



The Effect of Board Effectiveness on Dividend Policy in Turkey: Control-Ownership Wedge as Moderator

by

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TABLE OF CONTENTS

	PAGE
DECLARATION OF THESIS	i
ACKNOWLEDGEMENT	ii
TABLE OF CONTENTS	iii
LIST OF TABLES	viii
LIST OF FIGURES	ix
LIST OF ABBREVIATIONS	x
ABSTRAK	xi
ABSTRACT	xii
CHAPTER 1: INTRODUCTION	1
1.1 Background to the Study	1
1.2 Problem Statements	6
1.3 Research Questions	13
1.4 Research Objectives	13
1.5 Contribution of the Study	14
1.6 Significance of the Study	14
1.6.1 Significant to Literature	14
1.6.2 Significance to practice	16
1.7 Scope of the Study	17
1.8 Definition of the Key Terms	18
1.9 Organization of Thesis	20

CHAPTER 2: LITERATURE REVIEW	21
2.1 Introduction	21
2.2 Overview of Turkish Capital Market	21
2.3 Dividend Policy	24
2.3.1 Dividend Policy in the Context of Turkey	26
2.3.1.1 Provisions on Dividend	30
2.3.1.2 Company's Obligation to Distribute Dividends	30
2.3.1.3 General Principles on Distribution of Dividends under the TCC	31
2.3.1.4 Distribution of Dividends under Capital Markets Legislation	32
2.4 Corporate Governance in Turkey	33
2.5 Concept of Corporate Governance	37
2.5.1 Board Effectiveness	39
2.5.1.1 Board Size	42
2.5.1.2 Board gender diversity	43
2.5.1.3 Board Independence	45
2.5.1.4 Board Age Diversity	48
2.5.1.5 Board Expertise	39
2.6 Control-Ownership Wedge	54
2.7 Empirical Studies on Board Effectiveness and Dividend Policy Relationship	57
2.8 Underpinning Theory (Resource Dependence Theory)	62
2.9 Supporting Theory (Agency Theory)	63
2.10 Research Gap	65
2.11 Summary of the Chapter	67

CHAPTER 3: METHODODOLOGY	68
3.1 Introduction	68
3.2 Research Design	68
3.3 Research Framework	69
3.4 Hypotheses Development	72
3.4.1 Board Size and Dividend Policy	76
3.4.2 Board Independence and Dividend Policy	72
3.4.3 Board gender diversity and Dividend Policy	74
3.4.4 Board Expertise and Dividend Policy	80
3.4.5 Board Age and Dividend Policy	80
3.4.6 Control-Ownership Wedge as a Moderator	85
3.5 Data and Sources	86
3.6 Population and Sampling	87
3.7 Variable Definition and Measurement	90
3.7.1 Dependent Variable	90
3.7.2 Independent Variables	90
3.7.2.1 Board Gender Diversity	90
3.7.2.2 Board Size	90
3.7.2.3 Board Independence	90
3.7.2.4 Board Age Diversity	90
3.7.2.5 Board Expertise	90
3.7.3 Control-Ownership Wedge as Moderator	93
3.7.4 Control Variables	93
3.7.4.1 Firm Size	93
3.7.4.2 Leverage	93
3.7.4.3 Profitability	93

3.7.4.4	Firm age	93
3.8	Research Paradigm	96
3.9	Research Methods	96
3.10	Research Approach	97
3.11	Panel Data Analysis	99
3.12	Descriptive Analysis	100
3.13	Multiple Regression Analysis	100
3.14	Model Specification	101
3.15	Chapter Summary	102
CHAPTER 4:	RESULTS	103
4.1	Introduction	103
4.2	Descriptive Statistics	103
4.3	Correlation Analysis	109
4.4	Data Analysis Method	112
4.5	The Preliminary Tests	112
4.5.1	Multicollinearity	112
4.5.2	Breusch-Pagan Test	115
4.5.3	Results of Hausman Specification Test	118
4.5.	Linear Regression Assumptions	121
4.5.1	Results of Heteroscedasticity	121
4.5.2	Results of Autocorrelation	123
4.6	Regression Models Results	124
4.6.1	Board Size and Dividend Policy (Hypothesis 1)	126
4.6.2	Board Independence and Dividend Policy (Hypothesis 2)	127
4.6.3	Board Gender Diversity and Dividend Policy (Hypothesis 3)	128
4.6.4	Board Expertise and Dividend Policy (Hypothesis 4)	130

4.6.5	Board Age diversity and Dividend Policy (Hypothesis 5)	131
4.6.6	Board Size, Wedge and Dividend Policy (Hypothesis 6a)	132
4.6.7	Board Independence, Wedge and Dividend Policy (Hypothesis 6b)	133
4.6.8	Board Gender diversity, Wedge and Dividend Policy (Hypothesis 6c)	134
4.6.9	Board Expertise, Wedge and Dividend Policy (Hypothesis 6d)	134
4.6.10	Board Age diversity, Wedge and Dividend Policy (Hypothesis 6e)	135
4.7	Robustness test	136
4.8	Summary of the Chapter	139
CHAPTER 5: DISCUSSION AND CONCLUSION		140
5.1	Introduction	140
5.2	Summary of the Study	140
5.3	Implication of the Study	147
5.3.1	Theoretical Implications	147
5.3.2	Practical Implications	149
5.4	Limitations of the Study	151
5.5	Suggestions for Future Research	152
5.6	Conclusion	154
REFERENCES		156
APPENDIX		197

LIST OF TABLES

	PAGE
Table 2.1 Summary of the Previous Study	51
Table 3.1 The Processes Used to Select The Final Sample of Firms for the Study	88
Table 3.2 Data Composition	89
Table 3.3 Research Variables Summary and Measurements	95
Table 4.1 Descriptive Statistics of Variables	105
Table 4.2 Results of Pearson Correlation Analysis of the Study Variables (N = 745)	111
Table 4.3 Variance Inflation Factor (ITIF) and Tolerance Factor (1/VIF) Tests	114
Table 4.4 Summary of the Regression Results on a Random-Effects Regression and a pool OLS regression	116
Table 4.5 Summary of the Regression Results on a Fixed Effect (FE) and a Random Effect (RE) Model	119
Table 4.6 Residual Statistics-Test of Outliers	121
Table 4.7 Heteroscedasticity Test	122
Table 4.8 Wooldridge Test for Autocorrelation in Panel Data	124
Table 4.9 Summary of the Fixed Effect Results for Model 1 & 2	125
Table 4.10 Summary of the Robustness Test and Fixed Effect Results for Model 1&2	137

LIST OF FIGURES

	PAGE
Figure 2.1 Framework for corporate governance	38
Figure 2.2 Board Independence	47
Figure 2.3 Research Gap	66
Figure 3.1 Conceptual Framework	71
Figure 4.1 Average dividend payout/ year	104
Figure 4.2 Breusch and Pagan Lagrangian multiplier test	117
Figure 4.3 Hausman Model Specification Test	120

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LIST OF ABBREVIATIONS

CML	Capital Market Law
CMBT	Capital Market Board of Turkey
ABA	American Bar Association
CMB	Chemical Mass Balance
TCL	Turkey Company Law
WFE	World Federation of Exchanges
ISE	Istanbul Stock Exchange
BIST	Bursa Istanbul
CSD	Central Securities Depository
TDE	Turkish Derivatives Exchange
ABA	American Bar Association
SEC	Securities and Exchange Commission
GAAP	Generally Accepted Accounting Principle
AMEX	American Stock Exchange
ASE	Australia Stock Exchange
ISE	Istanbul Stock Exchange
IIF	Institute of International Finance
ISAs	International Standards on Auditing
CEO	Chief Executive Officer
TCC	Turkish Commercial Code
IFRSs	International Financial Report Standards
PCAOB	Public Company Accounting Oversight Board
KFTC	Korean Fair Trade Commission
TSE	Taiwan Stock Exchange
PDP	Public Disclosure Platform
EU	European Union
IGE	Istanbul Gold Exchange
GA	General Assembly
AOA	Article of Association
TCGC	Turkey Corporate Governance Council
PDP	Public Disclosure Platform
JSC	Joint Stock Companies
OECD	Organization for Economic Co-operation and Development

Kesan Kecekapan Ahli Lembaga Pengarah ke atas Polisi Dividen di Turki: Kawalan-Pemilikan Baji sebagai Moderator

ABSTRAK

Objektif kajian ini adalah untuk mengkaji kesan keberkesanan ahli lembaga pengarah (ALP) terhadap polisi dividen berkenaan dengan pengaruh baji (perbezaan antara hak kawalan dan hak aliran tunai) di Turki. Walau bagaimanapun, sebagai ahli organisasi EU, banyak peraturan dan perundangan seperti nilai tadbir urus syarikat dan pasaran modal dianggap meminimumkan jurang antara Turki dan EU. Analisis pengaruh perubahan tersebut telah menarik minat pengkaji untuk mengkaji pengaruh keberkesanan ALP terhadap polisi dividen. Kajian ini menggunakan data daripada 170 firma yang disenaraikan di Bursa Istanbul (BIST) sepanjang tempoh dari 2016 hingga 2020. Dengan menggunakan model regresi Driscoll-Kraay standard errors, hasil kajian ini adalah muktamad dalam mengesahkan bahawa keberkesanan ALP mengurangkan masalah Agensi Jenis II yang melibatkan kualiti audit yang tinggi, dan menyokong teori pergantungan-agensi. Kajian ini memberikan pandangan baharu dan membangunkan pemahaman tentang pengaruh baji terhadap insentif dan keupayaan pelanggan untuk menuntut dividen yang lebih tinggi, terutamanya dalam persekitaran pasaran baru muncul, kawalan institusi yang lemah, dan kekurangan kod tadbir urus korporat dan piawaian perakaunan yang kukuh dalam persekitaran Turki. Tambahan pula, kajian ini menggabungkan teori agensi dan teori pergantungan sumber untuk menganalisa tingkah laku strategi ALP dari segi fungsi pemantauan dalam konteks Turki. Walau bagaimanapun, baji melemahkan pengaruh keberkesanan ALP ke atas polisi dividen, yang akan menjadi hasil yang tidak menguntungkan bagi pemegang saham minoriti. Oleh itu, kajian ini mencadangkan agar pengawal selia, terutamanya Lembaga Pasaran Modal Turki (CMBT), harus meningkatkan penguatkuasaan undang-undang untuk meningkatkan tadbir urus korporat yang baik di Turki untuk menampung ciri-ciri unik firma-firma baji dan menyediakan persekitaran yang dilindungi untuk pelabur terutamanya, pemegang saham minoriti.

The Effect of Board Effectiveness on Dividend Policy in Turkey: Control-Ownership Wedge as Moderator

ABSTRACT

The objective of this study is to examine the effect of board effectiveness on dividend policy with respect to the influence of a wedge (divergence between control rights and cash flow rights) in Turkey. However, being a member of the EU organization, many rules and regulations such as companies' and capital markets' company governance values are considered to minimize the gap amongst Turkey and the EU. An analysis of the influence of these changes should be of interest to examine its influence board effectiveness on dividend policy. This study used the data of 170 firms listed on the Borsa Istanbul (BIST) over the period from 2016 to 2020. Using Driscoll-Kraay standard errors regression model, this study outcome is conclusive in validating that board effectiveness decrease Type II Agency Problems through engagement with high dividend policy, which supports agency-dependency theory. This study provides new insights and develops the understanding of the influence of a wedge on the incentives and ability of clients to demand a higher dividend, particularly in a setting of emerging markets, weak institutional controls, and the lack of strong corporate governance code and accounting standards in the Turkish environment. Furthermore, this study combined agency theory and resource dependency theory to analyses board strategy behaviour in terms of the monitoring function in the context of Turkey. However, the wedge weakened the influence of board Effectiveness on dividend policy, which will be an unfavourable outcome for the minority shareholders. Thus, this study proposes that regulators, particularly the Capital Market Board of Turkey (CMBT), should increase law enforcement to enhance good corporate governance in Turkey to accommodate the unique features of wedge firms and provide a protected environment for investors particularly, the minority shareholders.

CHAPTER 1: INTRODUCTION

1.1 Background to the Study

The policy of dividends of a company is of great concern in the literature of corporate governance. Since the emergence of the work of Modigliani and Miller (1961) on dividend irrelevance, several theories have been developed featuring their presumptions of ideal capital markets. As much as the concept of dividend irrelevance by Miller and Modigliani is realistic and compatible within an ideal financial market, their theorem becomes highly debatable in real and normal world with existence of market imperfections, for example information asymmetries, transaction costs, agency problems and differential tax rates (Almeida et al., 2020; Bostanci, Kadioglu & Sayilgan, 2018; Baker, Kilincarslan & Arsal 2018). As a result, financial scholars have considered several market imperfections and offered many challenging explanations as to reasons leading to companies pay or refuse to pay dividends, and to what depth can dividend policy impact firm value, or even whether dividends are used to minimize such imperfections (Baker, Kilincarslan & Arsal 2018).

According to Baker, Kilincarslan & Arsal (2018) and Franc-Dąbrowska et al. (2019), dividend is monetary value that an organization or firm pays to shareholders for the finances they invested in the company during a particular period of time. Due to this reason, the decision for dividend payout is not fully reliant on financial outcomes and the distribution of cash flow. The decisions of managers on payments of dividends can be controlled by hedging funds in an economic downturn situation, increasing volatility of profit, limiting financing from external sources or higher capital needs in future. Therefore,

the 'dividend puzzle' and dilemma has been the item and debate of investigations that are under way (Bostanci, Kadioglu & Sayilgan, 2018). The decision regarding dividend payment is complicated and based on competing viewpoints. A lower dividend pay-out (DPO) enables the firms to use the surplus for future business expansion to provide a higher gain in the future against the capital investment, whereas a higher dividend payment is a sign of potential for financial growth and a source of income for investors (Biswas, S., Bandyopadhyay, G., & Mukhopadhyaya, J. N. 2022).

In Turkey, an emerging market and a civil law country, dividend payments have been heavily regulated, and regulations went through some major changes since the debut of operations in Borsa Istanbul (Takmaz, 2017). The Capital Markets Panel of Turkey (CMBT) hereafter controls the policy of dividends of firms. As in many other emerging markets, the CMBT of Turkey, the key body charged with regulating and supervising the securities markets, heavily regulated policies of dividends of the publicly-listed companies in the stock market of Turkey, when it first emerged in 1985 and started to operate in 1986 Elmagrhi et al. (2017). However, being a member of the EU organization, many rules and regulations such as companies' and capital markets' company governance values are considered to minimise the gap amongst Turkey and the EU.

Moreover, corporate boards are involved in making main corporate decisions, including the policy of dividends, the effectiveness and implementations of those decisions depending on the features of that board. Also, previous studies looked at the effect of the characteristics of a panel, such as the individuality of the panel (Riaz, Liu, & Ahmad,

.2016), board composition (Shahid, 2016) and director busyness (Benson, et al. 2017) on dividend policy. Larger boards are usually associated with poor governance hence, companies are anticipated to pay higher shares averagely when having larger boards to compensate and cater for their bad structures of governance, for example defective managerial monitoring.

Furthermore, in Turkey, the general leadership structures of Turkish listed firms have characteristics such as investor protection and minority rights that are relatively weak (Ararat, M., & Yurtoglu, B. B. 2021; Durukan et al., 2009), ownership controlled by family with an arrangement that is complex-pyramidal where household participants are the CEOs, members of the board or top directors and an ownership that is concentrated (Choi, D., Gam, Y. K., & Shin, H. 2020).

Cigna et al. (2017) reported that disclosure on board evaluation is very limited in Turkey though and only one of the surveyed companies discloses performing an evaluation of its board, without providing much detail on the results and follow-up actions. Fiduciary duties are detailed in law; however, it seems that courts have not developed clear and robust standards and interpretation of director duties. Relevant court decisions regarding due care, good faith and honest belief for company affairs have reportedly been contradictory. Thus, dividend payout policy and regulations are a good criteria and mechanism for avoiding the conflict that may arise between a manager and shareholder. John and Knyazeva (2006) state that shares are functional instruments for regulating the charges of agency of free money flow due to their nature of pre-commitment and larger costs of diversions from the

policy of dividends given the negative reaction of the market to cuts in dividends. Companies with low and feeble corporate governance are usually highly susceptible to managerial infringement and a more serious problem with cash flow is anticipated, Therefore, companies with weak rights of shareholders require greater dividends compared to companies with strong rights of shareholders (Aydin & Cavdar, 2015).

In addition, the ownership and membership structure of Turkish firms and companies is highly concentrated. Firms are mostly owned by families, then by foreigners and finally by institutions (Al-Najjar and Kilincarslan, 2016; Takmaz, 2017). In summary, conventional agency accounts of the policy of dividends are of powerful moment in the context of upcoming countries like Turkey, bearing in mind the prevalence and dominance of weak governance, too high concentration of instability of the institution and ownership (Trinh, V. Q., Elnahass, M., & Salama, A, 2021). In such circumstances, availability of a board that is diverse can protect the minority shareholders' rights (Bathala & Rao, 1995). Ye, et al. (2019) states that a diverse and independent board do operate appropriately in sub-optimally invested environments by the companies to provide them with expropriation opportunities. Therefore, for the purposes of their interest protection, shareholders together with legislative and regulatory organizations have multiplied their pressure on companies for larger and higher variety of the board in current years (Saeed & Sameer, 2017).

Still, effectiveness in the boardroom has been a great debate for discussion in the recent years (Ajaz, A., Shenbei, Z., & Sarfraz, M, 2020). Having the standard and required experience, mix of skills, and expertise is of great importance in ensuring that the whole board is well furnished to implement the strategy of business for the company (Deloitte, 2015). Fernandez-Temprano and Tejerina-Gaite (2020) maintained that the effectiveness of a board has been extensively analysed as a part of good corporate governance. Although a large part of this study emphasises on the size and independence, there is a rising and upcoming literature which analyses the configuration of directors' demographic effectiveness (e.g. age, sex, training, race etc). Furthermore, variety has been the area of interest of active policy making and hence this makes it even more important to understand the values and role it plays (Deloitte, 2015).

Several studies and research have scrutinised the connection between panel effectiveness and the payout of dividends. Although, very few research has been done in developing countries, such as Turkey (Mustafa, Ahmad & Chandren, 2018). Based on the insufficient literature and the unreliability of the results of past research works on the board size, board independence, board gender diversity, board expertise, board age diversity, the study suggests the task of control-ownership wedge to moderate the rapport between dividend policy and board effectiveness.

1.2 Problem Statements

Dividend payment decision is still a puzzle since the seminal paper of Miller and Modigliani (1961). Since then, many studies have been conducted on the factors affecting the dividend policy of firms. The effect of dividend policy on the value of the firm is a controversial subject in the literature. Unlike Miller and Modigliani (1961), theories have been developed that state dividend policy affects the value of the firm. If the dividend policy affects the value of the firm, it is also worthwhile to study the factors affecting the dividend policy. Many factors affecting the dividend policy have been examined in the literature (Takmaz, 2017).

Historically, dividend studies essentially focused on developed economies while there is scarce literature on emerging markets context (Khan, 2021). The dividend-paying dynamics in emerging markets are widely different from developed economies due to ownership concentration, inadequate corporate governance and the legal environment protecting minority shareholders (Al-Najjar, B., & Kilincarslan, E; 2016). Emerging markets hold similarities based on inadequate institutional protection of minority shareholders, leading to principal-principal conflicts between controlling and minority shareholders due to ownership concentration (Khan, 2021; Aguilera & Haxhi 2019; Young et al., 2008). The controlling shareholders typically expropriate value from the minority shareholders by influencing the board-level decisions (Su et al., 2008). Such conflicts imply mitigating the dividend payouts in emerging markets (La Porta et al., 2000; Sanan 2019; Oh, H., & Park 2021; Iqbal et al., 2020).

In this connection, an effective board composition influencing decision-making, including dividend payouts (Tahir, Masri, & Rahman 2020; Hermalin & Weisbach, 2003), is warranted to resolve these conflicts. Besides, emerging markets are different from developed markets due to various factors such as social and political instability, inadequate laws and regulations, absence of satisfactory disclosure, different ownership structure and ineffective corporate governance measures (Aivazian et al., 2003; Alshirah, Rahman, & Mustafa (2020); Saeed & Zamir, 2021; Barwari, Saeed, & Aree, 2018; Ararat & Ugur, 2003).

According to agency theory, principal-agent conflicts are likely without appropriate incentives and monitoring (Jensen & Meckling, 1976). By contrast, ownership in emerging markets such as Turkey is typically concentrated in families and institutional investors with likely conflicts between controlling and minority shareholders (principal principal) (Young et al., 2008). The pyramid structure enables elites to take control of the majority of corporate sectors, and this leads to the deviations of rights these elites can maintain control (voting rights) with a relatively small fraction of ownership (cash flow rights). The control-ownership wedge is widened by cross-holdings, multiple class shares, and pyramidal ownership structures (Kang, M., Kim, S., & Cho, M. K., 2019). In Turkey featuring pyramid structures, the company such as Solares Ithalat A.S., Misr Pyramids Group Mpg, Dost Makina, Jagdamba Marble Handicrafts and Pyramid Stone & Tile usually tried to employ pyramidal company organizational arrangements or perhaps a further complex inter-corporate net of equity connections and shares that are double class to supplementary enrich the regulator of their firms at the cost of the rest of the shareholders, who are especially minority shareholders (Baker, et al., 2020).

Moreover, the Capital Markets Board (CMB) of Turkey, as in many other emerging markets, heavily regulated dividend policies of ISE-listed firms, when it first started to operate in 1986. According to the first regulation, the ISE-listed firms legally had to pay at least 50% of their distributable income as a cash dividend (Adaoglu, 1999, 2000; Kirkulak and Kurt, 2010). Thus, ISE managers lacked flexibility in setting their firms' dividend policies. Further, the presence of strict mandatory dividend policy regulations also diminished the role of dividend policy as a signalling tool for example some company in Turkey that have dividend policy problems are Aygaz A.Ş, Anadolu Isuzu Otomotiv Sanayi Ve Ticaret A.Ş, Döktaş Dökümcülük Ticaret Ve Sanayi A.Ş, Hürriyet Gazetecilik Ve Matbaacilik A.Ş and Katmerciler Araç Üstü Ekipman Sanayi Ve Ticaret A.Ş. In fact, a few studies conducted in early periods in Turkey show that firms-based cash dividend payments on their current year earnings, as imposed by regulations (Adaoglu, 2000; Aivazian et al., 2003)

Furthermore, financial crisis hit the Turkish economy in 2001. As a leading indicator, Turkish stock index lost most of its value and the wealth of investors went down (Takmaz, 2017). However, with the help of IMF support and major reforms, Turkish economy and the stock market recovered. But again, to support especially small shareholders, CMBT obliged listed firms to pay out dividends (Adaoglu, 2008). Kirkulak and Kurt (2010) state that Turkish firms are usually owned by families which are bond to an assemblage of corporations. Also, the dominator investor applies and uses a pyramidal arrangement or double class share to intensify the control and regulation on the company. The mandatory dividend policy started with fiscal year 2003 until now.

Previous studies indicate Turkish firms give relatively less protection to minority shareholders and creditors because it is a French-origin civil law country compared to common law countries (La Porta et al., 2000). The firms are predominantly owned by families with a high shareholding, which gives them high control (Kula & Tatoglu, 2006; Oba et al., 2010; OECD, 2013). Additionally, Turkish companies are less inclined to promote the representation of employees on boards. Besides, the information asymmetry is vast due to unequal opportunities of accessing information to all shareholders (Arslantas & Afacan Fındıklı, 2013). Furthermore, the legal system is typically costly, slow and somewhat outdated with low enforcement of corporate governance measures (OECD, 2013) regardless of strengthening it since 2001. The CML and the TCC define the dividend policy for Turkey's listed firms.

Yet, in Turkey, the probability of occurrence of agency problem is high between majority shareholders and minority shareholders. Emerging markets or developing countries, particularly Turkey, suffer from severe Type II Agency Problems, when the conflicts of interests between principle-principle (majority-minority ownership) is strongly improved because of the big deviation amongst regulator rights and possession. This type of ownership-control structure is called "wedge", and it exercises through a dual class shares, pyramidal structure, and cross ownership (Choi & Yoo, 2007). Wedge has been used in Turkey and many other emerging markets as a method to facilitate an impounding of minority shareholders' property-rights by the controlling and regulating shareholders for example company (GSD Holding) Group A, B and D degree of shares have privilege to choose board of directors and shareholders who hold A and B degree of

shares have privilege to choose external auditor (Fan & Wong, 2005; Orbay & Yurtoglu, 2006).

Furthermore, Turkish corporate governance guidelines are classified as weak corporate governance, offering poor minority and investor protection and rights (Ararat, Aksu, & Tansel Cetin, 2010; Demirag & Serter, 2003; Durukan et al., 2009; Karaibrahimoğlu, 2013). In practice, the minority shareholders of Turkish firms lack significant power to influence corporate strategy. Demirag and Serter (2003) advocate that to create an optimal financial market in Turkey, the country needs to discover new measures for minority shareholder protection. This argument is in line with Yurtoglu's (2003) opinion that the business environment of Turkey shares characteristics of a weak company regime of governance due to family possession concentration, pyramidal commercial assemblages, double class dividends and a weak institutional setting (investor and creditor safety, rule implementation and accounting standard).

In addition, a few research works have investigated the influence of board effectiveness on dividend policy. These comprise Pucheta-Martinez (2016) by means of Spanish figures; McGuinness et al. (2015) in Chinese venue. Results of these studies reveals that existence of women on board minimizes agency problematic by affecting company dividend disbursements. As much as these studies give significant perceptions into the improvement in the associated historical work however, the experimental inquiries are stayed motivated on the established nations and very minute consideration is paid to developing markets' firms (Saeed & Sameer, 2017). Specifically, the controlling

environment in upcoming markets is definitely dissimilar from the advanced ones which may comprise fragile exterior punishing instruments and high association of administration (Beck & Levine, 2004).

However, as we look in the current state of Turkey, only a single study steered by Ararat et al. (2015) examines the consequence of the firms' wedging in financial doing. The author's claims that monitoring of the board and evaluation intensity moderates the association of the board effectiveness and dividend policy. A wedge regulates the interrelationship of the board effectiveness of the board on monitoring intensity of the board. Thereby, with reference to this author's idea, the current research will offer further evidence on company authority criteria mechanisms and methodology by integrating the board effectiveness of managers and the policy of dividends to strengthen the review value in the environment of wedge.

Given the ownership structure, the board characteristics, such as female directors on the board, the board members' independence and the size of the board, imply different dynamics in performing their roles, probably due to their link with or influence from controlling families. Resources are necessary for an organization to survive. According to the resource dependency theory (RDT), a company must rely on other businesses for resources in order to remain sustainable. The board of directors is crucial in securing the necessary funding from outside sources, such as vendors, clients, and communities. As a result, diverse boards provide a variety of human and social capital in the form of knowledge, standing, and experience (Hillman, A. J, 2015). Board members provide

crucial resources in this situation through their strategic guidance and expertise, channels of communication with external organizations, support from important sources, and legitimacy (Khan, A., Yilmaz, M. K., & Aksoy, M.,2022). Hence, investigating such board characteristics along with ownership structure is warranted to understand the modalities of dividend policy in the Turkish market. Fourth, this study's results may be used to benchmark other developing and emerging markets trying to bring reformations in corporate governance measures.

Moreover, with regard to the inconsistent findings of previous studies on the association between board effectiveness and dividend policy, the study suggests the moderating role of the ownership wedge on the association of corporate governance mechanisms (Board Size, Board Independence, Board Gender Diversity, Board Expertise, Board Age Diversity) and dividend policy. Also, in the Turkish environment, controlling shareholders, via a deviation between control privileges and money stream rights (wedge), possess an entrenched negative influence that can jeopardize the minority shareholders' interests via unbalanced control between the majority and minority shareholders.

Again, this moderator is inevitably necessary due to the inconsistent mixed results on the association between board effectiveness and dividend policy (Baron & Kenny, 1986; Frazier, Tix, & Barron, 2004), in order to understand more about such relationship. Therefore, this study aims at examining the moderating role of control-ownership wedge on the association between board effectiveness and dividend policy in Turkey.