcomes (Jones, 1995). In sum, instrumental stakeholder theory starts with the principle of mutual interests and ends up with the premise of self-interest.

The purpose of instrumental stakeholder theory is to explain why certain altruistic behaviors, which are deemed as irrational, lead to economic success (Jones, 1995).The main thesis of instrumental stakeholder theory is that "if managers want to maximize the shareholder value over an uncertain period of time they have to pay attention to key stakeholder relationships" otherwise their aim of increasing the value will be uncertain (Freeman, 1999). It is difficult to find a relationship between performance and stakeholder orientation (Post, Preston, and Sachs 2002b), For example, instrumental stakeholder theory is studied by several scholars, and empirical results of these studies were all disappointing. On the other hand, a firm cannot maximize its value by ignoring the interests of its stakeholders. This rationale can be found in the definition of the stakeholder concept. Since stakeholders are groups without whose support the organization would cease to exist ignoring the interests of its stakeholders does not make sense.

1.8.7. Stakeholder-Agency Theory

Stakeholder-agency theory is proposed by Hill and Jones (1992). As it can be seen or perceived from the name of this theory, Hill and Jones tried to bring together or combine some aspects of the agency theory with the stakeholder theory. According to Hill and Jones, every stakeholder provides critical resources to the firm and, in return, they have legitimate interests on the firm. Therefore, the most important job of a firm/management is to serve the mutual-interests of the stakeholders rather than only one stakeholder group (e.g. stockholders). This argument is parallel to the stakeholder theory. On the other hand, Hill and Jones also defined stakeholders as the principals and management as the agent.

According to them, there is an asymmetric power in terms of information and resources between the stakeholders and management, so there must be a system of communication and interchange of information for both groups. Hence, institutional structures such as stock analyst services, labor unions, consumer unions, legislation emerged to reduce the asymmetric power between the management and stakeholders. In other words, the principle of positive distrust to management exists in their theory. This argument made by Hill and Jones is parallel to the agency theory. As a result, stakeholder-agency theory also starts with the principle of mutual-interests and ends up with the principle of self-interest.

1.8.8. Corporate Social Performance Theory

Corporate social performance theory can be said that it is almost related with the stakeholder theory because both of them include interests of all corporate stakeholders (Jones, Wicks 1999). Thus, corporate social performance theory and stakeholder theory are models which are developed for business and society (Jones 1995). Stakeholder construct is treated as a foundation for the theory of the firm.. This construct is also a framework for the corporate social performance theory, which became a theory of its own right recently (Rowley, 1997). (Carroll, 1979) is one of the major scholars who reconciled social and economic objectives in her corporate social performance model. Wartick and Cochran (1985) and Wood (1991) are some scholars who made important contributions to the corporate social performance theory. When the level of analysis is the firm rather than society public interest does not make sense for the managers of the firm because they can best perceive the stakeholders of the firm as a mean rather than ends (Clarkson, 1995) in individualistic societies. Therefore, Clarkson proposed ‘corporate social performance’

(CSP) framework for analyzing the relationships between the firm and stakeholders based on 70 field studies of CSP conducted between 1983 and 1993. In sum, mutual-interests rather than public-interest is the relevant main assumption in the corporate social performance theory. Thus, corporate social performance theory especially makes sense in the Anglo-Saxon world where the public-interest is perceived as a dangerous concept (Friedman 1962)

1.8.9. Integrative Social Contract Theory

Global managers operate in an increasingly complex and dynamic business environment which requires a lot of decision making tactics and planning. Thus, there is a need for reconciling global rules with local norms by forming integrative solutions that engender a degree of trust among allied corporations in order to improve the effectiveness of corporate governance worldwide, and any decisions and plans to be made must be considered the general culture, beliefs and norms in the environment in which the business operates (Sama and Shoaf, 2005). Integrative social contract theory is created by Donaldson and Dunfee (1994; 1995) to serve this need and it must be practiced by the Multinational National companies around the world. According to Donaldson and Dunfee, there are moral minimums that govern all business-community relationships at the macro level. Integrative social contract theory defines a good corporate citizen with behaviors and activities that meet or exceed expectations of a society. There are two types of cultures in the world: rule based cultures (e.g. U.S.) and norm-based cultures (e.g. Japan). Given these cultural differences, a norm-based society will resist to the imposition of rules for the purpose of corporate governance. On the other hand, a rule-based society will look at with skepticism to the principles or norms of corporate governance (Lovett, Simmons, and Kali, 1999). Thus, integrative social contract theory is created to reconcile these types of cultural differences.

1.8.10. Modern Stewardship Theory

The principles of modern stewardship theory based on covenantal approach are commitment to society, integration of shared interests, emphasis on long-term perspective, achievement of synergy, and creation of long-term economic wealth. In a modern stewardship theory, there is a dynamic balance among the interests of stakeholders who recognize that not every decision can benefit all parties equally that a long-term interdependent relationship exists among stakeholders. For example, long-term economic wealth, which is one of the principles of modern stewardship theory, is expected to ultimately serve not only to the interests of stockholders but also to the interests of stakeholders. Thus, the principle of long-term economic wealth is expected to maximize the long-term economic benefits of the society (Post, Preston, Sachs, 2002). Thus, modern stewardship theory tries to achieve a balance between self-interest and public-interest by developing a sense of community among the internal members of an organization (Caldwell, Karri 2005). As a result, the premise of mutual-interests is related with the modern stewardship theory.

1.8.11. Resource Based Theory

The purpose of resource based theory is to create competitive advantage for the firms via immobile and unique organizational competencies, simply to get a product unique for the company or a differentiation for the company's product to other company's products. Empowering the organizational members (Westley and Mintzberg, 1989), letting social interactions among the organizational members (Weick, 1979), making firm-specific investments in the employees due their unique knowledge and skills, forming ongoing and close relationships with the employees, trying to develop business outcomes (e.g. good reputation, product and service quality, and customer loyalty) in order to let stakeholders increase their supply of resources to the firm (March and Simon, 1958), forming active communications between the top management and employees with the help of human resources managers (Nonaka, 1988), creating an organizational system that inhibits employee turnover to induce firm-specific human capital (Jovanovic, 1979), reinforcing creativity, innovation, long-term orientation, cooperation, and trust are some of the features that refers to the resource based theory, as far as all things we have mentioned above are given special it contributes to the development of the company.

The common point among these features is that competitive advantage can be created through the workforce, and combining the efforts of all stakeholders of the organization (Pfeffer 1994), which is also the purpose of resource based theory. The most important common point in the resource based theory is the principle of resource interdependence between the firm and its stakeholders. This principle is closely related with the premise of mutual-interests.

1.8.12. Corporate Social Responsibility Theory

Wartickand Cochran (1985) described a range of organizational stakeholder orientations which differentiate self-interested behavior from the public interested behavior. Corporate social responsibility is that the business is not only concerned with profit maximization but should act in socially responsible manner that can enhance both the profits and social welfare of the society within it operates. In corporate social responsibility organizational outcomes are consistent with the social expectations. Corporate social responsibility is underappreciated by the all Anglo-American business paradigm (Frank 1992). Although the importance of corporate social responsibility has been acknowledged for fifty years, agency theory is still dominant mental model in corporate governance (Caldwell and Karri, 2005). Since CSR does not refer to the corporations that operate with Anglo-Saxon philosophy but to the firms that operate with a German-Japanese philosophy, the under appreciation of CSR is very normal. Altruism or concern for others, which refers to the public-interest principle and stands in the opposite pole of self interest, is the theme of corporate social responsibility. Thus, the premise of public-interest is the underlying assumption in the corporate social responsibility theory.

1.8.13. Normative Stakeholder Theory

The normative stakeholder theory acts the stakeholders of the corporation as an end. In other words, the interests of all stakeholders have intrinsic value for its own sake and not merely because of their ability to further the interests of stockholders. The correspondence between the theory and the observed facts of corporations is not a significant issue (Donaldson and Preston, 1995). “Who and what are the stakeholders of the firm?” is a question related with the normative stakeholder theory. This theory aims to explain why managers should consider certain constituents as stakeholders. According to normative stakeholder theory, managers should pursue the interests of multiple stakeholders because these interests have an intrinsic value (Donaldson, 1999).

Normative stakeholder theory is concerned with the moral value of the behavior of firms/managers (Jones, 1995). Proponents of normative stakeholder theory argue that firms should treat their stakeholders as ends or admit that the interests of their constituencies have an intrinsic value (Clarkson, 1995; Quinn and Jones, 1995). The main thesis of normative stakeholder theory is that "managers have to pay attention to key stakeholder relationships" (Freeman, 1999). The problem with normative stakeholder theory is that it is very difficult for firms, which operate in individualistic societies, to accept and implement the rules or principles of this theory because it refers to the public interests principle (Gunay, 2007).

1.9. Corporate governance systems

Corporate governance, during the history, can be said that it has dispersed from high developed countries to developing countries and even to non-developed countries. Because of different cultures and living standards among countries, corporate governance systems are national and vary from country to country.

Despite the differences that exist between countries in different continents and differing developments, Rajan and Zingales 2003 cited in (Şençitak, 2007) divide the corporate governance systems into two systems, as market- based and relationship-based system. Market-based system is also named as the outsider system, Anglo-American system, or stock-market capitalism. This system is characterized by the arm's length relationships between corporations and investors. Equity financing is important form for corporate finance and corporate shares widely held and easily traded (dispersed ownership). Shareholders have wide rights in market-based system; mostly those who are minority shareholders get their rights without making any discrimination between the ownership and the management. Institutional investors play important role. USA and UK are the main examples of market-based system.

Relationship-based system is also sometimes called as the insider system, the dedicated capital system, and welfare capitalism. Banks have dominant role in relationship-based system. Debt financing is mostly used and banks try to make complex and long term relationships with their corporate clients. The name of the system comes from the relationship emphasis. Concentrated ownership is the most common ownership structure in this system. Korean chaebol, Japanese Keiretsu or

European holding companies are the main concentrated ownerships. Germany and Japan are countries which have relationship-based corporate governance system.

1.9.1. United States

America's economic system is a good example of liberal economies in which financing is met by high liquid and well-developed securities market and where there is free market of trade for every investor. Dispersed ownership is common and shareholders' number is much. Managers' aim is to maximize shareholder value and the government let the market relations drive the economy by regulating the market and defending the rights of property and rules of contracts.

But the system is not always in this form. When unrestricted incorporation and limited liability became available in the mid-nineteenth century, closely-held family firms dominated the corporate form. This situation finished dispersed ownership, as the securities markets grew more robust and managerial control of enterprises increased. American banking was very regionally decentralized and fragmented. Much of its activities were consisting of the financing of trade. Banks did not affect industrial economy so much in the nineteenth century. Mostly young American corporations financed from bond issues. There were efforts to construct universal banking arrangements (involving both commercial and investment roles) allowing financial institutions to take equity stakes and intervene more directly in the internal governance of firms. Stakeholder views, especially in the guise of movements for manager autonomy, competed with stockholder views for much of the mid-twentieth century. Collective bargaining also regulated labor markets in important industrial sectors for much of this period, but stopped well short of union involvement in corporate governance. The government experimented with stronger forms of interventionism and collaboration with corporations and business associations during much of the Progressive and, especially, New Deal eras. But these mechanisms of intervention have been giving up since the 1980s (Herrigel, 2006).

1.9.2. Britain

Britain's corporate governance regime is very similar with United States. But the history of corporate governance system is quite different from America. In the nineteenth century, Britain was very negative to limited liability while it was opposite for Americans. Moreover, companies in Britain's economy were consisting from closely-held family companies. Not until the 1930s and a subsequent succession of merger waves, did dispersed ownership begin to predominate cited in (Herrigel, 2006).

Corporate finance in Britain has always been characterized by specialized in banking, and commercial and investment roles were widely dispersed from each other. The absence of universal banks, however, does not mean that bank industry relations were purely arms-length. On the contrary, long-term and often quite intimate relations frequently occurred between commercial bankers and their clients. Close, performance-monitoring ties were produced and reproduced through cooperatively constructed short-term contracts—loans, overdrafts, etc. But this "relational ship" in British banking stopped short of the strong form engaged in by continental universal banks: British banks did not become involved in the transfer of property and never strategically sought ownership stakes in their clients (though stock was sometimes accepted as collateral for loans). Securities markets were significant but often little utilized by domestic firms for much of the early period of industrialization. The London capital market grew significantly in both depth and liquidity over the course of the twentieth century (Ross, 1996) cited in also (Herrigel, 2006).

There is ambivalence in British corporate history about stakeholder rights. Labor governments supported unionization and worker rights relative to corporate actors for much of the twentieth century. Moreover, during the mid-twentieth century there were numerous nationalizations after which companies were run in stakeholders' interests, rather than according to strict market criteria. This stakeholder ship has declined since the 1980s, as privatization and merger were accompanied by the dispersal of stockownership and political struggles weakened the labor movement (Herrigel, 2006).

1.9.3. France

The main distinction between British- American case and France case is the role of state. The banking sector in France specialized in investment and commercial separately like Britain. In nineteenth and early twentieth century there were only a few large corporations which were closely-held. These firms were financed internally with earnings and they used banks only for short term loans. Banks did not have much equity stakes in firms. The securities market was used, especially during 1920s, but it was not a significant factor in corporate finance.

With the beginning of World War I, French government encouraged the development of ‘national champions’ in some industries. The government supplied required capital and other resources for these companies and became a big customer of them. After World War II, government’s influence had even increased and national plans developed and banks and firms nationalized. This influence affected also the composition of boards and corporate strategies of firms. The stock market weakened and firms became dependent on state- underwritten bank debt. In this period, the number of public corporate enterprises increased, and the ratio of large corporations in French economy increased. But the ownership remained concentrated. The main reason for this problem is firstly, the importance of public corporate enterprises is much.

And the second reason for this situation is the engagement of managers in ‘cross-shareholding’. Cross- shareholding is holding of shares between two or more publicly listed companies that give each company involved an equity stake in the other. Often employed as a means of preventing unsolicited takeovers**,** with high pressure from government, the corporate managers directed their companies towards stakeholder rather than stockholder interest. The rights of minority holders were not well protected in French Corporate law. Since the mid-1980s, following important financial system reforms, a series of Major self-dealing scandals involving prominent managers and state officials, and pressures from the European Union to reduce the economic role of the state, French corporations have become more exposed to market pressures. The size and role of the stock market has increased and shareholding has gradually become more dispersed (Herrigel, 2006).

1.9.4. Germany

Large scale corporate enterprises played an important role in German economy even earlier than USA (Kocka 1978, Dornseifer and Kocka 1993), cited in (Herrigel, 2006). In 1870, Germans liberalized incorporation law and it was reformed in 1884. Germans were very interested in limited liability and joint stock company form**.** But German laws were not sufficient for protecting minority shareholder rights. Closely held family enterprises have dominated German economy since the beginning of industrialization. But their share among all joint stock companies has varied over time. Between 1884 and 1933, it is decreased and after 1945 it is re-stabilized. And after 1990s it started to decline again. From 1884 to 1933, a gradual dispersal of shareholdings occurred. After 1945, this trend changed and concentrated holdings dominated ownership structure in Germany. Cross shareholding, especially after 1945, became an important form of concentrated ownership.

From the beginning of industrialization, German finance was bank driven and universal banking was the norm. Before World War II, it was not very significant. There were again banks in German finance, but their role was smaller than after World War II period. With the finishing of World War II, banks role increased. They created loans and credits, provided bridging finance, facilitated the transfer of ownership (securities underwriting) and participated in corporate governance through both the exercise of shareholders' proxy votes and direct equity holdings. In spite of great capacities of banks, this trend started to decrease after 1990s. Stakeholders' role is important in German corporate governance. Broader attention to stakeholders was written into the obligations of enterprise management after 1945 by co-determination legislation requiring labor representation on the supervisory boards of all corporations employing a minimum number of people (Jackson 2001, Streeck 1984), cited in (Herrigel, 2006).

Except for the centralized National Socialist Dictatorship term, German state has been federally organized with highly dispersed authority, and a small central bureaucracy in order to protect market order and coordinate public associational debate**.** Like France, Britain and USA, especially after 1990s in Germany there has been a great movement to greater dispersal of holdings, less usage of banking, greater importance to shareholder value, more liquidity in securities market and more emphasis on market solutions to public problems (Herrigel, 2006).

1.9.5. Japan

Before the militarization in 1930s, there were three types of corporate governance in Japan business environment. The first type of corporate governance was consisting of limited partnership holding company structure where family owners controlled diversified networks of publicly quoted enterprises, ran by professional management known as zaibatsu. The second type was classical state ownership corporate governance with professional bureaucratic managers directing towards economic goals of the government. The third and the most common corporate structure were broadly-held joint stock companies with highly liquid securities market and professional managers acting in the interest of stockholders (Hoshi &Kashyap 2001), cited in (Herrigel, 2006).

Until 1930s, Japanese financial sector was very well diversified and equity financing was more dominant than debt financing. Banks were used mostly in short term financing and relational banking did not exist. But there were some zaibatsu banks with close relationships with zaibatsu holdings. However, zaibatsu banks were not the primary finance resource for zaibatsu holdings. In this era, professional managers directed their companies towards the interests of its shareholders. The state regulated the economy by creating guideline rules for private actors. But the system changed after 1930s with war, military government, occupation and economic recovery respectively.

Firstly, strong securities market broke up by military government which is against to private economic interests. They made high taxation on stockholdings and made dividends illegal. The military government forced private companies to use banking instead of securities financing. The bank dominated finance sector was continued in the postwar era also.

Secondly, inter-corporate shareholding expanded. After the defeat of Japan in the war, the occupation authorities forced Japanese government to make new laws for forbidding zaibatsu holdings, sending their family owners to other countries and protecting minority rights (Hoshi and Kashyap 2001, Morck and Nakamura 2003, cited in (Herrigel, 2006). These reforms improved the capital market and with the help of inflation in devaluing the price of existing stocks, the managers bought big amount of shares in friendly or related companies in order to prevent from takeovers. During 1950s and 1960s, these situations produced loosely inter connected *keiretsu* in which related firms owned small amounts of shares in one another. These holdings were often small, but they summed up to a majority stake in the group by its own members—making it difficult for outsiders to enter into Japanese stock market. Banks were the most important directors of these interconnected holdings. Though each group borrowed from many banks, they lastly relied on a "main bank" to coordinate their financing. Main banks in many ways made the inter-corporate shareholding strategy work as a defense against takeovers. Main banks could coordinate the strategic development of member firms and mobilize disparate stakes in the event of an outside challenge. They also used their central position as credit givers to monitor keiretsu firms and took responsibility for directing restructuring efforts within member enterprises in the event of a crisis (Aoki & Patrick 1994), cited in (Herrigel, 2006).

Thirdly, employees acknowledged in Japanese corporate governance system. The key mechanism for this was the "institution" of permanent lifetime employment. Japanese courts penalized many large Japanese companies for employing regular workers. As a result, enterprise managers were practically achieved to manage their firms in the interest of shareholders, bankers, and employees. Lastly, the role of government in Japanese corporate governance changed significantly. The 1930s military government destroyed the securities market and the control of banks. In the postwar period, government control of banks got more indirect, but still remained significant. The Ministry of Finance rewarded banks which fostered investment in directions favored by state economic development policies and penalized banks which do not follow these policies. This linkage between the public and private sector was reinforced through the effective abolition of the national corporate bond market. With their stock bound up in highly complicated cross shareholdings, postwar Japanese enterprises –

unlike their prewar holdings—were extremely dependent on the banking system for finance. And the Japanese state was in a very strong position to direct the flow of investment funds from banks (Hoshi &Kashyap 2001), cited in (Herrigel, 2006: 11).

After reviewing the different countries' corporate governance structures, it is obvious that national and cultural differences created different corporate governance systems in each country. But, globalization is becoming more dispersed every day along the world. So, financial markets are getting more integrated to each other and this situation is creating a unique global financial market. At this point, corporate governance systems have been converging to each other in order to create the best corporate governance system that serves best for all investors all over the world.

1.9.6. Corporate Governance in Turkey

Corporate governance in Turkey is getting better and better and developing like all other developing countries' corporate governance in the world but Turkey has a weak corporate governance regime. According to the main characteristic of Turkish corporate governance is, it has very low shareholders' rights and very high creditor rights compared to developed countries, in which the creditor has first the right to get his/her paid credit and then the shareholder. Bond market for private corporations can be said that it is also not available. Turkey has almost all of the features of weak corporate governance regimes and is not mostly practiced in the Turkish markets and the weakness of the corporate governance including concentrated family ownership, weak institutions (law enforcement, accounting standards, and shareholder and creditor protection), pyramidal business groups and dual class shares. In pyramidal structure, the family achieves control of the constituent firms by a chain of ownership relations: the family directly controls a firm, which in turn controls another firm, which might itself control other firms, and so forth.

In general and as practiced in the developed countries strong corporate governance regime has high legal protection for minorities rather giving more rights to the majority owners of the firms. However; as it has been seen around the world a better legal protection leads to more valuable stock markets, to higher market valuation, greater dividend pay-out ratios, and to improved investment performance. The opposite of these consequences occurs in weak corporate governance regime, but as the economy of the country develops and more corporate standards and ownership standards are increased, there will be a good corporate governance system. In weak corporate governance regime, equity markets become thinner. Thin security markets are expected to have slower economic growth. As a result, improving a country's corporate governance standards, in the same time, increases the economic growth and investment performance of that country. (Yurtoglu, 2003:1)

On the other hand, There is also in Turkey a need for supervisory, regulatory and enforcement authorities to have the power, integrity and resources to act professionally and objectively. Independent regulators like the CMB need stable funding, freedom to decide how they spend their budget and clear support from government. The continued strong leadership and independence of the CMB and other independent financial sector authorities are crucial for the long-term vitality of the corporate sector in Turkey and the economy as a whole (Yuksek, 2008).

1.9.6.1. The History of Turkish Economy

In the history of Turkish economy, state-business enterprises are the starting and the most important factor in Turkey's business environment which is growing nowadays. Modern Turkish economy existed from agriculture dominated and foreign fund dependent Ottoman economy. Early surveys of the manufacturing industries disclose and show that establishments around 1920 were concentrated in the Western parts of the country with two employees on average indicating production for regional markets with old technology (Kepenek and Yentürk, 1996). In order to develop economy, domestic government directed strategies were followed until 1960s when a more conscious import substitution policy was started. During this period many state-owned enterprises were established and founded and it is controlled by the state. These failed to produce the desired degree of industrialization and rates of economic growth due to a number of reasons, because as the business is under the control of the government, the free market competition system comes to weak. The state had (and still has) a key role both as an owner of large industrial companies and by allocating resources to the private sector (Yurtoglu, 2003).

The import substitution policy was replaced in 1980 by an export-led stabilization and structural adjustment program implemented under a military regime. One major step of this program includes the liberalization of the capital market, which was carried out over the 1980-1989 period. The Capital Market Law was established in 1981 followed by the establishment of the Capital Market Board in 1982.

After a five-year preparation process that was dedicated to a lot of time and effort, Istanbul Stock Exchange was reorganized and reopened in 1986. An important feature of a variety of government policies towards industry was the inconsistency among their various elements and the consequent uncertainty they introduced into the decision making process of the private sector (Bugra, 1994). Government intervention was in general oriented towards short-term measures instead of generating long-term solutions to the structural problems of the economy (Yurtoglu, 2003) because as the governments makes long term interventions the balance of business in the private sector comes not fruitful and the ambition of the investors gets low. During 1980s and 1990s, Turkish corporate governance regime was characterized by opacity and was prone to corrupt practices.

The capital market at that time was characterized by low liquidity, high volatility, high cost of capital and limited new capital information. The shareholders with the most the shares which are the controlling shareholders maintained large stakes and have leveraged cash flow rights due to privileged shares and pyramidal ownership structures. In addition, shortcomings in the legal and regulatory framework were contributing substantially to the risk of investing in Turkish equity market. These deficiencies affected negatively foreign direct investments to Turkey and development of an equity market in Turkey. Financial crisis have important effect on the economies. Turkey experienced several financial crises during its history: The most recent ones were the 1994 financial crisis, the November 2000 and February 2001 financial crisis. These are the crises that strongly affected the Turkish economy, capital markets and caused high inflation rates. Turkish governments tried to stabilize the economy after the 1994 financial crisis. However, these efforts in 1995, 1998 and 2000 failed to reduce the inflation rate to levels below 25 per cent per year. In 2002, the Government made an agreement with the International Monetary Fund to make minor changes in the program to restructure the Turkish economy. Turkish government achieved to decrease the high inflation rate from 29,7% in 2002 to 8,39%

in 2007. With effort to joining European Union, systems are becoming more transparent among Turkish companies.

The revision of the Turkish Commercial Code and also the convergence to international accepted accounting, auditing and valuation standards are the reforms of the Turkish capital market regulations. Also Turkey has been taking strong and significant steps towards applying internationally accepted corporate governance practices for the last five years especially through Corporate Governance Principles of Turkish Capital Market Board (Arsoy and Crowther, 2008), but however there are a lot of organization that don’t apply these rules of corporate governance and a lot of research made in Turkey, it is revealed that corporate governance doesn’t have any impact mostly on the financial performance of the organization.

1.9.6.2. The Characteristics of Corporate Governance in Turkey

Characteristics of Turkish corporate governance are almost the same or similar with Turkish Capital market features which now in practice. First of all, only small part of companies are publicly listed and traded on Istanbul Stock Exchange (ISE). (Yurtoglu, 2003). As in the ISE, increasing of listed and traded companies is a proof of improvement of Turkish corporate governance regime during this decade which is getting better according its previous years.

Secondly, there is not any a proactive or an active market for corporate control in Turkey. Because concentrated ownership is the most common ownership type in Turkey, which causes organizations mostly not to practice corporate governance principles effectively. And in this ownership type, trading large blocks of sale (like hostile takeover) is not something that is possible usually because of the required permission of the controlling owner of the company. In the last decade, transferring of large block of shares is very rare and only $106 million on average. Controlling shareholders maintain large stakes and have leveraged cash flow rights due to pyramidal ownership structures (Ararat and Ugur, 2003) thirdly; existence of business groups is another feature of Turkish corporate governance.

According to these arguments, in the developing countries business groups are more likely to arise because these countries are characterized by poor institutional arrangements that prevent the creation of markets, but in the developed countries, because of the strict legal protections and standards it is more difficult for business groups to arise. BGs are common organizations in developing economies like Turkey. A single family or sometimes a coalition of a small number of families controls these BGs, which often include a bank. Scandals about these banks have risen for the last decade. Many of them were simple resource transfers of controlling shareholders from their firms in the form of outright theft or fraud. In this situation, mostly minority shareholders lost (Yurtoglu, 2003).

1.9.6.3. Corporate Governance Practices in Turkey

The main sources of corporate governance in Turkish legislation are the capital market law, Turkish commercial Code and Corporate Governance Principles of Turkish Capital Market Board and other regulations of Istanbul Stock Exchange are. The most important topic in Turkish corporate governance history is the capital Market Board's corporate governance principles. In July 2003 Turkish Capital Market Board issued corporate governance principles with the aim of enhancing the corporate governance regulations in Turkish listed companies. By recognizing and understanding the fact that no single model is valid and can be applied in for every country, Turkish Capital Market examined the regulations of many countries and generally accepted and recommended corporate governance principles, primarily the OECD Principles of 1999 and revision drafts have been taken into consideration during the preparation of these principles. These principles were developed and made on the basis of ''comply or explain'' approach which is meant that the implementation of Turkish Capital Market Principles is optional. But with law enforcement, after 2005 the companies are required to disclose their corporate governance practices and changes in their annual reports as they are preparing the yearend financial statements. Turkish Capital Market prepared the Turkish Capital Market Principles in order to fill the gaps in corporate governance practices. The Turkish Capital Market Principles have four main sections: shareholders, public disclosure and transparency, stakeholders and board of directors (Arsoy and Crowther, 2008).

In shareholders section, the rights of shareholders which are both minority and majority are explained. The principles about public disclosure and transparency concepts, information procedures and disclosure standards for all shareholders and the standards of information on financial reports are existed on public disclosure and transparency section. In the third section, the principles and standards which are about how to regulate the relationship between corporation and all of its stakeholders are given in detail or explained. In board of directors section, the function of the board, the roles and responsibilities of the board and some principles about establishing committees and delegating their managers in order to assist board of directors are found (Turkish Capital Market Board, 2003). The importance of corporate governance is increasing in Turkey like all other countries around the world. But importance of corporate governance among countries is not the same. According to (Arsoy and Crowther, 2008) the evolution of new corporate governance standards is similar with UK but compliance of them is relatively smaller than UK. Main reason for this is cultural differences (Dirim, 2008).

Corporate governance in Turkey has been a topic of increased interest in boardrooms due to the past financial crisis which had happened some years ago and affected the world, the desire to reduce economic backwardness, and international pressures toward a more market-based and shareholder-oriented model of governance.

The dominant non-governmental business structure in Turkey is the family-owned firm in which each family made their private company for their wealthy to become enlarged. Even the large holding companies are family owned, and top positions are occupied by family members, and it is hard for a non-family member to management the company; such as professional managers in the developed world. Turkey offers a rich base from which to undertake empirical research in the areas of corporate governance and family business management. The family stands at the heart of Turkish society, with family relationships having significant influence on the lives of Turkish people, which in turn influences the pattern of conducting business in Turkey.

It is said that it is something widely accepted that 30 percent of family firms survive into the second generation of family ownership, with only 15 percent surviving into the third generation (Morris et al., 1996). The case may be even worse in Turkey with multiple domestic and international financial crises, family companies were forced to take on short-term financial debts with high annual interest rates to fund their capital expenditures which can the firm go into bankruptcy if it is not well managed. Most of the companies were unable to repay their debts to creditor banks due to some of the problems associated with mismanagement, agency problem and separation of ownership and control which finally makes the firm go out of the sector. Since it has the status of a developing country, attracting an increase in the quality and quantity of international capital is essential to Turkey. The proper implementation of corporate governance principles is vital for the restructuring process of the Turkish capital markets and for attracting capital inflow into Turkey. Corporate governance structure in Turkey is a new concept as the Istanbul Stock Exchange (ISE) is fairly new, having only been established in 1989. The average free float is 31 percent in the ISE and there are few public companies with more than a 50 percent free float. Besides, in more than half of the ISE companies, families hold the majority of the shares, making it very difficult to separate governance from management. An overwhelming 95 percent of Turkish companies are family-owned, and further empirical analysis of the Istanbul Stock Exchange reveals that 74 percent of listed companies come under family control. Additionally, corporate culture in Turkish firms has been characterized by non-formal relationships between owners and stakeholders (contractors, customers, financers, or the government) and is often based on traditional or personal ties. Turkey.

However, more importantly, the rights of the minority shareholders, who invested in the company buying the shares from the ISE, are not adequately protected and this may make the minority shareholders disappointed that will not give an ambition the other potential minority shareholders to go to the market and invest in other companies in the same level. Incekara (2009), states that in parallel with the stagnation of the world economy, foreign direct investment (FDI) in Turkey is decreasing. According to World Investment Report by United Nations Conference on Trade and Development (UNCTAD) 2007, the countries that attract the highest FDI are USA and UK. Among developing countries, China is the first with 85 billion dollars of investment. Turkey is the 23rd country in the rankings by attracting 22 billion dollars of FDI. Turkey's ability to attract international capital is relatively low when compared to other countries, but in the last years there are changes in the former systems and principles of corporate governances practiced that attracts now the other countries to make investments in Turkey(Perek, 2009).

1.9.6.4. Corporate Governance Ratings in Turkey

In July 2007 the CMB has published and issued a declaration on Rating Activities and Rating Agencies in the Capital Market. The declaration states Corporate Governance rating as the "the independent, impartial and fair evaluation and rating of corporations' compliance with the CMB's Guide on Corporate Governance Principles". The rating of the implementation of Corporate Governance principles is to be based on varying degrees from 1 to 10, and the criteria are stakeholders' interests; disclosure and transparency; shareholders' protection; and the board of directors. Only agencies authorized by the CMB are entitled to carry out rating activities in Turkey. The rating agencies are required to report in their ratings any noncompliance with the CMB principles.

The long-awaited Corporate Governance Index of the Istanbul Stock Exchange (ISE) was published by the ISE on 31 August 2007. According to the rules, only those companies whose ratings are above 5 (i.e. at least six) are to be included in the Index. As of April 01 2009, 14 companies are listed in this Index. SAHA Corporate Governance and Credit Valuation Services Inc., is the first licensed valuation firm by CMB. The valuation reports prepared by them are gathered and the rating method for the board of directors section is analyzed. When the scoring technique was analyzed it was observed that the scoring methodology was parallel to the one used in the methodology section of this thesis. As in the reports of the rating agencies, the survey questions grades every company in the sample according to their compliance level. Hereby, the results of this thesis could also be used as the ratings for the board of directors section of corporate governance principles(Perek, 2009).

Actually when we look at the corporate governance index in Turkey, Corporate governance index (CGI) is a quite new concept in Turkey and unfortunately the number of companies at GCI is surprisingly low as compared to the number of listed companies at Istanbul Stock Exchange (ISE). Generally most of firms in Turkey are family owned and are, which usually don’t require making expansions with the money invested by outside investors, so that is the main reason behind the lack of application of the corporate governance in Turkey.

CHAPTER TWO

DIVIDEND POLICY

2.1. Definition

When talking about dividend policy, it is said that dividend policy is considered to be one of the most important financial decisions that corporate managers encounter. This is because it is hypothesized to perform a series of often contradictory roles in financial management to manage the various capital market imperfections prevalent in the real world. In turn, dividend policy outlines and often makes the basis upon which other theories of finance, such as asset pricing, capital structure and capital budgeting, rely(Dhanani, 2005).

In other words, Dividend policy is at the core of the theory of corporate finance. As, it is said and known by the scholars, the dividend policy is one of the most debated topics in the finance literature and still maintains its prominent position. Many researchers have formulated and devised theories and provided empirical evidence on the subject of the determinants of a firm's dividend policy. The dividend policy issue, however, remains unresolved. Clear guidelines for an 'optimal payout policy' have not yet emerged despite the voluminous literature. We still do not have an acceptable explanation for the observed dividend behavior of companies, mostly the dividend policy used by the companies is varying, and there is no a single method used for dividend payout. We are yet to understand completely the factors that drive dividend decisions and the manner in which these factors interact (Naceur, Goaied, Balanes, 2006).

In addition to that, when talking about the ways in which firm makes dividend payouts and initiations, it is common that dividend initiation announcements are associated with positive stock returns on average. For example, Asquith and Mullins (1983) report abnormal returns of 3.7% around the announcement of dividend initiations, although similar findings persist in studies using longer and more recent sample periods. These returns, along with those associated with announcements of increases in dividend payments, are typically interpreted as implying that dividend initiations (or increases) communicate valuable information to the market. In the existing literature, two main hypotheses (that are not mutually exclusive) have emerged to explain the nature of this information: (i) that dividend initiations signal higher cash-flow/profitability for initiating firms; and (ii) that dividend initiations signal lower agency costs at the initiating firm as managers will have less of their shareholders' cash to waste, expropriate, or overinvest in the future (Micah, 2007).

Today, it is said that when it comes to dividend, it has being made a lot of debate regarding the way of distributing and taking decisions regarding dividends when the firms gain profit. Hence, the scholars say that although firms have been distributing dividends to their shareholders for four centuries (Baskin, Barron, 1998), the motivation for this corporate policy is under debate in the academic community. In an early paper, coined the term the "dividends puzzle" to illustrate the poor understanding of dividend payment policy: "The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don't fit together." Over the years, dozens of theories have attempted to explain the dividends phenomenon with no consensus reached. Many of the theories view agents as rational and dividends either serve as an efficient way to resolve agency problems or as a signaling device to mitigate information asymmetry problems (Black, 1976). Even now it seems that different scholars and even firms different approaches, theories and methods for dividend distribution, so there is no a common way of distributing the dividends because of the varying interests of the shareholders in the firm, some require cash money, while the rest may require reinvestment of their earned money in to the business (David, 2010).

2.2. Dividend Policy and Stock Value

When dividend policy is talked about there are a number of factors that influence dividend policies. Some of these factors include the investment opportunities available to the firm, alternative sources of funds, and stockholders' preferences for current versus future income, the major goal of this part is to show how these factors interact to determine a firm's dividend policy. We begin by examining whether dividend policy affects the value of a firm's common stock.

2.2.1. Dividend Irrelevance- Dividend policy Does not Affect Stock Value

There has been an interesting argument saying that dividend policy has no effect on either the price of a firm's stock or its cost of capital – that is, that dividend policy is irrelevant. The principal proponents of the **dividend irrelevance theory** are Merton Miller and Franco Modigliani (MM). they argue and explain in their theories that the value of the firm is determined only by its basic earning power and its business risk not the dividends paid by the firm; in other words, MM argued that the value of the firm depends only on the income produced by its assets, not on how this income is split between dividends and are retained earnings (and hence growth), but apart from MM there another possibility that says if an stable dividends is paid out to the investors every time not relating to the income earned, it will increase the need for other investors to make investment to the come as far as the company pays predefined dividend income .

MM based their proposition solely on theoretical grounds; thus, they had to make some assumptions in order to develop a manageable theory that could be more beneficial to both business scholars and other interested parties. They assumed individuals neither pay taxes nor commissions on investments, firms do not go bankrupt, a firm's dividend policy does not affect its capital budgeting decisions, and investors are indifferent as to whether a firm pays dividends or retains earnings to invest in growth opportunities- thus, the dividend policy does not affect the cost of common equity. Given these assumptions, MM argued (correctly) that investors care only about the total returns they receive, not whether they receive those returns in the form of dividends or capital gains, and the only thing MM focus on is the return on asset gained. Thus, if the MM theory of dividend irrelevance is correct, there exists no optimal dividend policy, because dividend policy does not affect the value of the firm (Fred, Besley, 1996).

Modigliani and Miller (MM), according to their theories, provide the most comprehensive and affective argument for the irrelevance of dividends. They assert that, given the investment decision of the firm, the dividend-payout ratio is a mere detail and that it does not affect the wealth of shareholders. M&M argue that the value of the firm is determined sole by the earning power of the firm's assets, or its investment policy, and that the manner in which the earnings stream is split between dividends and retained earnings does not affect this value, the main and most necessary aspect for the investors is the return of the assets they invested. When we considered the capital structure decision, M&M assume perfect capital markets where there are no transactions costs, no flotation costs to companies issuing securities, and no taxes. Moreover, the future profits of the firm are assumed to be known with certainty.

Current dividends versus retention of earnings: The Crux of M&M's position is that the impact of dividend payouts on shareholder wealth is exactly offset by other means of financing. Let us first try to give consideration to the selling of additional common stock to raise equity capital instead of simply retaining earnings. After the firm makes all its investment decisions, it must decide whether (1) to retain earnings or (2) to pay dividends and sell new stock in the amount of these dividends in order to finance the investments. M&M suggest that the sum of the discounted value per share of common stock after financing plus current dividends paid exactly equal to the market value per share of common stock before the payment of current dividends. In other words, the common stock's decline in market price because of the **dilution** caused by external equity financing is exactly offset by the payment of the dividend. Thus, the shareholder is said to be indifferent between receiving dividends and having earnings retained by the firm.

Although it is still true that the market value of a share of common stock is the present value of all expected future dividends, the timing and magnitude of the dividends can vary. The dividend-irrelevance position simply argues that the present value of future dividends remains unchanged even though dividend policy may change the timing and magnitude of dividends. It does not argue that dividends, including a liquidating dividend, are never paid. On the contrary, it argues only that dividend postponement (but where the future dividend magnitude is allowed to grow) is a matter of indifference when it comes to the market price of common stock.

Conservation of value: Given M&M assumptions of certainty and perfect capital markets, the irrelevance of dividends naturally follows. As with our example, for corporate financial leverage, the *total-value principle* ensures that the sum of market value plus current dividends of two firms identical in all respects other than dividend payouts ratios will be the same (James, Wachowics, 1998).

Investors have the capacity to replicate any dividends stream the corporation might be able to pay but currently is not. If dividends become lower than as previously desired, investors can sell some shares of stock to obtain their desired cash distribution, so that their cash needs for that time be covered. If dividends are higher than desired, investors can use dividends to purchase additional shares of stock in the company, and that could increase the investor's voting power in the firm. Thus, investors are able to manufacture "homeland" dividends in the same way that they could devise "homeland" financial leverage if they were unhappy with a firm's current capital structure. For a corporate decision to have value, the company must be able to do something for shareholders that they cannot do for themselves. Because investors can manufacture homemade dividends, which are perfect substitutes for corporate dividends under the preceding assumptions, dividend policy is irrelevant. As result, one dividend policy is as good as the next. The firm is unable to create value simply by altering the mix of dividends and retained earnings. As in capital structure theory, there is a conservation of value so that the sum of the parts is always the same. The total size of the pie is not changed by the slicing (James, Wachowics, 1998).

2.2.2. Dividend Relevance – Dividend Policy Does Affect Stock Value

Actually when you think globally, it is usually possible to feel that the assumptions made by MM are unrealistic. In the real world, investors might prefer one dividend policy over another; if so, a firm's dividend policy is relevant, really a firm paying no dividend but making the retained earnings used for other things makes the investors go and search for other dividend paying firms, because investors aim to take risk is at least to get money when in need. According to the **dividend relevance theory,** then, dividend policy can affect the value of a firm through investor's preferences.

One of MM's assumptions that have been hotly debated over a time is that dividend policy does not affect investors' required rate of return on equity K_s. for example, Myron Gordon and John Lintner argued investors prefer to receive dividends "today" because current dividend payments are more certain than the future capital gains that might result from investing retained earnings in growth opportunities and nobody wants uncertain investments, so K_s should decrease as the dividend payout is increased. In effect, Gordon and Lintner said that investors value a dollar of expected dividends more highly than dollar of expected capital gains because the dividend yield component, D_1/p_o, is less risky than the capital gains component, g, in the total expected return equation, $k_s= D_1/p_o+ g$.

On the other hand, there is another factor that might cause or push investors to prefer one dividend policy over another, thus affecting the cost of common equity, is the tax effect of dividend receipts, investors must pay taxes at the same time dividends and capital gains are received, and this is necessary. Dividends are associated with ownership of the stock; thus, if a firm pays out dividends this year, the owners must pay taxes on those dividends this year, they have gained. On the other hand, capital gains are not taxed until the investment is sold, which can be many years into the future. So depending on his or her tax situation, an investor might prefer either a payout of current earnings as dividends, or capital gains associated with growth in stock value. Investors who prefer to delay the impact of taxes would be willing to pay more for low payout companies than for otherwise similar high payout companies, and vice versa (Fred, Besley, 1996).

2.2.3. Arguments for Dividend Relevance

A lot of arguments have been highly developed in support of the contrary position, namely, that dividends are relevant under conditions of uncertainty. In other words, investors are not indifferent as to whether they receive returns in the form of dividend income or share price appreciation. We shall examine these arguments under conditions of uncertainty.

Preference for Dividends: Some Certain investors may have a preference for dividends over capital gains, and this varies from an investor to another. They imbursement of dividends may resolve uncertainty in their minds concerning company profitability, but as dividends are not given in cash there may be uncertainty for the investors about the company's profitability. Dividends are received on a current, ongoing basis, while the prospect of realizing capital gains is in the future. Therefore, investors in a dividends-paying company resolve their uncertainty earlier than those investing in a non-dividend-paying company, as the investor invests in dividend paying company, his/her uncertainty decreases. To the extent that investors prefer the early resolution of uncertainty, they may be willing to pay a higher price for the stock that offers the greater dividend, all other things held constant. If, in fact, investors can manufacture "homemade" dividends, such a preference is irrational. Nonetheless, sufficient statements from make it difficult to dismiss this argument. Perhaps, for either psychological reasons or reasons of inconvenience, investors prefer not to manufacture "homemade" dividends but to get the "real thing" directly from the company (James, Wachowicz, 1998).

Taxes on the investor: When we allow for taxes, there are a variety of effects, because taxes have a lot of influences on the dividend on capital gains of the investor. To the extent that the personal tax rate on capital gains is less than that on dividend income, there may be an advantage to the retention of earnings. In addition, the capital gains tax is deferred until the actual sale of stock (when any gain is then *realized)*. Effectively, the shareholder is given a valuable timing option when the firm retains earnings as opposed to pays dividends. Also, the capital gains tax may be kept away from altogether if appreciated securities are given as gifts to charitable causes or if the security owner dies. For these reasons, the effective tax on capital gains (in present value terms) is less than that on dividend income, even when the federal tax rate on the two types of income is the same. This would suggest that a dividend paying stock will need to provide a higher expected before tax return than a non-dividend paying stock of the same risk. According to this notion, the greater the **dividend yield** on a stock, the higher the required before tax return, and all other things being constant.

However, all those who make investments and are investors do not experience the same taxation on the two types of income just discussed. Certain institutional investors, such as retirement and pension funds, pay no tax on either dividend income or realized capital gains; such investors would be indifferent from a tax standpoint between a dollar of dividend income and a dollar of capital gains. For corporate investors intercompany dividends are taxed at an effective rate below that applicable to capital gains. For example, if Alpha Corporation owns 100 shares of Omega Corporation, which pays a $0.9 per share annual dividend, 70 percent of the dividend income to Alpha Corporation is tax exempt. In other words, Alpha Corporation would pay taxes on $30 of dividend income at the corporate tax rate, the overall tax effect will be less than if Omega Corporation had share appreciation of $100 and all of this was taxed at the capital gains rate. Accordingly, there may be a preference for current dividends on the part of corporate investors (James, Wachowicz, 1998). Also, there are a growing number of institutional investors.

If there are clienteles of investors having different dividend preferences, corporations would adjust their dividend payout ratio to take advantage of the situation, and as much as these kind of investors are in the stock exchanges markets, companies those don't pay any dividends are in a condition that it is not easy for them to take advantage of such kind of investors. Suppose that tow fifths of all investors prefer a zero dividend payout ratio, one-fifth prefer a 35 percent payout ratio, and the remaining two-fifths prefer a 60 percent payout ratio. If most companies pay-out ratio 35 percent of their earnings in dividends, there will be excess demand for the shares of companies paying zero dividends and for the shares of companies whose dividend payout ratio is 60 percent, so generally investors prefer cash dividends as they the shareholders of the company because there is not an exact guarantee that the business will be successful in the next years. Presumably, a number of companies will recognize this excess demand and adjust their payout ratios in order to increase share price. Action of these companies will eliminate the excess demand. In equilibrium, the dividend-payout ratios of corporations will match the desires of investor groups. At this point, no company would be able to affect its share price by altering its dividend. As a result even with taxes, the dividend-payout ratio would be irrelevant.

Obviously, were left with an unsettled condition in which the effect of taxes on dividends is in ambiguous or simply unclear. Before considering some of the empirical evidence on the effect that dividends have on share price, we must look at other factors that may influence the payment of dividends.

Flotation costs. The irrelevance of the dividend payout is that of something based on the idea that when favorable investment opportunities exist and still the dividends are not paid, the funds paid out of the firm must be replaced by funds acquired through external financing. The introduction of the flotation costs involved with external financing favors the retention of earnings in the firm. For each dollar paid out in dividends, the firm nets less than a dollar after flotation costs per dollar of external financing (James, Wachowicz, 1998)

Transactions costs and divisibility of securities: Transactions costs which involved in the sale of securities have a tendency to restrict the arbitrage process in the same manner as the described for debt. Shareholders who are in the desire of the current income must pay brokerage fees on the sale of portions of their stock ownership if the dividend paid is not sufficient to satisfy their current desire for income, because sometimes the dividends paid to the shareholders may not be enough to cover their need for cash. This fee, per dollar of shares sold, varies inversely with the size of the sale, as the share sold is in large portion. For a small sale, the brokerage fee can be a rather significant percentage of the total sale. As a result of this fee, shareholders with consumption desires in excess of current dividends will prefer that the company pay additional dividends which sometimes may not be possible. Perfect capital markets also assume that securities are infinitely divisible. The fact that the smallest equity-security unit is one share may result in “lumpiness” with respect to selling shares for current income. This too, Acts as deterrent to the sale of stock in lieu of dividends (James, Wachowicz, 1998).

On the other hand, shareholders who are not in the hope of their dividends for current consumption purposes will require reinvesting their dividends. Here, again, transactions costs and divisibility problems work to the disadvantage of the shareholder, although this time as a deterrent to the purchase of stock. Thus, transactions costs and divisibility problems cut both ways, and one is not able to draw directional implications regarding paying dividends versus retaining earnings.

Institutional Restrictions: Certain institutional investors are limited and get restricted in the types of common stock they have to buy or in the portfolio percentages they can hold in various types of common stock, and the number or the percentage they can have are predefined. The prescribed list of eligible securities for these investors is determined in part by the length of time over which dividends have been paid. If company does not give dividends to such king of investors or has not paid them over a sufficiently long period, certain institutional investors are not permitted to invest in the stock of that company.

Universities, on the other hand, sometimes have limitations on the expenditure of capital gains from their endowments; they are given a limited number for their usage of the gains from their endowments. Also, a number of trusts have a prohibition against the liquidation of principal. In the case of common stocks, the trust beneficiary is entitled to dividend income but not to the proceeds from the sale of common stock. As a result of this stipulation, the trustee who manages the investments may feel constrained to pay particular attention to dividend yield and seek stocks paying reasonable dividends. Though the two influences described are small in aggregate, they work in the direction of a preference for dividends as opposed to earnings retention and capital gains.

Financial signaling: Financial signaling varies from the other arguments presented in this section in that it depends on imperfections in the market for financial information. It suggests that dividends have an impact on share price because they communicate information, or signals, about the firm’s profitability; investors perceive that the much the company pays for dividend is the more the organization has gained as profit from its operations. Presumably, firms with good news about their future profitability will want to tell investors; so that they encourage the investors for the risk taking decisions they have made. Rather than make a simple announcement, dividends may be increased to add conviction to the statement (James, Wachowicz, 1998). When a firm has a target dividend-payout ratio that has been stable over time and the firm increases this ratio, investors may believe that management is announcing a positive change in the expected future profitability of the firm; and any firm with positive growth and economic stability should try to give their investors to a possible dividend ratios that can both enhance the good will of the company within the environment it operates and can increase the chances for external financing of the firm it requires. The signal to investors is that management and the boards of directors truly believe that things are better than the stock price reflects.

Accordingly, the price of the stock may react positively to this increase in dividends, because a company with good dividend paying capacity, every investor will try to benefit from the dividends paid and make an investment to that company and as the demand for that company's shares starts the shares prices goes up. The idea here is that the reported accounting earnings of a company may not be a proper reflection of the company's economic earnings. To the extent that dividends provide information on economic earnings not provided by reported earnings, share price will respond. Put another way, cash dividends speak louder than words. Thus, dividends are said to be used by investors as predictors of the firm's future performance. Dividends convey management's expectations of the future (James, Wachowicz, 1998).

2.2.4. The Assumptions Behind Dividend Irrelevance

Obviously, it is hard and difficulty for many stockholders and business people to accept the suggestion that dividend policy is irrelevant. When faced with MM's arguments, they often give the answer that dividends are cash in hand while capital gains are at best in the bush. It may be true, they say, that the recipient of an extra cash dividend forgoes an equal capital gain, but if the dividend is safe and the capital gains is risky, isn't the stockholder ahead?

It's correct that dividends are more predictable than capital gains which are the profit that results from investments in the capital assets. Managers can stabilize dividends but they cannot control stock price, because is affected by external factors that is not control by the management but the dividends are in the hands of the management. From this it seems a small step to conclude that increased dividends make the firm less risky. But the important point is, once again, that as long as investment policy and borrowing are held constant, a firm's overall cash flows are the same regardless of payout policy. The risks borne by all the firm's stockholders are likewise fixed by its investment and borrowing policies and unaffected by dividend policy, but actually sometimes it is good for the firm to reinvest the retained earnings rather giving as dividends to the shareholders as far as the firm wants to invest in other profitable projects; if the firm pays the dividends and ask for loan to the banks this will decrease the overall potential profitability of the firm (Brealey, Myers, Marcus, 2004).

If we really believed that existing stockholders are better off by trading a risky asset for cash, then we would also have to argue that the new stockholder-those who trade cash for the newly issued shares-are worse off. But this doesn't make sense: the new stockholders are bearing risk by investing their assets, but they are getting their risks paid for it. They are willing to buy because the news shares priced to offer an expected return adequate to compensate for the risk.

MM's arguments for the irrelevance of dividend policy do not assume a world of certainty; it assumes an efficient capital market. Market efficiency means that the transfers of ownership created by shifts in dividend policy are carried out on fair terms. And since the overall value of (old and new) stockholders' equity is unaffected, nobody gains or losses (Brealey, Myers, Marcus, 2004).

2.3. Investors and Dividend Policy

There are a lot of debates among the scholars about the dividend and through academic researchers have studied the dividend policy issue extensively, they have yet to reach definitive conclusions about which dividend theory is more correct. As a result, the issue remains unresolved and still confusing; researchers at this time actually cannot give corporate decision makers exactly how dividend policy affects stock prices and capital costs because there are a lot of opposing theories each with different meaning and explanations. But, from the research, some views have been presented concerning investors' reactions to dividend policy changes and why firms have particular dividend policy. Three of these views are discussed in this section.

2.3.1. Information Content, or Signaling:

If investors are anticipating a company's dividend to get increased by 5 percent per year, and if, in fact, the dividend is increased by 5 percent, then the stock price generally will not change significantly on the day the dividend increase is announced because this is something already expected to increase and doesn't make more sense. In Wall Street parlance, such a dividend increase would be "discounted," or *anticipated* by the market. However, if investors expect a 5 percent increase, but the company actually increases the dividend by 25 percent- say from $2 to $2.50- this generally would be accompanied by an increase in the price of the stock. Conversely, a less-than-expected dividend increase, or a reduction, generally would result in a price decline; so here it can be understood that however the retained earnings increases if the dividends as are expected are not paid it will cause the prices of the firm's shares goes down, but as long as there is surprise increase in the prices of the shares this will enhance both the price of the stock and the good will of the come within the area it operates (Brealey, Myers, Marcus, 2004).

The fact that large dividend increases generally cause stock price increases suggests to some that investors in the aggregate prefer dividends to capital gains, according to this perception there are contradicting view and theories from other scholars. However, MM argued differently. They noted the well-established facts that corporations are always reluctant to cut dividends and, consequently, that managers do not raise dividends unless they anticipate higher, or at least stable, earnings in the future, but companies with higher profits make the retained earnings invest in other projects rather than increasing the dividend payout ratio to the shareholders. Therefore, according to MM, this means that a larger-than-expected dividend increase is taken by investors as a "signal" that the firm's management forecasts improved future earnings, whereas a dividend reduction signals a forecast of poor earnings. Thus, MM claimed that investors' reactions to changes in dividend payments do not show that investors prefer dividends to retained earnings; rather, the stock price changes simply indicate that important information is contained in dividend announcements- in effect, dividend announcements provide investors with information previously known only to management. This theory is referred to as the **information content**, or **signaling, hypothesis.**

2.3.2. Clientele Effect

MM also suggested that a **clientele effect** might exist, and, if so, this might help explain why stock prices change after announced changes in dividend policy. Their argument went like this: a firm sets a particular dividend payout policy, which then attracts a “clientele” consisting of those investors who like this particular dividend policy, some investors like predefined dividends payout ratio so that they can count for it at the end of the year. For example, some stockholders, such as university endowment funds and retired individuals, prefer current income to future capital gains, so they want the firm to pay out a high percentage of its earnings, because they are in need of cash dividends at that time to cover their operating expenses. Other stockholders have no need for current investment income-they would simply reinvest any dividend income received, after first paying income taxes on it, so they favor a low payout ratio, according to the above mentioned theories, keep in mind that the needs of the people change; some are in need of money at that time because they don’t have any net income; some have enough income and the dividends they receive make reinvestment again.

If the firm retained and reinvested earnings rather than paying dividends, those stockholders who need current income would be disadvantaged and this can cause some conflict of interest within the organization between the management and stockholders. They presumable could realize some capital gains, but they would have to go to the trouble and expense of selling some of their shares to obtain cash. Because brokerage costs are quite high on small transactions, selling a few shares to obtain periodic income would be expensive and inefficient. Also, some institutional investors (or trustees for individuals) are precluded from selling stock and then “spending capital.” On the other hand, if the firm paid out most of its income, other stockholders who did not need current cash income would be forced to receive such income. Pay taxes on it, and then go to the trouble and expense of reinvesting what is left of their dividends after taxes. MM concluded from all this that those investors who desired current investment income would purchase shares in high-dividend payout firm, whereas those who did not need current cash income would invest in low-payout firms. This suggests that firms’ stockholders are attracted to companies because they have particular dividend policies (Brealey, Myers, Marcus, 2004).

2.3.3. Free Cash Flow Hypothesis

Generally the views and purposes of the management and those of the shareholder; so if it’s the intent of the financial manager to maximize the value of the firm, then investors should prefer that a firm pay dividends only if acceptable capital budgeting opportunities do not exist. We know that acceptable capital budgeting projects increase the value of the firm and such kind of projects help the organization boom and increase the welfare of the shareholders (Fred, Besley, 1996). We also know that, because flotation costs are incurred when issuing new stock, it costs a firm more to raise funds using new common equity than it does using retained earnings. So, to maximize value, where possible, a firm should use retained earnings rather than issue new common stock to finance capital budgeting projects and it's generally good for the shareholders to accept these kinds of reinvestments for the firm. Thus, dividends should be paid only when free cash flows in excess of capital budgeting needs exist. If management does otherwise, the firm's value will not be maximized.

According to the **free ash flow hypothesis,** the firm should distribute and give to its shareholders any earnings that cannot be reinvested at a rate at least as great as the investors' required rate of return K_s. everything else equal, firms that retain free cash flows will have lower values than firms that distribute free cash flows, because the firms that retain free cash flows actually decrease investors' wealth by investing in projects with IRR<$K_{S.}$ (Fred, Besley, 1996).

The free cash flow hypothesis might help to explain why investors react in somewhat varying ways to identical dividend changes made by similar firms. For example, a firm's stock price will not change dramatically if it reduces its dividend for the purpose of investing in capital budgeting projects with positive NPVs, but as the firm is willing to invest in a project with its NPV lower than expected it will cause the firm's stock price goes down. On the other hand, a company that reduces its dividend simply to increase free cash flows will experience a significant decline in the market value of its stock, because the dividend reduction is not in the best interests of the stockholders- in this case, an agency problem exists, so it is better for any business managers to keep in mind if dividends are cut for a purpose other than reinvesting the firm will cause problem for the market value and image of the firm. Thus, the free cash flow hypothesis suggests the dividend policy can provide information about the firm's behavior with respect to wealth maximization.

2.4. Dividend Policy in Practice

We have presented some insights which are concerning the relevance of dividend policy and how investors might view dividend payments from firm. However, no one has been able or succeeded to develop a formula that can be used to tell management specifically how a given dividend policy will affect a firm's stock price (Fred, Besley, 1996).

2.5. Types of Dividend Payments

The dollar amounts of dividends paid by firms follow a different of ways and patterns. In general, though, firms pay dividends using one of the four payout policies discussed in this section.

2.5.1. Residual Dividend Policy

In practice, dividend policy is always affected and influenced by investment opportunities existing at the date of the dividend payment and by the availability of funds with which to finance new investments. This fact has led to the development of a **residual dividend policy,** which states that a firm should follow these steps when deciding how much earnings should be paid out as dividends: (1) determine the optimal capital budget of the year, (2) determine the amount of capital needed to finance that budget, (3) use retained earnings to supply the equity component of the extent possible, and (4) pay dividends only if more earnings are available than are needed to support the optimal capital budget. The word residual means "left over," and the residual policy implies that dividends should be paid only out of "left over," earnings, or free cash flows, so if the company has no any residual cash and then pays dividends it causes the firm to be in cash deficiency which will finally push to borrow money .

The basis of the residual policy is the fact that mostly those who are the investors of the firm prefer to have the firm retain and reinvest earnings rather than pay them out in dividends if the rate of return the firm can earn on reinvested earnings exceeds the rate investors, on average, can themselves obtain on other investments of comparable risk, but as long as the expected return is less they prefer not to make reinvestment.

For example, if the corporation can reinvest retained earnings at a 14 percent rate of return, whereas the best rate the average stockholder can obtain if the earnings are passed on in the form of dividends is 12 percent, then stockholders will prefer to have the firm retain the profits.

Most firms have a target capital structure that calls for at least some debt, so new financing is done partly with debt and partly with equity. As long as the firm finances with the optimal mix of debt and equity, and as long as it uses only internally generated equity (retained earnings), its marginal cost of each new dollar of capital will be minimized. Internally generated equity is available for financing a certain amount of new investment, but beyond that amount the firm must turn to more expensive new common stock. At the point where new stock must be sold, the cost of equity, and consequently the marginal cost of capital, rises. So, it is usually better for companies to make investment from the retained earnings as much as possible, because financing with debt can cause a lot of problem for the firm as the payment of interests and also issuing new stock to financing for projects with positive NPV value makes the firm too costly

2.5.2. Stable, Predictable Dividends

In the past and also now it changes from one firm to another, many firms set a specific annual dollar dividend per share and then maintained it, increasing the annual dividend only if it seemed clear that future earnings would be sufficient to allow the new dividend to be maintained. Corollary of that policy was this rule: N*ever reduce the annual dividend.*

More recently, inflation plus reinvested earnings have had a tendency to push earnings up; so many firms that would otherwise have followed the stable dollar dividend payment policy have switched over to a “stable growth rate” policy. Here the firm sets a target growth rate for dividends and strives to increase dividends by this amount each year. Obviously, earnings must be growing at a reasonable steady rate for this policy to be feasible, but where it can be followed, such a policy provides investors with a stable real income, and investors, as the dividends increases will be very delighted with the performance of the firm (Fred, Besley, 1996).

There are two good reasons for paying **stable, predictable dividends** rather than following the residual dividend policy. First, given the existence of the information content, or signaling, idea, a fluctuating payment policy would lead to greater uncertainty, hence to a higher risk K_s and a lower stock price, than would exist under a stable policy. Second, many stockholders use dividends for current consumption, and they would be put to trouble and expense if they had to sell part of their shares to obtain cash if the company cut the dividend; this is in addition to the anxiety a significant dividend cut would cause them, as we have seen in the some other parts, the needs of the investors vary and some of them may require in cash their dividends rather than reinvest and such kind of people must considered (Fred, Besley, 1996). Further, it is possible for most firms to avoid these problems and try to get the best solution for the trouble existing within the firm. Even though the optimal dividend as prescribed by the residual policy might vary somewhat from a year to year, actions such as delaying some investment projects, departing from the target capital structure during a particular year, or even issuing new common stock make it possible for a company to avoid the problems associated with unstable dividends. As a rule, stable, predictable dividends imply more certainty than variable dividends, thus a lower K_s and a higher firm value.

2.5.3. Constant Payout Ratio

It would be possible for a firm to pay out a constant *percentage of earnings,* but because earnings surely will fluctuate, this policy would mean that the dollar amount of dividends would vary, and if the investors adopted with the constant payout ratio for each year and the firm is not able to continue this may cause for the stock price of the firm to decline rather than to increase because investors sometimes use their investment in a way of daily consumption (Fred, Besley, 1996). For example, if it had paid out a constant percentage of earnings, Eastman Kodak would have had to cut its dividend in several different years, and this probably would have caused its stock price to fall sharply because as mentioned above as dividends are cut the problem of stock price decrease starts suddenly. (Kodak's stock price was relatively stable during the 1980s and the first of the 1990s, in spite of earnings fluctuations. Had it cut the dividend to keep the payout ratio constant, the stock price would have "fallen out of bed" several times if investors interpreted the dividend reduction as a signal that management thought the earnings declines was permanent.)

If Kodak had followed the policy of paying a constant percentage of earnings per share, say 50 percent, the dividends per share paid since 1978 would have got fluctuated exactly the same as earnings per share. With the constant payout ratio dividend policy, investors would have had much greater uncertainty concerning the expected dividends each year, and chances are Ks also would be greater.

2.5.4. Low Regular Dividend Plus Extras

A policy of paying a low regular dividend plus a year-end extra in good years is a compromise between a stable, predictable dividend and a constant payout rate and most investors prefer this kind of method while the payment method of the firm is not stable and changes from period to period. Even such a policy gives the firm flexibility, yet investors can count on receiving at least a minimum dividend plus if the company or the firm financial performance is good some other benefits over the fixed dividend. Therefore, if a firm's earnings and cash flows are quite volatile; this policy might be its best choice. The directors can set a relatively low regular dividend-low enough so that it can be maintained even in low-profit years or in years when a considerable amount of retained earnings is needed-and then supplement it with an **extra dividend** in years when excess funds are available. Ford, General Motors, and other auto companies, whose earnings fluctuate widely from year to year, formerly followed such a policy, but in recent years they have joined the crowd and now follow our first choice, a stable, predictable dividend policy (Fred, Besley, 1996).

2.6. Payment Procedures

Obviously, as the firm pays to its investors it is usually paid quarterly, and, if conditions permit, the dividend is increased once each year. For example, Kodak paid $0.40 per quarter in 1994, or at an annual rate of $1.60. In common financial parlance, we say that in 1994 Kodak's regular quarterly dividend was $0.40, and its annual dividend was $1.60. In late 1994, Kodak's board of directors met, reviewed projections for 1995, and decided to keep the 1995 dividend at $1.60. The directors

announced their intentions to maintain the $1.60 rate, so stockholders could count on receiving it unless the company experienced unanticipated operating problems.
The actual payment procedure is as follows

1. **Declaration Date.** On the declaration date- say, on November 13- the board of directors meets to discuss the amount of dividend to be paid to investors and declares the regular dividend, issuing a statement similar to the following: “On November 13, 1995, the directors of the XYZ company met and after meeting decided to declare the regular quarterly dividend of $0.50 per share, payable to holders of record on December 8, payment to be made on January 4, 1996,” for accounting purposes, the declared dividend becomes an actual liability on the declaration date, and if a balance sheet were constructed, the amount ($0.50) x (Number of shares outstanding) would appear as a current liability, and retained earnings would be reduced by a like amount.
2. **Holder-of-record date.** At the close of business on the **holder-of-record date**, or **date of record**, December 8, the company closes its stock transfer books and prepares to produce a list of shareholders as of that date which are to be given the dividend in that time. If XYZ Company is notified of the sale and transfer of some stock before 5 p.m. on December 8, then the new owner receives the dividend. However, if notification is received after December 8, the previous owner of the stock gets the dividend check, because his or her name appears on the company’s ownership records.
3. **Ex-dividend date.** Suppose Jean buyer buys 100 shares of stock from John seller on December 4. Will the company be notified of the transfer in time to list Buyer as the new owner and thus pay the dividend to her? To avoid conflict, the securities industry has set up a convention of declaring that the right to the dividend remains with the stock until four business days prior to the holder-of-record date; on the fourth day before that date, the right to the dividend no longer goes with the shares. The date when the right to the dividend leaves to the stock is called the ex-dividend date.
4. **Payment Date.** The company actually mails the checks to the holders of record on January 4, the payment date (Fred, Besley, 1996).

2.7. Dividend Reinvestment Plans

In recent years, there is a newly issued system in which larger companies have instituted **dividend reinvestment plans (DRPs),** whereby stockholders can automatically reinvest dividends received in the stock of the paying corporation if they don't want cash dividends for consumption at that time. There are two types of DRPs: (1) plans that involve only "old" stock that already is outstanding, this means only stock already outstanding can be bought and used for reinvestment and (2) plans that involve newly issued stock. In either case, the stockholder my pay income taxes on the amount of the dividends even though stock rather than cash is received. Under the "old-stock" type of plan, the stockholder chooses between receiving dividend checks and having the company use the dividends to buy more stock in the corporation. If the stockholder elects reinvestment, purchases to the participating stockholder's accounts on a *pro rata* basis. The transactions costs of buying shares (brokerage costs) are low because of volume purchases, so these plans benefit small stockholders who do not need cash dividends for current consumption (Fred, Besley, 1996).

2.8. Factors Influencing Dividend Policy

So far we have analyzed and got discussed only the theoretical aspects of dividend policy. Yet when a company establishes a dividend policy, it looks at a number of other matters. These additional considerations should be related to the theoretical concepts surrounding dividend payout and the valuation of the firm. In what follows, we take up various practical factors that firms actually do (and should) analyze when approaching a dividend policy decision (James.Wachowicz. 1998).

2.8.1. Legal Rules

The laws of a firm's state of incorporation decide the legality of any distribution to common shareholders. The legal rules that we discuss below are important in establishing the legal boundaries within which a firm's finalized dividend policy can operate, as the rules are followed the dividend payments can be said are in the assigned legal rules. These legal rules have to do with capital impairment, insolvency, and undue retention of earnings.

Capital Impairment Rule. Although country laws are different considerably, many countries prohibit the payment of dividends if these dividends impair capital. Some countries define capital as the total par value of the common stock. If a firm's shareholder's equity consists of $4 million in common stock (at par), $3 million in additional paid-in-capital, and $2 million in retained earnings, totaling more than $5 million without impairing capital (i.e., reducing shareholders' equity below $4 million).

Other states define capital to include not only the total par value of the common stock but also the additional paid-in capital. Under such state statues, dividends can be paid only "to the extent of retained earnings." Notice, we did not say that dividends can be paid "out of retained earnings." A company pays dividends "out of cash," while incurring a corresponding reduction in the retained earnings account.

Insolvency Rule: Some countries and some states in the USA prohibit the payment of cash dividends if the company is insolvent. Insolvency is defined either in a legal sense, as total liabilities of a company exceeding its assets "at a fair valuation" or, in an "equitable" (technical) sense, as the firm's inability to pay its creditors as obligations come due, while the firm is in risk it is not possible to pay dividends to its stockholders so some countries and states don't allow the company to pay dividend while it is in such mood. As the firm's ability to pay its obligations is dependent on its liquidity rather than on its capital, the equitable (technical) insolvency restriction gives creditors a good deal of protection. When cash is limited, a company is restricted from favoring shareholders to the determent of creditors (James.Wachowicz. 1998).

Undue Retention of Earnings Rule: The internal revenue code of the USA prohibits the undue retention of earnings. Although undue retention is vaguely defined, it is typically thought to mean retention significantly in excess of the present and future investment needs of the company. The purpose of the law is to prevent companies from retained earnings for the sake of avoiding taxes because some companies use tactics to avoid the payment of taxes. For example, a company might retain all of its earnings and build up a substantial cash and marketable securities position. The entire company could then be sold, and shareholders would be subject to only a capital gains tax, which is postponed relative to what could occur if dividends were paid. If the internal Revenue Service can prove unjustified retention, it can impose penalty tax rates on the earnings accumulation, so it's better for the companies to follow the process already defined or if found guilty and misrepresentation they will face penalty. Whenever a company does build up a substantial liquid position, it has to be sure that it can justify the retention of these funds to the IRS. Otherwise, it may be more prudent to pay the excess funds as dividends to shareholders (James.Wachowicz. 1998).

2.8.2. Funding Needs of the Firm

Once the legal limits and the boundaries for the firm's dividend policy have been established and put forward, the next step involves an assessment of the funding needs of the firm, by just an analysis for understanding the exactly needed funds. In this regard, cash budgets, projected sources and uses of funds statements, and projected cash flow statements are of particular use. The key is to determine the likely cash flows and cash position of the company in the absence of a change in dividend policy. In addition to looking at expected outcomes, we should factor in business risk, so that we may obtain a range of possible cash-flow outcomes (James.Wachowicz. 1998).

On the other hand, by just keeping our earlier discussions of the theoretical aspects of dividend policy, the firm would wish to determine if anything is left over after servicing its funding needs, including funding acceptable investment projects and the management must be careful in such critical decisions which relate to the firm's future existence and profitability. In this regard, the firm should look at its situation over a reasonable number of future years to iron out fluctuations. The likely ability of the firm to sustain a dividend should be analyzed relative to the probability distributions of possible future cash flows and cash balances. On the basis of this analysis, a company can determine its likely future residual funds.

2.8.3. Liquidity

One of the considered elements in the financial position of the company is its liquidity. The liquidity of a company is a prime consideration in many dividend decisions and it's given a lot of consideration when making decisions. Because dividends represent a cash outflow, the greater the cash position and overall liquidity of a company, the greater its ability to pay a dividend, a company that is growing and profitable may not be liquid since its funds may go into fixed assets and permanent working capital. Because the management of such a company usually desires to maintain some liquidity cushion to give it financial flexibility and protection against uncertainty, it may be reluctant to jeopardize this position in order to pay a large dividend.

2.8.4. Ability to Borrow

The liquidity position of the company is not the only way to provide for financial flexibility and thereby protect against uncertainty. If a firm has the capacity and ability to borrow on comparatively short notice, it may be relatively financially flexible, because a firm with the ability to borrow a short term credit and pay back can be said even financially it is good. This ability to borrow can be in the form of a line of credit or a revolving credit agreement form a bank, or simply the informal willingness of a financial institution to extend credit. In addition, financial flexibility can come from the ability of a firm to go to the capital market with a bond issue. The larger and more established a company, the better its access to the capital market. The greater the ability of the firm to borrow, the greater its financial flexibility, and the greater its ability to pay a cash dividend, with ready access to debt funds, management should be less concerned with the effect that a cash dividend has on its liquidity (James.Wachowicz. 1998).

2.8.5. Restrictions in Debt Contracts

The protective covenants in a bond indenture or loan agreement often include a restriction on the payment of dividends, in this case, most institutions specially banking impose restriction to firm how much dividend it can bay unless the firm pays back the credit. The restriction is employed by the lenders to preserve the company's ability to service debt. Usually it is expressed as a maximum percentage of cumulative earnings (reinvested) in the firm. When such a restriction is in force, it naturally influences the firm's dividend policy. Sometimes the management of a company welcomes a dividend restriction imposed by lenders, because then it does not have to justify the retention of earnings to its shareholders. It only needs to point to the restrictions.

2.8.6. Control

If a company pays considerable dividends, it may require a capital raise at a later time through the sale of stock in order to finance profitable investment opportunities. Under such circumstances, the controlling interest of the company may be diluted if controlling shareholders do not or cannot subscribe for additional shares. These shareholders may prefer a low dividend payout and the financing of investment needs by retaining earnings. Such a dividend policy may not maximize overall shareholder wealth, but it still may be in the best interests of those in control.

2.8.7. Some Final Observations

In determining a dividend payout, the typical company will put the analyzing table a number of factors just described. These factors largely state and dictate the legal standards, rules and other boundaries within which a dividend can be paid. When a company gives a dividend to its shareholders that are in excess of its residual funds, it implies that management and the board of directors believe that the payment has a favorable effect on shareholder wealth. The frustrating thing is that we have so little in the way of clear generalizations from the empirical evidence. The lack of a firm footing for predicting the long-run effect of a specific dividend policy on valuation makes the dividend choice a most difficult policy decision, (James.Wachowicz. 1998).

Considerations taken up in this section allow a company to determine with reasonable accuracy what would be an appropriate passive dividend strategy, and getting the right dividend policy is a matter of debate among the business scholars. An active dividend policy involves and required actually an act of faith, because it demands that a portion of the cumulative dividends paid out ultimately be replaced with common stock financing. Such a strategy is undertaken in a foggy area, but one in which most academics have difficulty believing that shareholder wealth will be enhanced. Notwithstanding, many companies profess a belief that dividend payout affects share price and behave in a manner consistent with dividend importance.

2.9. Dividend Stability

Stability of dividend payments is an attractive feature to many investors, which also encourages the other investors to buy the outstanding shares of the company. By stability we mean maintaining the position of the firm's dividend payments in relation to a trend line, preferably one that is upward sloping, but a dividend payment that changes suddenly without constancy cannot be said dividend stability. All other things being the same, a share of stock may command a higher price if it pays a stable dividend over time than if it pays out a fixed percentage of earnings. Suppose that company X has a system of long-run dividend-payout ratio of 40 percent of earnings. It pays out his percentage every year, despite the fact that its earnings are cyclical. Company Y, On the other hand, has exactly the same earnings and a long-run dividend payout ratio of 40 percent, but it maintains a relatively stable dividend over time. It changes the absolute amount of dividend payment only in keeping with the underlying trend of earnings.

Over the long run, total amount of dividends paid by these two firms is the same. However, one thing remarkable is that the market price per share of Company Y may be higher than that of company X, all other things being constant. The shareholders who are the Investors of the firm may well place a positive utility on dividend stability and pay a premium for the company that offers it (James.Wachowicz. 1998).. To the extent that investors value dividend stability, the overall dividend policy of company Y would be better than that of Company X. this policy encompasses not only the percentage of dividend payout in relation to earnings but also the manner in which the actual dividend are paid. Rather than vary dividends directly with changes in earnings per share, company Y raises the dividend only when reasonably confident a higher dividend can be maintained.

2.10. Valuation of Dividend Stability

Investors may be ready and willing to pay a premium for stable dividends because of the information content of dividends, the desire of investors for current income, and certain institutional considerations.

Informational content: When earnings go down and a company does not cut its dividend, the market may have more confidence in the stock than it would have if the dividend were cut. The stable dividend may convey management’s view that the future of the company is better than the drop in earnings suggests. Thus, management may be able to affect the expectations of investors through the informational content of dividends, management will not be able to fool the market permanently if there is a downward trend in earnings, and stable dividend will not convey forever an impression of a promising future. Moreover, if a firm in an unstable business with wide swings in earnings, a stable dividend cannot give the illusion of underlying stability.

Current Income Desires: A second factor may favor stable dividends. Investors who desire a specific periodic income will prefer a company with stable dividends to one with unstable dividends, even though both companies may have the same pattern of earnings and long-run dividend payout, generally the needs of the investors vary so those with the need of cash dividend usually prefer a stable dividend strategy, but investors who don’t prefer cash dividends can make investment in other firms with no stable dividend policy. Although investors can always sell a portion of their common stock for income when the dividend is not sufficient to meet their current needs, many investors have an aversion to dipping into principal (James.Wachowicz. 1998).. Moreover, when a company reduces its dividend, earnings are usually down and the market price of the common stock depressed. Overall, income-conscious investors place a positive utility on stable dividends, even though they can always sell a few shares of stock for income.

Institutional Considerations: A stable dividend may be a trustable and very advantageous from the legal standpoint of permitting certain institutional investors to buy the common stock and also which encourages the other parts to get engaged in buying those kind of stock. Various governmental bodies prepare *approved (or legal) lists* of securities in which pension funds, saving banks, trustees, insurance companies, and certain other institutions may invest. To qualify, a company often must have an uninterrupted pattern of dividends. A cut in dividends may result in the removal of a company from these approved lists.

The arguments presented in support of the notion that stable dividends have a positive effect on the market price of the stock are only suggestive. Little empirical evidence sheds light on the question. Although studies of individual stocks often suggest that stable dividends buffer the market price of the stock when earnings are down, there have been no comprehensive studies of a large sample of stocks dealing with the relationship dividend stability and valuation. Nevertheless, most companies strive for stability in their dividend payments. This is consistent with a belief that stable dividends have a positive effect on value.

2.11. Target Payout Ratios

A number of companies appear to follow the policy of a target dividend-payout ratio over the long run which is been applied by other organizations and seems to be more beneficial. John Lintner contends that dividends are adjusted to changes in earnings, but only with a lag. When earnings increase to a new level, a company increases dividends only when it feels it can maintain the increase in earnings because if it cannot maintain that earnings and just increases the dividends in one year and the other goes down it will be hard for the company and the company's stock prices will also decline. Companies are also reluctant to cut the absolute amount of their cash dividend. Both of these factors help explain why dividend changes often lag behind changes in earnings. In an economic upturn, the lag relationship becomes visible when retained earnings increase in relation to dividends. In a contraction, retained earnings will decrease relative to dividends (James.Wachowicz. 1998).

2.12. Regular and Extra Dividends

One of the best strategies for a company to increase its cash distribution to shareholders in periods of prosperity is to declare an **extra dividend** in addition to the

regular dividend that is generally paid on a quarterly or semiannual basis, because if the dividends are not paid as an extra dividend it will be like a dividend that will be paid continuously in each period. By declaring an extra dividend, the company warns investors that the dividend is not an increase in the established dividend rate, otherwise it will cause a problem for the management and investors will push demanding such kind of dividends each time. The declaration of an extra dividend is particularly suitable for companies with fluctuating earnings. General Motors, for example, has declared extra dividends in good years. The use of extra dividends enables the company to maintain a stable record of regular dividends and also to distribute some of the rewards of prosperity. If a company pays extra dividends continuously, it defeats its purpose. The extra dividend becomes expected. When properly labeled, however, an extra or special, dividend still conveys positive information to the market concerning the firm's present and future performance (James.Wachowicz. 1998).

2.13. Stock Dividends and Stock Splits

Stock dividends and stock splits are related to the firm's cash dividend policy, the firm can either use stock dividends or stock split. The rationale for stock dividends and splits can best be explained through an example, in which everybody can understand very well. We will use porter Electronic controls inc. a $700 million electronic components manufacture, for this purpose. Since its inception, Porter markets have been expanding, and the company has enjoyed growth in sales and earnings. Some of its earnings have been paid out in dividends, but some also are retained each year, causing earnings per share and market price per share to grow. The company began its life with only a few thousand shares outstanding, and after some years of growth, each of Porter's shares had a very high EPS and DPS. When a "normal" P/E ratio was applied, the derived market price was so high that few people could afford to buy a "round a lot" of 100 shares. This limited the demand for the stock and thus kept the total market value of the firm below what it would have been if more shares, at lower price, had been outstanding. To correct this situation, Porter "split its stock" as described in the next section.

2.13.1. Stock Splits

Although there is little empirical evidence to support the contention, there is nevertheless a widespread belief in financial circles that an optimal, or *psychological, price range* exists for stocks. “Optimal” means that if the price is within this range, the price/earnings ratio, hence the value of the firm will be maximized. Many observers, including Porter’s management, believe that the best range for most stocks is from $20 to $80 per share. According, if the price of Porter’s stock rose to $80, management probably would declare a two-for-one **stock split**, thus doubling the number of shares outstanding, halving the earnings and dividends per share, and thereby lowering the price of the stock, each stockholder would have more shares, but each share would be worth less, if the post-split price were $40. Porter’s stockholders would be exactly as well of as they were before the split. However, if the price of the stock were to stabilize above $40, stockholders would be better off, stock splits can be of any size-for example, the stock could be split two-for-one, three-for-one, and one-and-a-half-for-one, or in any other way.

2.13.2. Stock Dividends

Stock dividends are almost the same to stock splits in that they “dive the pie into smaller slices” without affecting the fundamental position of the current stockholders. On a 5 percent stock dividend, the holder of 100 shares would receive an additional 5 shares (without cost); on a 20 percent stock dividend, the same holder would receive 20 new shares; and so on. Again, the total number of shares is increased, so earnings, dividends, and price per share all decline. If a firm wants to reduce the price of its stock, should it use a stock split or stock dividends? Stock splits generally are used after a sharp price run-up to produce a large price reduction. Stock dividends typically are used on a regular annual basis to keep the stock price more or less constrained. For example, if a firm’s earnings and dividends were growing at about 10 percent per year, its stock price would tend to go up at about the same rate, and it would soon be outside the desired trading range. A 10 percent annual stock dividend would maintain the stock price within the optimal trading range (Fred, Besley, 1996).

CHAPTER THREE

AN EMPIRICAL ANALYSIS OF THE INFLUENCE OF CORPORATEGOVERNANCE ON DIVIDEND PAYOUT RATIO

3.1. Research Design

This study is aimed at finding the effect of corporate governance on dividend payout policy in companies operating in the Turkish markets especially in ISE 100 firms. It is about finding statistical evidence that states if there is any effect of corporate governance on dividend payout policy, and to ensure that the statistical evidence could be positive or negative effect.

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In the study, the researcher considers dividend payout ratio as the dependent variable, while as an independent variable, we have here board size, shares holding by directors, independent outside directors, executives, and other control variables which are firm size lagged dividend, roe, and lastly leverage. By using these four corporate governance independent variables and control variables which will be looked at if they have any influence on dividend payout ratios of the companies.

3.1.1. Sample Selection (Target Population)

The sample of this study is quoted from Istanbul Stock Exchange simply known as (ISE). In ISE there companies which are normally grouped as ISE 100, and from the ISE 100, the researcher has officially selected the non financial companies in ISE 100. So, in order to clarify the exact group the researcher was targeting. The study was excluded financial companies such as banking industry, investing firms and etc. So, the sample consists of 49 companies selected from ISE 100 non-financial firms and the study is based on 2010.

3.1.2. Data Description

The data which used for calculating and finding statistical evidence from the study, was mainly gathered from the official websites of the companies in the ISE 100, their annual financial reports, activities reports and their disclosures and even by using the website of each firm in the ISE and downloading all data related to the study. The data specially used for getting dependent variable (dividend payout ratio) is driven from the balance sheet and the net income statements of 2010, while the other independent variables such board size, shares holding by directors, independent outside directors, and executives, and also control variables which are firm size lagged dividend, roe and lastly leverage, their data are from both the annual activities reports and financial statements in 2010.

3.1.3. Measuring Dependent Variable

In the study, **dividend payout ratio** is used as the dependent variable, and while calculating the dividend payout ratio it computed as dividends to net income. The ratio illustrates the fraction or we can say the part of the earnings that is paid to investors or in other way, it is the part of the earnings not paid to investors is left for investment to provide for future earnings growth. There are some investors those are seeking for high current income and limited capital growth; these kinds of investors usually prefer companies with high Dividend payout ratio.

On the other hand, from time to time when it comes to the ways of paying dividend and the amount of dividend the companies pay to their shareholders, if the company has high and excessive payout ratioit suggests that the company might be paying out more than it can comfortably afford. This leads the company into a position that it will be susceptible to a decline in future dividend payments. However the case, we use dividend payout ratio as the dependent variable and data used in the study is from financial reports from 2010.

3.1.3. Measuring Independent Variables

In the study, we use corporate governance variables as the independent variables, in which the researcher wants to know the exact effect these independent variables have on the dividend payout ratio, which represents our dependent variable.

The first independent variables the researcher used in the study are the ***board size***. This variable indicates the number of the board of the directors each company has in its management hierarchy. In any business company, generally the minimum number usually allowed in the board of directors consists of five members. But when we look at what they do, a board of directors is a body of elected or appointed members who jointly watch over the general activities and processes of the company or the organization.

Usually it differs from one company to another the duties and powers of the board. But a board's activities are determined by the powers, duties, and responsibilities delegated to it by an authority outside itself these matters are typically detailed in the organization's bylaws.

So, the researcher needs to know whether, the size of the board of directors of the company influence the dividend payout ratio of the company and how it effects. After that the researcher can get to know if the board is to be increased or decreased if the firm wants to buy higher or less dividends to its shareholders.

The second independent variable is the ***independent outside directors***, are the directors who don’t take part the daily day to day actions of the company or in other words Member of the Board of Directors of an entity who is an outsider, meaning he or she is not an employee of that entity..

So, in here the researcher needs to look at whether independent outside directors can have influence on the dividend payout ratio, and to understand if the independent outside directors increase will it have a negative or positive effect on the dividend payout of the company. However, this will be our second variable of the corporate governance.

The third independent variable describes whether the boards of directors of the company are ***executives*** within the company or non-executives which mean that they are not taking part the day to day operations of the company or its managing directors. Generally the executives are those directors that make the design of the company, also the strategic plans of the company and even the plans of the company, and as well as make the implementation of those strategic plans. The executive directors also cooperate with the board of directors and have direct contact with them. The Board may offer suggestions and ideas about how to improve the organization, but the Executive Director decides whether or not, and how, to implement these ideas.

However the case, in this study, the researcher needs to know the effect of the members of the board of directors working as executives have on the dividend payout ratio, and how they influence dividend payout ratio if the number of the executives is increased or decreased.

The fourth variable we want to use as the independent variable of the study is the ***shares holding by directors*** of the company. We need to find out if there is statistical evidence that indicates if the directors of the company have more or less shares how it affects the dividend payout ratio, if the directors have more shares will they offer more dividends to the other shareholders or will they set aside the cash for further investment.

The fifth one is the lagged dividend which is the dividends already announced last year but not paid yet, so we want know whether there is effect with the dividend payout ratio or not. The sixth independent variable is the roe while the seventh one is the leverage and finally, we want to see whether firm size has effect on the dividend ratio payout ratio, and how it influences and we use the logarithm of dividend payout ratio.

3.2. Methodology and Hypotheses

In the study, we have different independent variables that we are now engaged in how it is possible to get a statistical evidence that approves or disapproves whether the corporate governance independent variables effect the dividend payout ratio, the hypothesis of the study will be...

H_1*: The variable board size has an influence on the dividend payout ratio of the company.*

Here, we need to know whether if the board size of a company has any influence on the dividend payout of the firm, sometimes the board of size of a company may be five while another company may have more than twelve, such companies with more than 15 board will it affect how much dividend the company is going to give its shareholders?, will it the board decide to make the retained earnings for further investment or extension of the firm?. So, we need here to know if this has a direct or indirect effect on the dividend payout ratio of the company.

H*$_{2}$*:* *The independent outside directors of a company has an influence on the dividend payout ratio of the firm.

In the study, the researcher wants to see if the increasing of independent outside directors has an influence on the payment of dividend to shareholders of the company, generally the outside independent directors are those directors that don't have any shares of the company and are not involved in the day to day operations of the company. So, if their number is increase will they have negative or positive effect on the dividend payout ratio. Here, we will try to get statistical evidence if there is such kind of evidence.

H*$_{3}$*:* *The firm size of a company has an influence on the dividend payout ratio of the firm.

In study, the researcher needs to look at if the firm size has any influence on the dividend payout of the company. People usually think about that the more the company is bigger, the more dividends it pays to its shareholders and the smaller the firm is, the less dividends it can pay to its shareholders. So, here the researcher is in a way to figure out if the size of the firm could have any effect on the dividend payout policy of the company.

H*$_{4}$*:* *If the board members of the company are also executives in the company, it affects the dividend payout of the company.

The researcher here wants to note that if the board of directors are executives of the company and taking part the day to day operations of the company, how it affects the firm's dividend payout policy. After making analysis through SPSS program through data collected from the official websites and personal websites of the companies, the researcher needs to find out the statistical evidence which will approve whether there is effect or not.

$H_{5:}$ *If most of the shares of the company are held by the members of the board, it influences the dividend payout of the company.*

We are looking at here, if most of the shares of the company are held by the board members; will it affect the dividend payments? We are considering that if the boards are the decision makers of company, and they are required to make the decision how much should be given to the shareholders of whom they are the majority, there is a possibility that they could allocate themselves much dividends and should influence they dividend payout policy of the firm.

$H_{6:}$ *The ROE has an influence on the dividend payout ratio of the company*

The researcher is in need to get evidence whether the roe can have an influence on the dividend payout ratio of the company, and that influence can be a negative one or positive.

$H_{7:}$ *The lagged dividend of the company has an influence on its dividend payout ratio*

The lagged dividend which dividends that have been announced but not yet paid, may sometimes has negative or positive effect on the dividend payout ratio of the firm. So, here the researcher wants to see which kind of influence the lagged dividend has on the dividend payout ratio.

$H_{8:}$ *The leverage of the company has an influence on the dividend payout ratio of the company*

The researcher is investigating how the leverage can have an influence on the dividend payout ratio, and classify whether it is negative or positive influence

CHAPTER FOUR

EMPERICAL RESULTS

4.1. Data Analysis

The researcher used quantitative approaches in the analysis of the data according to Creswell (1994), quantitative research focuses on examining a problem based on testing a theory and analyzing it using statistical techniques. In order to investigate the relationships in this study, the researcher regression analysis using Statistical Package for the Social Sciences (SPSS) version 18.

This section attempts to clearly analyses and interprets the study findings arising from the field information collected from companies in the ISE 100, their annual financial reports, activities reports and their disclosures and even by using the website of each firm in the ISE on corporate governance; dividend payout ratio on the Firm Performance of selected from Istanbul Stock Exchange simply known as (ISE). To establish the extent to which corporate governance impacted on the prevailing payout ratio, a regression analysis was conducted using adjusted R2 values, standardized beta values, t values and the significance measured at 0.05 confidence level of which the findings are presented in table 4.1.4. below.

Table 4.1.1.

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
boardsize	50	3.000000	14.000000	7.44000000	2.296048069
independentoutsidedirectos	50	.000000	3.000000	.48000000	.908912784
executive	49	.000000	5.000000	1.08163265	1.272083833
sharesholdingsbydirectors	49	.000000	70.440000	7.29820943	16.369991625
dividentpayoutratio	50	-6.943113E6	4.707900E4	-1.37920549E5	9.820629128E5
FIRMSIZE	50	13.000000	23.000000	19.16000000	2.333080647
LEVERAGE	50	.024843	6.764075	1.21362005	1.266389107
Laggeddividend	50	.00	19.81	8.7064	7.56820
Valid N (listwise)	49				

The top box showing the variables entered is self-explanatory

Table 4.1.2.

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	,558[a]	,312	,174	9,013173758E5

a. Predictors: (Constant), LaggedDividend, LEVERAGE, Roe, FIRMSIZE, boardsize, sharesholdingsbydirectors, independentoutsidedirectos, executive

The above Model Summery shows the goodness of fit statistics indicating whether the model is good fit.

- **R** is the correlation coefficient measuring the strength of the linear relationship and the analysis illustrated 0.558 strength, which is strong enough because it is required to be minimum of 0.5 to be significant and valid
- **R Square** is the coefficient of determination, more usually expressed as percentage. The R Square (R^2) figure gives an estimate of the variability accounted by the regression. Here 31.2% of the variance is accounted for the by the regression equation, so the remaining 76.2% are not explained by these variables.
- **Standard Error of the estimate** can be thought of as typical residual; the difference between what is predicted by the model and what is observed. See the table below.

Table 4.1.3.

ANOVA[b]

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	1,473E13	8	1,841E12	2,266	,042[a]
	Residual	3,249E13	40	8,124E11		
	Total	4,722E13	48			

a. Predictors: (Constant), LaggedDividend, LEVERAGE, Roe, FIRMSIZE, boardsize, sharesholdingsbydirectors, independentoutsidedirectos, executive

b. Dependent Variable: dividentpayoutratio

The researcher was interesting to find out the influence of the corporate governance variables on dividend policy payout ratio and has grouped into **A)** Predictors: (Constant), FIRMSIZE, board size, independent outside directors, shareholdings by directors, executive, roe, leverage, and lagged dividend and **B)** Dependent Variable: dividend payout ratio. The study was used one-way *Analysis of Variance* (ANOVA) to compare two or more independent groups' respondents on a single dependent variable.

Based on the data found in the Analysis of Variance (ANOVA), the P Value is normally required to be (Sig. 0.05) or less than for the model to be significant, so according to the result found in Table 4.3, it shows that the model is significant (Sig. 0.042).

Table 4.1.4.

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	267443,696	480638,569		,556	,581
	boardsize	-11180,242	59030,772	-,026	-,189	,851
	independentoutsidedirectos	-445567,682	168167,427	-,400	-2,650	,011
	executive	-265974,083	119692,049	-,341	-2,222	,032
	sharesholdingsbydirectors	2578,212	8734,734	,043	,295	,769
	FIRMSIZE	,000	,000	,285	1,941	,059
	LEVERAGE	-50930,877	119471,184	-,060	-,426	,672
	Roe	92869,012	124584,312	,103	,745	,460
	LaggedDividend	-,001	,002	-,084	-,612	,544

a. Dependent Variable: dividentpayoutratio

The **Coefficient** box tells us that the equation that models the line has a **slope and** also points **the interception.**

The table above shows the results for the variables in the equation which is used regression analysis of SPSS 18 in the analysis of the data of the company. So, the researcher has got to discuss some of the expectation that some of the corporate governance variable may have impact or influence on the dividend payout ratio of the companies.

So, here researcher will look at each hypothesis mentioned before and compare with the empirical results found in the analysis.

The variable board size has an influence on the dividend payout ratio of the company.

The regression results in table 4.4 indicate a negative significant relationship between board size and a dividend payout ratio of the company (sig. = 0.851). Based on this result, the researcher rejected the hypothesis which argued the variable board size has an influence on the dividend payout ratio of the company, since the significance value is (0.851) was above than 0.05 (or 5%) which is the required level of significance in social sciences for us to reject the alternate hypothesis. In other study such as (Jiraporn, S. Kim, J.C, Kim, 2010) also argues that the board size doesn't have any influence on the dividend payout ratio of the firm. So, this results imply that the there is unenthusiastic effect on board size and a dividend payout ratio of the company, the payout ratio it is likely to make and the reverse relationship the dividend payout ratio it is likely not control and vice versa. The computed correlation coefficient statistic (r=0.558) suggest that strength, measuring the strength of the linear relationship board size and a dividend payout ratio of the company and the analysis illustrated 0.558 strength.

If most of the shares of the company are held by the members of the board, it influences the dividend payout of the company.

The regression results in table 4.1.4. Indicate a negative significant relationship between shares holding by directors and a dividend payout ratio of the company (sig. = 0.769). This means that if most of the shares are held by the directors of the company it is unlike to be protected by the minor shareholders, because of their minority, countries without strict protection of minorities, such kind of problems are likely to happen. So, Based on this result, the researcher rejected the hypothesis which argued the variable shareholdings by directors has an influence on the dividend payout ratio of the company, since the significance value is (0.769) was above than 0.05 (or 5%) which is the required level of significance in social sciences for us to reject the alternate hypothesis. This results imply that the there is indifferent effect on shareholdings by directors and a dividend payout ratio of the company. In the article of (Jiraporn, S. Kim, J.C, Kim, 2010), it is argued that some scholars as La Porta, Lopez-De Salinas, Shleifer, and Vishny (2000), examining over 4,000 firms in 33 countries, find strong support for the outcome model. Firms pay more dividends in countries where minority shareholder rights are better protected. This shows us that Turkey may be one of the countries that minority shareholders are not protected, that why the relationship is negative. The payout ratio it is likely to make and the reverse relationship the dividend payout ratio it is likely not control and vice versa. The computed correlation coefficient statistic (r=0.558) suggest that strength, measuring the strength of the linear relationship shareholdings by directors and a dividend payout ratio of the company and the analysis illustrated 0.558 strength.

If the board members of the company are also executives in the company, it affects the dividend payout of the company.

The regression results in table 4.1.4. Indicate a positive significant relationship between executives and a dividend payout ratio of the company (sig. = 0.032). Based on this result, the researcher accepts the hypothesis which argued If the board members of the company are also executives in the company, it influences the dividend payout of the company, since the significance value is (0.032) and was below than 0.05 (or 5%) which is the required level of significance in social sciences for us to accept the alternate hypothesis, this shows that as far as the board of directors and executives are almost the same, the possibility that the dividend is paid and announced to themselves is high, in some other studies, it is argued that the board composition has effective system it enables dividends to increase and are one variable of the board composition(Fodil Adjaoud, 2010). This results imply that the there is a positive effect on executives and a dividend payout ratio of the company, the payout ratio it is likely to make and the direct impact the dividend payout ratio it is likely control and vice versa.

The independent outside directors of a company has an influence on the dividend payout ratio of the firm.

The regression results in table 4.1.4.shows that the relationship and influence between independent outside directors and a dividend payout ratio of the company is significantly positive because the P value is (sig. = 0.011) which is below the standard value of 5%. Based on this result, the researcher accepted the hypothesis which argued The independent outside directors of a company has an influence on the dividend payout ratio of the firm, it effects the dividend payout of the company, since the significance value is (0.011) was below than 0.05 (or 5%) which is the required level of significance in social sciences for us to accept the alternate hypothesis. This results imply that the there is positive effect on independent outside directors and a dividend payout ratio of the company, the payout ratio it is likely to make and the direct effect the dividend payout ratio it is likely control and in a study (FodilAdjaoud, 2010) argues that board compositionispositivelyrelatedtodividendpayouts(significantatthe5%level).Thesefindings suggest that the board of directors may be effective in monitoring managerialopportunism, and independent outside directors are those which are part of the board of composition.

The firm size of a company has an influence on the dividend payout ratio of the firm

The regression results in table 4.1.4. Indicate that there is some significant relationship between *firm size*s and a dividend payout ratio of the company (sig. = 0.059). according to this result, it seems that the P value was almost near to (Sig.

0.05) but when looked at the result we can little bit say that there is a little bit relation between firm size and dividend payout ratio, but in general the hypothesis is to be rejected because the P value is not below 0.05 and the researcher rejected the hypothesis which argues that as in general there is no positive relation between the two variables but as it is near to border of 0.05, we can say a little of influence can affect the dividend payout ratio the variable. And mostly big firms as in common pay dividends to their shareholders. In other studies like Fama and French (2001) and (Fodil Adjaoud, 2010), they both agree that there is a relationship between the firm size and dividend payout ratio of the company, which is somewhat consistent with this study.

The ROE has an influence on the dividend payout ratio of the company

Based on the result from the regression analysis, it shows that there is a negative relationship between roe and dividend payout ratio, as the P value (Sig. 0.460) is below the standard value which is 0.05 (5%), and according to other studies, the result is consistent with the study made (Fodil Adjaoud, 2010), and study also showed that there is a negative relationship between roe and dividend payout ratio.

The lagged dividend of the company has an influence on its dividend payout ratio

According to the results found in the study (Table 4.1.4.), it shows that the lagged dividends don't have any influence on dividend payout ratio, and this shows that because, after making the regression analysis the researcher the P value (sig. 0.544) which for the P value to be significant it is required to be below ($P < 0.05$), but in other studies, these findings are not in consistent with their findings, (Fodil Adjaoud, 2010) argue that there is a positive effect on dividend payout ratio, while here there is negative effect between the lagged dividend and dividend payout ratio, also in some other studies (Lintner, 1956) argue that if the company pays a fixed or constant amount of dividend each year, the lagged dividend has an effect on dividend payout ratio of the company.

The leverage of the company has an influence on the dividend payout ratio of the company

Based on the data found, leverage seems to be insignificant, because the P value is above 0.05 that means it is not significant. So, the researcher has the right to reject the hypothesis, and argue that there is no relationship or influence between dividend payout ratio and leverage because the P value is (Sig. 0.672) as shown in Table 4.1.4. In other studies as (Jiraporn, S. Kim, J.C, Kim, 2010)' the scholars argue that there is relationship between leverage and dividend policy, but they say that the relationship is almost negative one. So, it can be understood here that companies that mostly financed with debt are not in a position to pay dividends to their shareholders as the company is almost debt financing.

CHAPTER FIVE

5. Conclusion

In this study, two main topics are discussed in detail, in which the first element of the study was about wide discussed topic which is the corporate governance. Corporate governance is a topic that is argued around the world in which different scholars have varying thoughts regarding the exact definition of corporate governance.

It is an exciting subject today in the business world which is intended to defend the rights of shareholders and investors of any existing business. It is about an area under discussion that business managers are required not to work for their own interests and personal benefits but are called for to work for the good and interests of company's shareholders and stakeholders.

Let's come to the corporate governance in Turkey. First, in Turkey the public listed companies in Istanbul stock exchange (ISE) is increasing in the last, as the business in Turkey is mostly family owned businesses, and those public traded companies are trying to apply the corporate governance principles which the principle boards intended to protect the interests of shareholders and stakeholders of those publicly listed companies. There are almost many rules, regulations and principles that were produced by the OECD or CMB in Turkey which is about the corporate governance codes of Turkey.

The second element in which in the study is discussed in detail is the dividend policy or dividend payout ratio, dividend payout ratio which is part of the earnings of the company in which the board of directors decide to pay for the company's shareholders. In the second chapter of the study, the researched give enough details about the way it is decided, announced and paid to the shareholders; the researcher also gave enough information about type of dividends paid and also the dividend reinvestment plans of the companies.

This study is aimed at finding the influence of corporate governance on dividend policy; the data used in the analysis/study was based on 2010 data from financial statements of the companies and from the personal websites of each company, and also data that was available in the ISE website. The data is based on the Turkish firms that are operating in the provinces of Turkey.

In this study, the dividend payout ratio was used as the dependent variable of the analysis while the corporate governance variables are used like board size, independent outside directors, executive and as percentage of the shares holding by directors. These corporate governance variables are used in the analysis to show if they have an influence on the dividend payout ratio. Also, in the study, some control variables are used such as the firm size, roe, lagged dividend, and lagged dividend.

The SPSS 18 program is used for data analysis which enabled the researcher to get a result. According to the results found from the SPSS program, the variables of the corporate governance showed that there is a relationship between them and the dividend payout ratio.

In the analysis, the variable independent outside directors, shows that if the board of directors are from outside the company and are not taking part the day to day operations of the company or are not member of the managers, they have a positive influence on the dividend payout ratio of the company, which means that they are mostly in a way to protect the rights of the shareholders and stakeholders of the company. This also illustrates that dividends that as far as the company's board of directors are wholly from outside it could increase the dividend paid to the shareholders.

Another variable that demonstrates that there is a positive relationship between corporate governance and dividend policy is the executive. This corporate governance variables explains that if board of directors are also wholly the executives of the company, this shows that these executives could have influence on the increase of dividend payout ratio. So, here we can see that almost that there is a positive effect of corporate governance on dividend policy.

There are also other two corporate governance variables that was used in the study analysis, these variables are the board size and also the shares holding by directors, these two variables showed negative relationship between corporate governance and dividend policy. So, this illustrates that if the board size is large or small it doesn't positively influence the dividend payout ratio.

So, as in general the researcher found if the company applies corporate governance as intended it could have influence on the dividend payout ratio, as far as the management specially the board of directors are outside from the normal management of the company, and there is an availability of cash in the company, there will be a possibility of increasing the dividend paid to the shareholders of the company. And even if the management (executives) and board of directors are the same, the study shows that there is a positive relationship between the dividend and the corporate governance.

In the study, the researcher used control variables that could also influence, but the control variables which were firm size, roe, leverage and also the lagged dividend, most of the control variables were found insignificant in the study, but the firm size showed a positive relationship with the dividend payout ratio. This means if the size of the firm is enough large, it could increase the dividend payout ratio of the company. In smaller firms the possibility to pay dividends is very low because the firm is need of expansion and enlargement which could cause not to pay dividends to its shareholders.

So, this study contributes to the ongoing debate on the relationship between governance quality and dividend policy. In particular, our results confirm that effective corporate governance mechanisms attenuate agency conflicts between managers and shareholders and limit managers' opportunistic behavior in payout policy, thus supporting the outcome model of dividend policy. These findings may be useful to Turkish regulators seeking to establish effective rules to prevent managers and controlling shareholders from expropriating minority shareholders through dividend policy. But one thing to remember in the Turkish firms, is that most of the firms in Turkey are not publicly listed as far as the firms are family owned business which other foreign investments are not in need. So, for corporate governance to be effective in Turkey, firms should be made public that foreign investors could have the opportunities to invest, but as the time goes by, it shows that the corporate governance in Turkey is getting better and better after day.

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- **In 2001-2003** Worked as an electrician and cashier in **Elman Human Rights** center in Mogadishu, Somalia

- **In 2003-2004** worked as a teacher of computer software in **Al-Harameyn Computer** Centre in Mogadishu.

- **May 2008- August 2008: SIMAD UNIVERSITY** in Mogadishu, Somali, **Assistant lecturer** for the subject of accounting for governmental and non for profit organizations.

- **August 2008- November 2008: SIMAD UNIVERSITY,** Mogadishu, Somali, **Full lecturer** for the subject of accounting for governmental and nonprofit organizations.

- **June 2010 – July 2011:** Working in **International Helsinki citizen's assembly** (Helsinki yurttaşlar derneği) in Istanbul as a part time employee.
- **March, 2011 – April 2012:** Worked as assistant to honorary consul in the **Somali Honorary Consulate** in Istanbul.
- **August 2011—June 2012,** I also worked in the presidential palace of Somalia as Somali-Turkish Coordinator

Present:

From July 2012 upto now, Working as the Executive Director of **SESNSES GROUP OF COMPANIES** in Mogadishu, Somalia