

**BOARD INDEPENDENCE AND FINANCIAL PERFORMANCE IN
TURKEY: AN EVIDENCE ON BIST 100****Emre Selçuk SARI¹****Emir OTLUOĞLU²****ABSTRACT**

The communique issued by Capital Markets Board of Turkey (CPM) in 2011 requires the attendance of independent board members of public companies. This study examines the relationship between the presence of independent board member and financial performance. The sample of the study consists of the companies listed on Borsa Istanbul (BIST) 100 Index. The relationship between the board independence and accounting based, market based and cash based financial performance indicators is examined. The result of regression analysis indicates that the board independence affects Tobin's Q positively and ROE and Cash Flow negatively. This study implicates that the presence of independent board member has caused an increase in market based financial performance of companies.

Keywords: Board Independence, Financial Performance, Corporate Governance, Regression Analysis.

**TÜRKİYE'DE YÖNETİM KURULU BAĞIMSIZLIĞI VE FİNANSAL
PERFORMANS İLİŞKİSİ: BİST 100 ÜZERİNE BİR ARAŞTIRMA
ÖZ**

SPK'nın 2011 yılında yayınladığı tebliğ ile halka açık şirketlerin yönetim kurullarında bağımsız üye bulundurma zorunlu hale gelmiştir. Bu çalışma, yönetim kurullarında bağımsız üye bulunmasının finansal performans üzerindeki etkisini araştırmaktadır. Çalışmanın örneklemini BİST100 Endeksi'nde yer alan şirketler oluşturmaktadır. Çalışmada yönetim kurulu bağımsızlığı ile muhasebe temelli, piyasa temelli ve nakit temelli finansal performans ölçütleri arasındaki ilişki incelenmiştir. Uygulanan regresyon analizinin sonuçlarına göre yönetim kurulu bağımsızlığının, Tobin'in q oranı üzerine olumlu yönde, özsermaye kârlılığı ve nakit akışları üzerinde olumsuz yönde etkisi olduğu gözlemlenmiştir. Bu çalışma yönetim kurullarında bağımsız üye bulunmasının piyasa temelli finansal performans ölçütleri üzerinde bir artış meydana getirdiğini göstermiştir.

Anahtar Kelimeler: Yönetim Kurulu Bağımsızlığı, Finansal Performans, Kurumsal Yönetim, Regresyon Analizi.

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1. Introduction

The effects of board structure on a firm's financial performance is an extensively examined subject in corporate governance. It is not possible to overemphasize the role of board composition as an integral part of corporate governance mechanism. The composition of the Board has an impact on the extent and effectiveness of the Directors' dealings in order to mitigate the Agency's problem and to align the top management efforts with the interests of the shareholders (Altuwajri and Kalyanaraman, 2016). Board of directors is the focus of the internal governance in a company. Furthermore, board's direction offers a key monitoring role achieving the agency problems in the company (Lefort and Urzua, 2008). In recent years, the role of board of directors has attracted many parties (academicians, financial analysts, etc.) for several reasons. One of the reason is that developing countries are pursuing for funds and investments from global investors. Two, recent accounting scandals such as Enron showed the necessity for establishing policies to enhance board independence and other issues related to corporate governance. Different forms are linked with different sets of agency problems. Ownership is highly diffused in countries such as United States (US) and United Kingdom (UK), so agency problem in these countries is commonplace between managers and shareholders (Sanda, Garba and Mikailu, 2008). On the other hand, agency problem exists between dominant shareholder and minority shareholders in developing countries with concentrated equity ownership (Sanda, Garba and Mikailu, 2008). Also Jensen and Mechling (1976) are mentioned an agency problem between debt holders and managers.

After the recent accounting scandals such as Enron and WorldCom, almost all organizations recognize the crucial roles played by the independent directors. The concept of independent board member is a pivotal issue in the context of corporate governance (Iwu-Egwuonwu, 2010). In 1992 and 2003, the role of the non-executive directors is explained in the Cadbury Report and the Tyson Report, respectively. The Cadbury Report draw interest to the effectiveness of the board structure as an important corporate governance mechanism. Later, the Tyson Report emphasized the roles of non-executive directors who were expected to have extensive knowledge, to enhance board effectiveness (Fuza, Halim and Julizaerma, 2016). In addition to these, numerous theories are

found in literature about the executive and non-executive board members. Some theories suggest that executive board members are more effective because they possess detailed information about the firm's activities so their decisions are more accurate for the organization, on the other hand, some theories suggested that including non-executive board members would be more efficient because of their knowledge, expertise, controlling role (Rehman and Shah, 2013).

Consequently, this study assesses the impact of board independence on firm financial performance, as measured by the return on assets (ROA), the return of equity (ROE), Tobins' Q, and cash flow. For this purpose, we manually collected corporate governance and performance related data from the annual reports of the companies listed on the "Borsa İstanbul 100 Index (BIST100)" in each year over 2008-2015, excluding financial institutions.

2. Corporate Governance in Turkey

Corporate governance aims to increase shareholders' welfare by minimizing principal-agent problems. Recent accounting scandals all around the world validated for new regulations to spread corporate governance practices. For example, one of the most important regulation is the Sarbanes-Oxley act in 2002 in the US. Besides this act, the Dodd-Frank Wall Street Reform and Consumer Protection Act came into effect in July 2011, which aims to prevent another financial crisis. In the United Kingdom, the Turnbull Guidance on Internal Control was renewed in 2005. Germany made corporate governance principles a legal obligation by passing a law on the matter. In Turkey, there were several financial crises, specifically in 1994, 1998, 2001 and 2008. In order to deal with the issues related to these crises, Capital Markets Board of Turkey adopted corporate governance principles of the Organization for Economic Co-operation and Development (OECD) in 2005 (Ergin, 2012).

The Corporate Governance Principles of Turkey employs the "Comply or Explain" approach. Although these principles suggest a significant level of independence for the boards of the public companies, the only legal requirement is about formation of an audit committee. From 2005, public companies were required to publish a "Corporate Governance Compliance Report", which clarifies their

compliance with these principles. Instead of the fact that these principles demand more than 100 provisions, most reports were far from sufficient (Ararat and Yurtoğlu, 2006). OECD made a detailed assessment on effectiveness of the corporate governance practices of Turkish public companies showed that the dominant shareholders informally decide on board members without any significant contribution of other parties (such as minority shareholders, institutional investors, etc.)(Ararat, Orbay and Yurtoğlu, 2010).

Legal changes in 2011 and 2012 (to the Turkish Commercial Code, The Capital Markets Law in 2011 and 2012, and regulations issued by the Capital Markets Board) increased disclosure standards and introduced board independence requirements, including a requirement, effective in 2012, that public companies have at least one-third independent directors (Ararat, Black and Yurtoğlu, 2016).

3. Literature Review

The literature on the board independence and financial performance is rich and deep. The previous studies related to the board independence and financial performance indicated contrasting results. Some studies have found a positive relation between board independence and financial performance, while others have found a negative relation. In addition, there are studies showing that there is no relation between board independence and financial performance. In previous studies, financial performance is measured using accounting based and market-based measures. The accounting based mostly measure through ROA, ROE and earnings per share. Meanwhile, Tobins' q and cash flows are generally used as market-based measures.

Bhagat and Black (2000) found a significant relation between weak financial performance and increase in board independence. According to Bhagat and Black, the worsening in the financial performance of the companies affect the level of board independence more than growth opportunities of the companies or industry. However, there is no evidence that greater board independence leads to improved firm performance. Fernandes (2008) suggests that independent board members are not successful enough to protect the interest of shareholders and managers. Fernandes also determined that, there is a higher correlation between the firm performance and executive remuneration in the companies, which do

not have independent board member. According to Gani and Jarmies (2006), the independence level of the executive board should not be considered as a performance-enhancing factor for all companies because the effect of board independence may vary according to the strategies of the companies. Krishna (2006) concludes that the board independence has no effect on improving the firm value or financial performance. On the other hand, according to Choi, Park and Yoo (2007) there is a strong and positive relation between the presence of non-executive board members and financial performance of the company. They also found that this positive relation between presence of non-executive board members and financial performance exists both before and after the financial crisis in South Korea. Kumar and Sivaramakrishnan (2008) examined the effect of board independence on shareholder value and eventually they found that shareholder value could increase as board dependence (not independence). According to Garg (2007) independent directors have a mixed effect on firms' performance. Sandra, Garba and Mikailu (2008) analyzed the effect of board independence on financial performance in Nigerian Stock Exchange and they determined a positive relationship between board independence and financial performance. Another study to determine the effect of independence made by Lefort and Urzua (2008). Lefort and Urzua determined that the level of non-executive directors in the board has an impact on firm value after correcting for endogeneity. Duchin, Matsusaka and Ozbas (2010) analyzed the effects of board independence on performance that are largely free from endogeneity problems. They found a relation between the effectivity of independent board members and cost of information. The independent directors have a high performance if the information cost is low. On the contrary, if the information cost is high, the performance of independent board members deteriorates. Ponnu and Karthigeyan (2010) studied the effect of board independence on financial performance and they found that the presence and level of non-executive directors have no effect in enhancing the performance of the listed companies on Kuala Lumpur Stock Exchange. Ararat, Orbay and Yurtoglu (2010) indicated that the level of independent directors has a negative effect on stock prices and firm performance. Saat, Karbhari, Heravi and Nassir (2011) determined that board independence improved financial when a senior independent director and an independent board's chairman were present on the board, and chief executive officer, chief financial officer, chief

operating officer or managing director was not a board member. Rehman and Shah (2013) examined the effect of presence of non-executive board members and ownership structure on firm performance of listed companies in Karachi Stock Exchange. Rehman and Shah found that there is a positive relation between level of non-executive directors and market based performance measures. On the contrary, this kind of relation does not exist between level of non-executive directors and financial performance of companies when they use accounting based performance measures. Liu, Miletkov, Wie and Yang (2015) conducted a similar study on Shanghai and Shenzhen Stock Exchange from 1999 to 2012. According to their results, there is a positive and significant relation between level of non-executive directors on board and financial performance. Also Altuwajiri and Kalyanaraman (2016) determined that level of board independence positively related to the financial performance of companies.

4. Methodology and Analysis

This study investigates whether board independence enhances financial performance. In this study, we selected the non-financial companies from all companies listed at Borsa İstanbul 100 index (BIST 100) for the period 2008-2015. At first 65 companies were selected for sample but due to non-availability of data for all years and all selected variables 24 company are excluded.

In this study we used two accounting based measures (ROA and ROE), one market based measure (Tobin's Q) and an economic-based measure (CF). In addition, we determined the control variables as firm size, block-holder ownership, leverage, assets-in-place, volatility, sales growth and capital expenditures (capex).

Table 1 and Table 2 presents the dependent and independent variables of the analysis.

Table 1. Dependent Variables

Model 1	ROA	$ROA = \frac{Net\ Income}{Total\ Assets}$
Model 2	ROE	$ROE = \frac{EBIT}{Total\ Shareholders' Equity}$

Model 3	TOBIN'S Q	$Q = \frac{\text{Total Liabilities} + \text{Market Value of Equity}}{\text{Total Assets}}$
Model 4	CASH FLOW	$CF = \frac{\text{EBIT} + \text{Depreciation}}{\text{Total Assets}}$

Table 2. Independent Variables

Board Independence	NEX = Dummy for the non-executive members on board.
Firm Size	FSIZE = Total Assets
Block-Holder Ownership	BHO= Shareholders who own more than 5% of a company's common shares
Leverage	$Lev = \frac{\text{Long Term Debt}}{\text{Total Assets}}$
Assets-in-Place	$AIP = \frac{\text{Inventories} + \text{Tangible Assets}}{\text{Total Assets}}$
Volatility	Vol = Annual Standard deviation of daily stock return
Sales Growth	SG = Annual growth rate of sales
Capital Expenditures	$CAPEX = \frac{\Delta \text{Fixed Assets} + \text{Depreciation}}{\text{Total Assets}}$

We measured firm performance by using two accounting measures: ROA and ROE, these two measures are generally accepted and used in corporate governance studies. In addition that, there are studies, which employ market measures instead of accounting measures. (Ponnu and Karthigeyan, 2010). ROA and ROE are accounting based measures, which based on firm's past performance (Otluglu, Sari and Cakmak-Otluglu, 2016). As a market based performance measure, we used Tobin's Q. It is necessary to be careful when using stock returns as a tool of performance measurement because stock price returns are heavily affected by investors'

expectations. If investors are able to predict the effect of board structure on financial performance, the long-term stock returns will be insignificant. even if presence of non-executive directors have an effect of financial performance of the company. Hence, we rely on Tobin's q as a performance measure (Bhagat and Black, 2000). According to Givoly and Hayn (2000), cash flow from operations is the most suitable performance measure while analyzing the relation between board independence and financial performance, because cash flows is hard to manipulate and accrual accounting has no effect on cash flows from operations. Following them, we used the ratio of CFO-to-assets to assess firms' economic performance.

The existence of non-executive directors (NEX) in board is the independent variable. We determined NEX as a dummy variable to separate the periods which has no non-executive board members (2008-2011) and has non-executive board members on board (2012-2015). In this case, each dummy variable is coded as 1, if the board had at least one non-executive member or 0 otherwise. Firm size is our first control variable. Firm size is a typical determinant of firm performance (Isidro and Sobral, 2015). Larger firms tend to have higher performance compared to their smaller counterparts because of higher market power (Smith, Smith and Vernel., 2006) or efficiency gains (Lee, 2009). Firm size is generally measured as the logarithm of total assets (Kılıç and Kuzey, 2016). Our second control variable is Block-holder ownership (BHO). BHO is defined as shareholders who own more than 5% of a company's common shares (Morck, Shleifer and Vishny, 1988). Leverage (Lev) is defined as ratio of book value of long-term debt to book value of total assets. According to Stiglitz (1985) leverage is positively associated with firm performance (Rehman and Shah, 2013). Assets-in-place (AIP) is used as a proxy for the investment opportunity set and is used as an inverse growth option indicator following Zingales (2000) and Frye (2004). While calculating the AIP, we divided sum of inventories and tangible assets to total assets. Last two control variables are volatility (Vol) and sales growth (SG) (Liu, Miletkov, Wei and Yang, 2015). Stock price volatility, which is the annualized standard deviation of weekly stock returns, and sales growth is the mean of sales growth rate over the past eight years.

For the purpose of the study we suggest four hypotheses:

- H1: The presence of non-executive director(s) on a board significantly impacts ROA
H2: The presence of non-executive director(s) on a board significantly impacts ROE
H3: The presence of non-executive director(s) on a board significantly impacts Tobin's Q
H4: The presence of non-executive director(s) on a board significantly impacts Cash Flow

Descriptive statistics of our sample is presented at Table 3.

Table 3. Descriptive Statistics

	<i>N</i>	<i>Minimum</i>	<i>Maximum</i>	<i>Mean</i>	<i>Std. Dev.</i>
<i>ROA</i>	82	-,1057	,1703	,0540	,0514
<i>ROE</i>	82	-,0660	,2265	,0773	,0550
<i>TQ</i>	82	,5354	5,4628	1,5271	,9176
<i>CF</i>	82	-,0037	,3204	,1122	,0603
<i>NonExec</i>	82	,0000	1,0000	,5000	,5031
<i>LogFS*</i>	82	17,9335	23,7705	21,3623	1,2905
<i>BHO</i>	82	,2498	17,3157	,8695	1,8459
<i>Lev</i>	82	,0000	5,1933	,5717	,8144
<i>AIP</i>	82	,1948	,8837	,6615	,1289
<i>Vol</i>	82	,0424	,3695	,0676	,0359
<i>SalG</i>	82	-,0060	,4299	,1388	,0792
<i>Capex</i>	82	,0064	,3059	,0826	,0560
<i>Valid N</i>	82				

*Log of Firm Size

Table 4. Comparison of the Means for Firm with and Without Non-Executive Directors

	<i>Average NEX = 0</i>	<i>Average NEX = 1</i>	<i>T-Test</i>
<i>ROA</i>	0,0523	0,0558	0,2420

<i>ROE</i>	0,0802	0,0743	0,3720
<i>TQ</i>	1,4068	1,6474	0,0000
<i>CF</i>	0,1171	0,1072	0,1224
<i>LogFSIZE</i>	21,0940	21,6307	0,0000
<i>BHO</i>	1,0713	0,6677	0,1597
<i>Lev</i>	0,5390	0,6045	0,1910
<i>AIP</i>	0,6579	0,6652	0,3512
<i>Vol</i>	0,0778	0,0574	0,0014
<i>SG</i>	0,1335	0,1442	0,2987
<i>CAPEX</i>	0,0793	0,0859	0,2218

As a result of the T-Test we determined that there is no significant difference between the means of with and without non-executive directors on board.

According to the literature, we use linear regression (OLS) models to measure the relation between the financial performance and board independence. We used SPSS 21.0 for all statistical analysis. We developed the following models to test the hypothesis:

Model 1:

$$ROA_i = \beta_0 + \beta_1 NEX_i + \beta_2 FSIZE_i + \beta_3 BHO_i + \beta_4 LEV_i + \beta_5 AIP_i + \beta_6 VOL_i + \beta_7 SG_i + \beta_8 CAPEX_i + \varepsilon_i$$

Model 2:

$$ROE_i = \beta_0 + \beta_1 NEX_i + \beta_2 FSIZE_i + \beta_3 BHO_i + \beta_4 LEV_i + \beta_5 AIP_i + \beta_6 VOL_i + \beta_7 SG_i + \beta_8 CAPEX_i + \varepsilon_i$$

Model 3:

$$TQ_i = \beta_0 + \beta_1 NEX_i + \beta_2 FSIZE_i + \beta_3 BHO_i + \beta_4 LEV_i + \beta_5 AIP_i + \beta_6 VOL_i + \beta_7 SG_i + \beta_8 CAPEX_i + \varepsilon_i$$

Model 4:

$$CF_i = \beta_0 + \beta_1 NEX_i + \beta_2 FSIZE_i + \beta_3 BHO_i + \beta_4 LEV_i + \beta_5 AIP_i + \beta_6 VOL_i + \beta_7 SG_i + \beta_8 CAPEX_i + \varepsilon_i$$

Table 5 presents regression results based on the sample. Four measures of firm performance were regressed against a set of eight regressors including board independence dummy. As can be seen in the table, coefficient estimates for the variables are reported all of the firm performance measures.

Table 5. Regression Analysis Results

	Model 1: ROA		Model 2: ROE		Model 3: TQ		Model 4: CF	
	Coefficient	T-Stat	Coefficient	T-Stat	Coefficient	T-Stat	Coefficient	T-Stat
NonExec	-0,0047	-0,4497	-0,0210	-1,9177**	0,4548	2,4565**	-0,0244	-
LogFS	0,0041	0,8989	0,0098	2,0238**	-0,0421	-0,5142	0,0103	1,9314***
BHO	-0,0034	-1,2413	-0,0039	-1,3643	-0,0472	-0,9676	-0,0053	-1,5902
Lev	-0,0289	-4,3780*	-0,0220	-3,1422*	-0,2744	-2,3260**	-0,0249	-3,0854*
AIP	-0,0994	-1,9933**	-0,0968	-	-0,7776	-0,8713	-0,0984	-1,6130
Vol	-0,2963	-	-0,3938	-2,3465**	11,1919	3,9487*	-0,3321	-
SalG	0,0182	0,2775	0,1511	2,1750**	2,0878	1,7792***	0,0939	1,1709
Capex	0,1343	1,1957	0,1032	0,8672	2,8648	1,4251	0,2003	1,4574
R ²	0,3310		0,3456		0,3286		0,2742	

* 1% significance level

** 5% significance level

*** 10% significance level

In Table 5, the NonExec dummy variable is used as an indicator of independent board membership, representing whether the board has an independent member. When Model 1 is examined, it is seen that there is a negative relationship between return on assets (ROA) and leverage (Lev), assets-in-place (AIP) and volatility (Vol). The significance level of these relations are 1%, 5% and 10% respectively. When the variables affecting asset profitability are examined, firms with low financial leverage, low stock and fixed asset ratio and low price volatility have been found to perform better. On the other hand, it has been determined that the existence of independent members in the board of directors has no effect on the return on assets. In model 2, we determined that, non-executive board members (NonExec), leverage (Lev), assets-in-place (AIP) and volatility (Vol) have a negative effect on ROE, on significance levels of 5%, 1%, 10% and 5%, respectively. Firm size (LogFS) and sales growth (SalG) were found to be positively correlated with ROE at the

level of 5% significance. In Model 2, in compliance with Model 1, companies with low financial leverage, low stock and fixed asset ratio and low price volatility have a better performance. In addition, the increase in firm size and sales growth has a positive effect on performance. Also, presence of the independent member in the board affects return on equity as a financial performance indicator, negatively. We analyzed Tobin's Q (TQ) in Model 3. According to the results, the existence of an independent board member (NonExec) positively affects the financial performance, at the level of 5% significance. Furthermore, volatility of stock prices (Vol) and growth rate of sales (SalG) positively affect the financial performance, at the level of 1% and 10% significance, respectively. Leverage (Lev) is the only variable negatively affecting Tobin's Q (TQ), at the 5% significance level. In Model 4 we tested cash flow (CF), similar to Model 3, there is a negative relationship between financial performance and the presence of an independent board member (NonExec) and leverage (Lev); There is positive relationship with firm size (LogFS), at the level of 10%, 10% and 1% respectively. Moreover, congruently with Model 1, there is a negative correlation between financial performance and price volatility. This result is in contradiction with Model 2.

When F values of 4 different regression models are examined, it is determined that all F values are at 1% significance level. This result indicates that the established models are valid. The R² statistic indicates that the independent variables included in the Model 1 explain the 33.1% of the change in ROA. R² values are 34.6%, 32.9% and 27.4% for Model 2, 3 and 4, respectively. According to the histogram and probability (P-P plots) graphs obtained from regression analysis results, standard errors are normally distributed. Scatter plots were examined to determine the linearity of standard errors and homogeneity of variances. According to scatter charts, standard errors show linearity and homogeneous variances for all models. The Durbin-Watson statistics was used to determine autocorrelation between standard errors. According to the Durbin-Watson test statistics, no autocorrelation was found between the independent variables for each model. We examined the variance inflation factors (VIF) in order to determine the whether there is a multicollinearity problem between independent variables. VIF scores stated that no multicollinearity problem in models.

5. Conclusion

The purpose of this study has been to investigate the possible increase in financial performance due to independent board members. The presence of independent board members is a major corporate governance requirement identified in the OECD principles. Also, with the Capital Markets Board of Turkey's Communiqué, Serial: IV No: 56, the public companies in Turkey were obliged to have independent members on the board of directors. The motivation of this study is to investigate whether this change has a positive effect on firm performance.

Financial performance is measured in terms of ROA, ROE, Tobin's Q and Cash Flow. A dummy, indicating the independent member in the executive board has been used as the independent variable. We used linear regression (OLS) models to measure the relation between the financial performance and board independence for 41 public companies in BIST100.

First, the effect of the board independence on the ROA was tested and no significant relationship was found. However, it has been determined that independent membership has a significant effect on ROE, Tobin's Q and Cash Flow. At the 5% level of significance, board independence was found to have a positive effect on Tobin's Q as expected. It can be concluded that, Tobin's Q may increase as a result of the presence of independent board member. On the contrary, board independence has a negative effect on ROE and Cash Flow, at a significance level of 5% and 10%. This result is the opposite of our expectations, because we predicted that the presence of independent board member would positively affect transparency and agency problem thus positively affect financial performance. Whereas, the result of analysis showed that presence of independent board member has caused a decrease in financial performance.

However, the results of this study should be interpreted considering two limitations. First, this study uses data from 41 companies from BIST100. Further research can be applied on all non-financial companies on BIST. Second, the concept of independent board member is a new concept for Turkey and this situation restricted our analysis period. In addition, the number of observable data is expected to increase in time, further research might examine

the relationship between board independence and financial performance again.

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