

## CHAPTER 2

### AN OVERVIEW OF CORPORATE GOVERNANCE

#### 2.1 Introduction

This chapter reviews and discusses the definitions of CG concepts, then, presenting an overview of CG in developed and developing countries in general, particularly in Palestine. Thus, this Section defines CG from various perceptions. It also discusses the economic and political situation in Palestine. The Sections of this chapter are as follows: The main definitions of CG are presented in Section 2.2. Section 2.3 introduces a brief overview of the environment of CG in developed and developing countries, while the political, economic, and CG in Palestine are presented in Section 2.4. Finally, Section 2.5 is a summary of this chapter.

#### 2.2 Corporate Governance Definitions

The agency problem was the main issue that drove the appearance of CG topics (Jensen & Meckling, 1976). As a result, the quality of CG has become an essential matter after the world financial scandals because of the failure of CG systems for several large companies in the United States, Canada, the European Union, and some developing countries. These included Enron, WorldCom, Adelphia, Tyco, HealthSouth, Fannie Mae, AIG Nortel, Crocus Parmalat, and Royal Ahold (Bremer & Elias, 2007; Zgarni & Fedhila, 2019; Abata & Migiro, 2016). So, CG arose to the surface and received massive attention from the developed and developing states as a method to mitigate the consequences of the financial crisis.

Prior studies have discussed several definitions of CG. Among the earliest definitions of CG was that of the Cadbury Committee Report in December 1992. The report described CG as “the system by which companies are directed and controlled” and that the “BOD is responsible for the CG of their companies.” The role of the stockholders in CG was “to appoint the directors and the auditors and to satisfy themselves that the appropriate CG structure is in place” (Cadbury, 1992, p. 25).

Morck, Shleifer, and Vishn (1988) proposed that the division of CG mechanisms into internal mechanisms and external mechanisms facilitates the monitoring and measurement of these mechanisms. Furthermore, they found that the external and internal mechanisms differ from one country to another country according to four factors. These are (1) the economic environment in which operate companies, (2) political regimes, (3) the labor relationships, and (4) industrial sectors. These four factors are imminence important to structure the CG system in the shareholding corporations in any country, which may help strengthen the monitoring functions of the CG.

Indeed, OECD presented a comprehensive definition of CG. OECD (1999) defined CG as a system that determines a corporation’s structure that has four levels, which are the BOD, executive managers, stockholders, and other stakeholders. The role of a CG system is to control and direct these levels and identify their rights, duties, and responsibilities. Furthermore, a CG should clarify the procedures, rules, and regulations for decision making related to a corporation’s affairs. OCED also added that a CG system helps a corporation carry out a set of objectives and provide them with the means to attain these objectives and monitor performance.

Meanwhile, Xie, Davidson, and Dadalt (2003) defined CG as a concerned critical issue, with ways in which stakeholders attempt to ensure that BOD and the executive

management have adopted mechanisms that will protect the interests of stakeholders, which entails the separation of ownership from the management. CG has several objectives that a corporation should achieve, such as creating an environment of transparency, trust, and accountability. The achievement of these objectives is essential to attract more investments, financial inclusion, and the stability and integrity of a corporation (OECD, 2015).

Bruijl (2017) defined CG as a system of rules, practices, and procedures, through which companies are directed and supervised; it mainly consists of balancing the interests of owners in the company, which includes existing and potential shareholders, internal staff, customers, vendors, financial practitioners, countries, and society. CG also provides a framework for achieving a company's goals. Therefore, CG covers all areas of management, from business plans and internal controls to performance measurement and corporate disclosure (Hambrick, Werder, & Zajac, 2008). Moreover, CG systems are considered exceedingly crucial to a company, the society, and a country to achieve the desired goals efficiently and effectively.

More specifically, Kamaruddin Hanefah, Shafii, Salleh, and Zakaria (2020) classified the objective of CG into these types of complementary views: (1) a legal point of view, (2) accounting point of view, and (3) the economic view. In respect of the legal point of view, the corporation is a separate entity owned by the shareholders as the owner of the capital. At the same time, the board of directors is supervisors of managing the companies' capital, and the managers are working to operate the organization using the mandate granted to them by the BODs on behalf of the owners. Meantime, from an economic point of view, CG systems may be considered as a separation between ownership and management in decision-making processes. So, CG may reduce the agency problems when managers get their compensation fairly and carrying out their

responsibilities effectively, while owners as a stockholder can protect their rights and investments. In terms of an accounting point of view, CG can be considered as the accountability and transparency of management to shareholders as owners and other stakeholders. Accountability and transparency can be carried out through comprehensive disclosure practices by management (Kamaruddin et al., 2020).

To conclude, OCED (2014) set the three main elements for good CG practices to maintain the interests of the stockholders as the corporation's owners. These elements are to appoint an effective BOD, imposing non-duality between the CEO position and chairperson role, and to have BOD comprises the non-executive directors as a majority. Thus, these elements and others will be the core issue of this study by investigating the impact of CG attributes on EM practices in Palestine. Furthermore, the elements of best practices of CG will be discussed in the following sections and chapters.

### **2.3 CG in Developed and Developing Countries**

The last century and the current one has witnessed numerous financial scandals and crises, such as the Asian financial crisis in 1997; the collapse of some of the largest companies in the United States such as Enron, the worldwide financial crisis in 2007-08, and most recently the pandemic of Coronavirus (COVID-19). CG issues have become a global pivot point for developed countries and developing countries as well. This section focuses on CG in developed and developing countries. The first sub-section is about the CG situation in developed countries, and the second sub-section is about the CG situation in developing countries.

### 2.3.1 The CG Situation in Developed Countries

CG system is a key to protecting stakeholders against fraudulent financial actions. So, a CG system consists of sundry of mechanisms, including BOD characteristics, executive management, AC characteristics, the internal audit function, ownership structures, external audit quality, and others (Bajra & Cadez, 2017). Strict and robust CG systems will mitigate the consequences of accounting scandals and fraudulent behaviors. On the other hand, the impairment in CG systems has generated several accounting scandals during the past several decades.

Indeed, regulatory policies have significantly changed after scandals on both sides of the Atlantic, including the United States and the European Union (Bajra & Cadez, 2017). A richness of studies has addressed CG in developed countries (Almasarwah, 2015). For example, Bleicher et al. (1989) comparative study as cited in (Almasarwah, 2015) was among the first of several studies of CG conducted in the context of developed countries, comparing CG effectiveness in the United States and Switzerland. They found that CG systems in these countries were developed, and this led to improving the capability of managers in monitoring the financial activities of a company. Accordingly, considerable prior studies have investigated the effectiveness of CG systems in the United States (e.g., Abbott et al., 2004; Klein 2002; Lin et al. 2006; Xie et al. 2003; Yang & Krishnan 2006) and the United Kingdom. (e.g., Peasnell et al., 2005) in the United Kingdom.

The United States was forced to improve and strengthen its CG systems in the wake of financial scandals. Hence, the U.S. Congress passed the Sarbanes-Oxley Act in 2002. This federal law established rigorous requirements for companies listed on stock exchanges concerning the audit function in evaluating internal control function and financial reporting quality (Bajra & Cadez 2017; Grein & Tate 2011; Patterson &

Smith 2007; Sun et al., 2014). Much prior literature related to CG mechanisms has examined the influence of Sarbanes-Oxley on internal audit role, and external audit as well, EM, and the financial reporting system, among others. Cohen et al. (2008) examined the level of EM in the pre-SOX and post-SOX periods. They found that the level of EM had decreased after the publishing of SOX. Patterson and Smith (2007) found that under Sarbanes-Oxley, control systems became better and less fraud occurred. Thus, Sarbanes-Oxley has played a vital role in improving the audit function by improving internal control systems, thereby decreasing fraudulent actions by dishonest managers.

The 8th Company Law Directive, which was published by the European Union in 2006, strengthened the role of CG quality, which, in turn, lead to increased financial reports quality in the EU. Bajra and Čadež (2018) found that after the promulgation of the 8th Company Law, the effectiveness of AC monitoring and competencies increased; thereby, the quality of financial reporting also increased. Finally, Bajra and Cadez (2017) reported that the implementation of the Sarbanes-Oxley Act and the 8th Company Law Directive had had positive effects on CG system quality.

### **2.3.2 Overview of CG Situation in the United Kingdom**

Indeed, the United Kingdom has a comprehensive approach for a strong system of CG, which is strictly applied. The United Kingdom built this comprehensive approach to improving the quality of the BOD to run the companies efficiently and effectively to enhance accountability to stockholders. The United Kingdom CG approach is better than other countries' approaches due to its ability to achieve higher criteria for CG (Almasarwah, 2015). So, the United Kingdom CG system is considered a basic outline for other countries that want to apply a robust CG system.

In 1992, the Cadbury Committee, which Sir Adrian Cadbury chaired, examined the financial aspects of CG in the wake of the Maxwell scandal. The critical outcome of this report was to upgrade the mechanisms of CG in the United Kingdom. The Cadbury report dealt with several issues connected with CG, such as clarifying the association between the quality of BOD and stockholders (Belcher, 1996). Later, the Turnbull report, with the support of the London Stock Exchange, informed directors of their obligations concerning maintaining sound internal controls and conducting good audits.

The Financial Reporting Council was an independent regulator in the United Kingdom, which was replaced by the Audit, Governance, and Governance Authority in 2019. They operated the UK's Corporate Governance Code, which was designed to underpin trust in how companies are run, and the Stewardship Code, which encourages active engagement by investors with companies in which they invest. In 2003, they complemented the recommendations from these reports, especially concerning the role of non-executive directors (Higgs, 2003) and the functions of the AC (Smith, 2003). In 2006, the Financial Reporting Council reviewed the code of CG and made changes in the former CG code (FRC, 2006). Similarly, the Financial Services Authority in the United Kingdom issued a code for the financial services industries, titled the CG Combined Code (2003), that included several new recommendations.

Thus, developed states such as the United States, the United Kingdom, and the European Union countries have developed CG systems. These systems have served as guidelines for developing and emerging countries such as MENA countries, especially Palestine. Palestine issued a code of CG in 2009 that contains many recommendations from international systems.

CG studies have been extensively conducted in developed countries rather than in developing states (Hassan et al., 2016). Thus, this study examines the association of CG characteristics (BOD and AC characteristics and OS) with EM practices. Regulators could use the findings of the current study to evaluate and improve the effectiveness of BOD, AC, and OS monitoring regarding CG good practices in developed countries. Hence, the current study intends to supply, compare, and contrast evidence from Palestine related to the findings of previous studies conducted in developed countries to determine whether their results and conclusions can be generalized in Palestine.

### **2.3.3 CG Situation in Developing Countries**

The financial scandals in the previous century in the United States of America, Canada, and the European Union uncover shortcomings in CG systems. These scandals have had negative side-effects on stock exchanges in developing countries and have shed light on the weaknesses in CG systems as well. Indeed, the stock markets in developing countries are emerging markets and often suffer from the impairment of transparency, weak investor protection, and the absence of good governance. Hence, these markets have faced several difficulties attracting more foreign and local investors (Bremer & Elias, 2007; Farooq & Zarouali, 2016; Oehmichen, 2018).

Several prior studies have been associated with improving the CG systems in developing countries. For instance, Arora and Sharma (2016) examined the influence of CG on firm financial performance by using a large sample of companies covering 20 important industries in India from 2001-2010. They found that companies that exhibit a high level of CG practices tend to have higher financial and market performance. Theoretically, this study confirmed that higher quality of CG practice minimizes agency costs.

Ebaid (2013) demonstrated that stronger CG is associated with more appropriate auditors' decisions other than weaker CG. The results of his study showed that voluntary compliance with CG rules by Egyptian companies increased the quality of financial reporting and, therefore, affected the decision of external auditors. In a comparative study between developing and developed countries, Mulili and Wong (2011) argued that the culture, technology, and political situation were the main reasons for differences between CGs in developing and developed countries. Hence, based on the differences in the mentioned factors, each country establishes a set of CG mechanisms to adopt to the situation of the country. Bilal (2018) recommended that the regulators, practitioners, and policymakers in developing countries must improve the institutional transparency of CG systems to achieve effective monitoring of financial reporting procedures in those countries.

#### **2.3.3.1 Overview of CG in Malaysia**

Malaysia is considered one of the economic success stories in the continent of Asia in the past few decades. One leading cause of financial scandals in Asia in 1997 was the weakness of CG systems; hence, Malaysia has taken many steps to improve the standards and the principles of CG in this area to overcome the financial crisis and to avoid such crises in the future (OECD, 2013). As a result, Malaysia proposed its first code of CG in 2000. This code has affected CG practices of companies positively, rebuilt the confidence of local and international investors, and reflects global principles of CG, which are the minimum requirements applied by Bursa Malaysia (MCCG, 2017). While the code of CG established in 2000 achieved significant improvements, the code needed a further review to strengthen the CG effectiveness to align with the requirements of the domestic and international stock markets.

The Malaysian Code of Corporate Governance (MCCG), which was revised in 2007, offered an ongoing collaborative effort between the government and the private sector. This code made essential amendments that were aimed to strengthen the effectiveness of BOD and ACs (Hamid & Aziz, 2012). Furthermore, the Securities Commission Malaysia (SCM) established CG blueprint in 2011. The objective of the blueprint was to create excellence in CG mechanisms through strengthening self and market discipline and promoting good compliance and CG culture. Boards and stockholders were asked to embrace the understanding that good business was not just about achieving the desired financial bottom line by being competitive but also being ethical and sustainable. The SCM established a new “Malaysian Code on CG 2017” (MCCG, 2017). This code replaced the 2012 code and took effect on 26 April 2017. The new MCCG introduced essential changes and recommendations to develop criteria for CG in Malaysia (MCCG, 2017).

While SCM has reviewed and reformed the CG code of Malaysia at least four times to improve the CG systems, PCMA has not reviewed the PCCG since its issuance in 2009. That means the CG system in Palestine needs progress and reform to be more effective. The updated version of the Malaysian CG code is stricter than the old code, and the involved articles are mandatory, and some seek to enhance the role of females in the BOD. Conversely, many articles included in the PCCG are voluntary, such as AC formation and other committees. Indeed, Malaysia is considered as a good example that Palestine and other developing countries can follow in enhancing the effectiveness of overall CG mechanisms, which, in turn, will boost the transparency, accentuality, and the credibility of financial reports. To conclude, Malaysia considered as an excellent example for Muslims and developing countries. The governance in Malaysia is developed, so it is considered as a guideline for other countries such as Palestine.

### 2.3.3.2 Overview of CG in Jordan

Jordanian is a small, developing, Middle Eastern country and has a long border with Palestine. Indeed, Jordan has the longest border with Occupied Palestine and enjoying the same culture, religion, language, and geographical area with it. Historically, Jordan governed the West Bank before 1967 and imposed its guardianship on the holy city of Jerusalem and the Al-Aqsa mosque. Furthermore, Jordan has hosted most Palestinian refugees who were driven from Palestine by Zionist occupation that began in 1948. Hence, Jordan and Palestine have had the same social and economic circumstances except for the political unrest in Palestine because of the Zionist occupation and its procedures against Palestinian people and their homeland.

Despite the challenging economic conditions in Jordan, especially after the events of the Arab Spring, substantial improvements were observed in the Jordanian economy, as the number of companies listed increased significantly on the ASE. This increase was because of the efforts made by the Jordanian leadership to attract local and foreign investors. Among these efforts was the introduction of regulations to improve transparency, accountability, disclosure, and reform of the systems of CG in Jordan (Idris 2012). Moreover, implementing a series of changes and improvements in financial legislation to enhance transparency and accountability was a response to the financial scandals that took place internationally and locally. In 1997, the Jordanian Companies Law was issued. Accordingly, this law contained some principles of corporate governance regarding the characteristics and responsibilities of the Board of Directors, activating the role of shareholders in corporate governance and protecting the rights of all shareholders (Makhlouf et al., 2018). This was in addition to the issuance

of many other laws such as the Securities Law, the Investment Promotion Law, and the Commercial Law, which provided the basis for the proposal of the code of CG.

Accordingly, a code of corporate governance for Jordanian companies was issued in 2009 to develop the Jordanian economy at all levels (JCGC, 2009). This code includes corporate governance rules for companies to apply to Jordanian companies listed on the Amman Stock Exchange to regulate the relationship between the company's management and its shareholders. The CG Code also aims to define the duties and responsibilities of the BOD to achieve corporate goals and protect the rights of all shareholders and other stakeholders (Almasarwah, 2015).

The rules of corporate governance in Jordan are designed based on laws and legislation in effect, such as the Jordanian Securities Law, the Jordanian Companies Law, and international rules established by the Organization for Economic Cooperation and Development (Shanikat & Abbadi, 2011). The hope is that compliance with corporate governance code rules in Jordan will lead to several benefits, such as enhancing the performance of the national economy and improving practices in business communities.

Jordan and Palestine have many similarities, as they are both Muslim countries. Also, many of the Palestinian population immigrated to Jordan during the Palestinian Nakba in 1948 and during 1967, when Israel occupied the West Bank and Gaza Strip. Unofficial statistics indicated that about 60% of Jordan's population is Palestinian and has a similar cultural, social, and ethnic context. So, Palestinians who live in Jordan play a pivotal role in the Jordanian economy by establishing many companies.

Despite the similarities between the Palestinians and Jordanians, there are some differences between them. Jordan is an independent and old country and has a more developed legal and constitutional structure than Palestine, and Jordan has been

politically stable for decades. Therefore, despite some differences between Jordan and Palestine, it is possible for Palestinian companies, especially those listed in the PEX, to imitate the professional behavior of Jordanian companies listed on the ASE because of the cultural and social ties between both countries. Additionally, many studies conducted in Jordan have addressed CG issues, while few studies have studies conducted in Palestine. So, the studies conducted in Jordan serve as guidelines for the researchers who want to conduct their studies in the Palestinian context.

### **2.3.3.3 Overview of CG in Syria**

Since 2000, Syria's economy has shifted toward more market-based policies. "The State found it necessary, after more than 40 years of socialist, centrally planned economy, to adopt economic reforms under the so-called "Social Market-Economy. The Syrian Financial Markets and Securities Commission (SCFMS) was founded in 2005 with the goal of 'organizing and improving financial markets, promoting investment, and saving activities and protecting investors in securities from unfair and illegal practices. Then, to govern all procedures related to the issue of shares, floatation, trading, settlement, and transfer of ownership, a Stock Exchange Law was issued. The CG framework in Syria is new and is marked by many supervisory regulators' involvement in the issuance of rules and standards for CG. Inspired by the governance structures adopted in the developed states, the Syrian institutions concerned have provided guidelines and are acting to enforce such governance requirements on the companies under their jurisdiction. First, the disclosure instruction act was issued by SCFMS in 2006. In addition to the implementation of IFRS, the act clarifies the structure of the AC and the attributes of the external auditor to be respected by the firms under the supervision of the SCFMS. The guide includes provisions relating to the board

of directors, the audit committees, and the insurance companies' external auditors. In addition to the need for the establishment of committees within the BOD and the non-duality of the CEO and the head of the BOD, the structure of the BOD in these companies is determined by this guide. One year later, the CG Act was issued by SCFMS. In addition to clarifying the structure of the board and the requirements of the ACs, the SCFMS' act enforces the provisions of accountability and transparency in companies. The Code of Governance of Islamic and traditional banks was also published in 2009 by the Central Bank of Syria to ensure adequate protection of assets and banking facilities, the rights of depositors, the preservation of financial position, and the strengthening of financial and administrative stability. It is interesting to note that in these guides and actions, the governance provisions are like those introduced in developed countries by the governance guides. The United Nations Development Program creates a governance program for the Arab region. The aim of this program is to encourage and improve good CG practices and related reforms in Arab countries. According to the program, between 2005 and 2007, Syria has seen a modest increase in the efficacy of government and political stability, but it is still marked by low levels of consistency of legislation and voting, transparency, and control over infringements (Kaufmann et al., 2003). In its report on business performance, the World Bank (2008) classifies investor protection in Syria as below the regional average and below the average level of the OECD index of countries.

The war conditions which were starting in 2011 have paused CG efforts in Syria. Consequently, a gap between boards and executives is expanded. Previous research on CG in Syria is rather scarce and driven by questionnaires. Naddeh and Alkaadi (2010) used 47 questions to compare the available CG guidelines in three countries: Egypt, Jordan, and Syria between each other and with OECD principles. They find that 49%

of CG provisions in Syria at that time are inconsistent with the principles of OECD provisions. Also, Mousa (2014) used a questionnaire to examine the commitment of Syrian private banks to OECD principles in 2011. He found that respondents thought that commitments by Syrian private banks to OECD values were just facial and had no real effect on the ground. Our research is distinguished by the creation of an index for CG and its key provisions that allow us to calculate its effect on company results numerically.

The most recent study conducted by Mardnly, Mouselli, and Abdulraouf, (2018) analyzed the effect of aggregate and individual CG on firm performance of all companies listed on the Damascus Stock Exchange (DSE) for the period from 2011 to 2015. They found a positive and significant impact of ownership structure on firm performance. However, other CG provisions and the aggregate index of CG generally have insignificant impact on firm performance. This may be because of the weak oversight and leniency by Syrian Securities and Exchange Commission in supervising and enforcing the commitment of companies to implement the provisions of governance. This can also be attributed to the current crisis in Syria that badly affected the performance of firms and shift their concentration from improving CG practices to surviving the war conditions. Furthermore, and despite the improvements of CG regulations in Syria, the recent war conditions may bias the results toward finding insignificant impact of CG provisions on firm performance.

Syrian and Palestine have many similarities, as they are both Muslim countries. Also, many of the Palestinian population immigrated to Syria during the Palestinian Nakba in 1948 and during 1967, when Israel occupied the WB and GS. Economically, the stock market in Syria and Palestine still emerging, small, and working under war

and political instability conditions. So, the results of this study will be generalizing to the Syrian context and other regional countries such as Lebanon and Iraq.

#### **2.3.3.4 Overview of CG in Lebanon**

The Lebanese culture, like that of the MENA countries, has made CG in Lebanon less effective than in other countries, due to a lack of legal standards for businesses, among other things. To counter the above, the government has recently placed new conditions on companies doing business in Lebanon regarding the composition of board of directors' committees. However, audit committees are present in 14 percent of Lebanon's enterprises, with just 18 percent of these committees working effectively. The Lebanese government has made several attempts to adopt International Accounting Principles (IAS). Except in the banking sector, there were no processes in place to ensure IAS compliance. For small and medium-sized firms with limited knowledge of these principles, the IAS tends to be very complex, raising the likelihood of financial accounting errors. Even though audit firms follow the International Standards on Auditing (ISA), the quality of audits differs greatly due to the auditing profession's lack of oversight. The number of audited companies in Lebanon has risen in the last decade for three key reasons: first, new foreign acquisitions were reported, and the companies involved were needed by the parent company to be audited; second, investors and creditors became more interested in the credibility of the financial statements, demanding audited information before making their decisions; and third, investors and creditors became more interested in the credibility of the financial statements, requesting audited information before making their decisions; third, many businesses chose to be audited voluntarily, whether to increase accounting efficiency or to benefit from the market's favourable view of audited financial statements.

## 2.4 Overview of Palestine (West Bank & Gaza Strip)

Palestine, as a developing country, needs to attract more investments to boost its business sectors. Thus, Palestinian firms must be concerned about the quality of their CG mechanisms. PCMA looks to ensure the availability of high-quality financial information to the stakeholders. Since its establishment in 2004, PCMA has wanted to implement convenient CG mechanisms and transparency rules to improve the quality of the financial reports (Asmar, Alia, & Ali, 2018).

The purpose of this current study is to investigate the association between CG mechanisms and EM practices of non-financial companies listed on PEX during the period from 2011 to 2018. Exploring the relationship between CG characteristics and EM practices helps test the validity of agency theory, which is a primary theory addressing a small emerging market such as PEX. Therefore, this study would fill the gap in the earlier literature related to the effects of CG mechanisms on EM practices in MENA countries in general and Palestine in particular.

Also, this study, to the best of the researchers' knowledge, will be the first study that investigates the impact of the CG code on the EM since the establishment of PCCG (2009). The PCCG (2009) applies to all companies listed on the PEX as the PCMA supervises all listed companies. The PCMA promulgated the PCCG in 2009, which became effective from November 2009. Although Palestine shares the same social, cultural, political, and economic characteristics with the other Arab countries, Palestine offers an interesting and unique institutional feature to justify studying the relationship between CG mechanisms and EM practices due to its unique unstable environment.

### 2.4.1 Geographic Context

The state of Palestine is in western Asia, between 33 '15" and 29' 30 " longitudes, and between 35 '40" and 34' 15 " latitudes. The entire Palestinian country is approximately 27,009 square kilometers, lengthening from Ras Al-Naqoura in the north to Ommerreshrash in the south. Palestine borders Lebanon to the north with a border of 79 kilometers: Syria with a border of 70 kilometers, and Jordan with a border of 360 kilometers to the east. To the south, Egypt is bordered by Palestine, with a total border length of 240 km. From the west, the Mediterranean Sea borders Palestine with a coastline of 224 Km. With a coastline of 10.5 km, Palestine also overlooks the Gulf of Aqaba. PNA is now restricted to two geographically separated regions, the governorates of Gaza (also known as southern governorates, Gaza Strip, GS) and the governorates of the West Bank (also known as northern governorates, WB), with a total area of 6020 km<sup>2</sup>, representing 22% of the historical state of Palestine (PCBS, 2013a).

GS is a very small, narrow band of land, 45 km long and 6-12 km wide, situated on the Mediterranean coast in the southern region of the historical state of Palestine, with an area of 365 km<sup>2</sup>. North Gaza, Gaza, the Mid Zone, Khan Younis, and Rafah are divided into five provinces. GS's total land boundaries are 62 Km: 11 Km for Egypt and 51 Km for Israel (PCBS, 2014).

WB, including East Jerusalem, has a 5,640 km<sup>2</sup> land area plus a 220 km<sup>2</sup> water area, consisting of the Dead Sea's northwest portion. It has an estimated population of 2,747,943 Palestinians and about 391,000 Israeli settlers as of July 2017, and about 201,200 Israeli settlers in East Jerusalem as of July 2017.

### **2.4.2 Demography Context**

The total estimated population of the PNA at mid-2015 was about 4.68 million, according to PCBS (2015); 2.38 million males and 2.3 million females. The GS's total estimated population was 1.82 million people. Data showed that the PNA population is a young population; as at mid-2015, the number of individuals aged 0 to 14 accounted for 39.4 percent of the total population, of which 37.2 percent were in WB and 43.0 percent in GS. The elderly population aged 65 years and older accounted for 2.9% of the overall population, with 3.2% in WB and 2.4% in GS at mid-2015. As per PCBSS, population density is generally high in GS, reaching 4,986 people/km<sup>2</sup> (2015). In 2014, the average size of the household in PNA was 5.2: 4.9 in WB and 5.7 in GS. In 2015, the natural rate of population growth was 2.9 percent, 2.6 percent in WB and 3.4 percent in GS (PCBS, 2015). In 2012, 42.1 percent of the overall population were Palestinian refugees: 27.0 percent in WB and 67.0 percent in GS.

### **2.4.3 Socio-Economic Context**

The continuing blockade, current occupation, recurrent wars have undermined the Palestinian economy to unprecedented extent. In the year 2012, the average per capita GDP was 1679.3\$: 2093.3\$ in WB and 1074.5\$ in GS (PCBS, 2013b). Labor force participation rate in 2015 was 45.6 percent, distributed as 71.7 percent for males and 18.8 percent for females (PCBS, 2015). In 2015, Out of the total rate of employment: full employment rate was 70.8 percent, underemployment rate was 3.6 percent, and unemployment rate was 25.6 percent (PCBS, 2015). (PCBS, 2015). According to the United Nations Office for the Coordination of Humanitarian Affairs (OCHA,2014), the existing poverty and unemployment rates are very high; In GS, unemployment rate has risen drastically since mid-2013, following halt of the illicit tunnel trade with Egypt,

soaring from 28 percent in the third quarter of 2013 to 45 percent in the second quarter of 2014; almost 70 percent of the youth aged 20-24 were unemployed in GS in the second quarter of 2014 and further decline is highly anticipated (OCHA, 2014). The overall diffusion rate of poverty among Palestinian individuals was 25.8 percent in 2011: 17.8 percent in the WB and 38.8 percent in the GS. In 2014, the poverty rate in the GS has risen to 39 percent (World Bank, 2014). In 2014, the literacy rate was 96.9 percent in the GS.

Regarding to the normalization accords between Israel and Some Arab states, the Palestinians consider that the Arab countries' establishment of diplomatic relations with Israel constitutes a threat to the existence of their desired future state. The economic prosperity that Israel has shown in its development and in providing the necessary resources and equipment to the Palestinians will be a mirage from the Palestinians' point of view. Unfortunately, the Palestinian remains the victim, and the Palestinian economy will only benefit from these agreements by a large zero.

#### **2.4.4 Palestine Exchange (PEX)**

PEX is considered one of the youngest and emerging exchanges in MENA countries (Hassan et al., 2016). PEX is a private firm that was founded in 1995. Less than two years later, the first session of trading was held in February 1997 to promote investments in the state of Palestine, which had recently emerged. After that, 2010 was a decisive year for the PEX, as it became the second public Arab Bourse owned entirely by the private sector. The PEX focuses basically on magnetizing potential foreign and domestic investors and Palestinians in the districts of diaspora. Enhancing transparency, integrity, and the protection of shareholders are the main targets of PEX, so the newest technology has been used in its information system. NASDAQ OMX systems were

utilized to supervise PEX trading and CSD. In 2019, trading shifted to NASDAQ's next-gen "X-Stream" platform. The PEX is classified as "Frontier Market" by FTSE Russell and as a country within the indices of MSCI and S&P. PEX has a presence regionally and globally. It has membership in several institutions, including the Federation of Arab Stock Exchanges, the Federation of Euro-Asian Stock Exchanges (FEAS), the World Federation of Exchanges (WFE), the Association of National Numbering Agencies (ANNA), and the Forum of Islamic Stock Exchanges the Africa & Middle East Depositories Association (AMEDA) (PEX, 2020).

The PEX is registered as a shareholding company licensed by the Palestinian Ministry of National Economy and is subject to its control. Moreover, PEX operates under the supervision of the PCMA to monitor the implementation of sound governance mechanisms to protect current and potential investors and other stakeholders. The electronic website of PEX (2018) showed that 48 firms were listed on PEX as of May 31, 2018, with a capitalization of about USD 3,789 million distributed among five sectors. These include the banking sector that has eight commercial and Islamic banks, the insurance sector with seven shareholding insurance firms, the investments sector, which includes nine real estate companies, the industries sector that contains thirteen corporations, and finally, the services sector that has eleven services and real estate companies.

The sectors in PEX are divided into two main sections, namely financial listed companies, and non-financial listed companies. The financial sector represents both bank and insurance companies and totaled sixteen companies of the forty-eight companies listed. The non-financial listed companies include industries, services, and investments sector, with thirty-two companies listed (PEX, 2018). The securities of the

listed companies are traded in two common currencies in Palestine, which are the Jordanian Dinar and US Dollars.

The sample of this study is the Palestinian non-financial companies listed on PEX for several reasons. First, the non-financial companies comprise 70% of the total companies listed on PEX, while the rest of this percentage belongs to financial companies listed. Second, the PCCG (2009) applies to listed non-financial companies listed, while there is another strict code of CG that applies only to listed financial companies. Third, the nature of financial items of the non-financial firms is different from the items of financial companies. Finally, the models of calculating DAC in the non-financial companies are different from those used to calculate EM in financial companies.

Thereby, the PEX works in a unique environment that is interesting to study in terms of the relationship between CG and EM. Accordingly, the objective of this current study is to explore the association between CG mechanisms (BOD characteristics, AC characteristics, and OS) and EM practices in the Palestinian non-financial companies listed on the PEX. In this study, the accrual-based EM approach is used to calculate the EM level by employing the Kothari et al. (2005) model.

#### **2.4.5 Political and Economic Situation in Palestine**

Palestine has been considered an occupied country since 1948. Everything was under Israeli occupation control in Palestine until the Oslo peace agreement took place in the mid-1993. The Palestine Liberation Organization (PLO) and Israeli as an occupation authority have agreed to establish the Palestinian National Authority (PNA) as a transitive authority with limited jurisdiction over some separated zones of the West Bank and the Gaza Strip. The year 1995 witnessed the birth of the PEX. Thus, PEX is

established as a private shareholding company to attract potential local and foreign investments to infuse their funds in the Palestinian territories (Gaza Strip and West bank).

The PEX held its first session in early 1997. The establishment of the PEX was considered an important economic achievement in the wake of the Oslo peace accords. Improved security and economic conditions, along with support from international donors, had created significant progress in the Palestinian economy, and Palestine became an attractive destination for both domestic and foreign private investment. When the five-year transitional period of the Oslo agreement expired in 1999 without reaching a comprehensive peace agreement, the region experienced an increased level of violence. Once again, Israel redeployed forces in the PNA areas and imposed severe restrictions on Palestinian movements and the economy.

As a result, since 2000, the Palestinian economy has suffered from a downward tendency. Although a strong belief existed that security, political and economic instability negatively influence investors' confidence and PEX performance, the performance of PEX in the last few years did not support this belief (Hassan et al. 2016). Indeed, the number of listed companies on PEX increased from eight in 1997, with a \$530 million market capitalization, to 48 in 2018 with a \$3.789 billion market capitalization. Thus, studying and assessing the influence the quality of CG on EM practices in an unstable environment like Palestine is import. Hence, PEX offers an interesting and unique environment to study this phenomenon.

In terms of the political situation and governance quality in Palestine, this study investigates the influence of CG characteristics and EM in Palestine during the severe political instability from the beginning of 2011 to 2014 and the period from 2015 to 2018, which represents light political instability. The Worldwide Governance Indicators

(WGI, 2019) provide an aggregate indicator of six governance factors, namely, Voice and Accountability, Political Stability, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption.

**Table 2.1:** CG and Regulatory Quality in Palestine

Year	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption
2011	-1.01	-1.94	-0.59	0.2	-0.43	-0.45
2012	-0.94	-1.96	-0.71	0.08	-0.44	-0.25
2013	-0.93	-1.78	-0.73	0.12	-0.4	-0.28
2014	-0.88	-1.99	-0.49	0.21	-0.39	-0.28
<b>Mean (2011-2014)</b>	-0.94	-1.92	-0.63	0.1525	-0.415	-0.315
2015	-0.99	-2.16	-0.47	0.1	-0.51	-0.45
2016	-1.09	-1.98	-0.64	0.06	-0.34	-0.15
2017	-1.03	-1.66	-0.4	0.02	-0.42	-0.03
2018	-0.9	-1.74	-0.76	0.05	-0.48	-0.2
<b>Mean (2015-2018)</b>	-1.0025	-1.88	-0.5675	0.0575	-0.4375	-0.2075

Source: The Worldwide Governance Indicators (WGI) (2019)

Table 2.1 elaborates about political instability and governance quality in Palestine, which covers the period of this study from 2011 to 2018. The estimator ranged from -2.5 to 2.5 during this period, which ranged from the lowest stability to the highest stability, respectively. Table 2.1 shows that the political situation and governance quality is very weak, according to the estimators. Regarding political stability, it is clear from the mean value (-1.92) from 2011 to 2014 was higher than the mean value (-1.88) from 2015 to 2018. The results of political instability supported splitting period into a severe crisis period from 2011 to 2014 and semi-stability from 2015 to 2018. Table 2.1 provides concrete motivation to conduct this study in the environment, such as Palestine, and include political instability as an essential factor to be investigated.

The companies listed on PEX were affected by several events that occurred in 2008 and 2009, such as the global financial crisis and the devastating war on the Gaza

Strip launched by the Israeli occupation, as well as the restrictions imposed on the movements of the Palestinians and goods and services in the West Bank and Gaza Strip. Subsequently, the Arab revolutions (Arab Spring), which happened in 2011, adversely affected the economics of MENA countries. So, this current study focusses on political instability as a factor that might influence the effectiveness of CG in mitigating EM practices in Palestine.

Abu Jamia (2013) documented that the Palestinian economy was negatively affected by the Arab Spring. He argued that the foreign investments fled from the countries affected by the Arab Spring, such as Egypt, Tunis, Libya, Syria, and other countries due to political unrest and the economic situation. He also found that the volume of Palestinian exports notably declined during this time. Accordingly, he recommended that PCCG (2009) should be updated and reviewed to provide more protection to foreign investors and attract additional local and foreign investors to enter the Palestinian private sector.

The World Bank (2015) has elaborated that the recorded economic growth in Palestine in 2014 declined due to the devastating war that occurred in the Gaza Strip in the summer of 2014. In part, the report said, "The 2014 summer war shaved about \$460 million off Gaza's economy, leading to a 15 percent contraction of its GDP." Moreover, a 2017 World Bank report illustrated that the devastating effects of the war that occurred in 2014, which left negative social and economic consequences in its wake and caused the collapse of the Palestinian economy. The annual average of economic growth in 2015 and 2016 was 3.4%, while it declined to 0.7% in 2017 due to the continued political tension in Gaza Strip and West Bank that began in 2007. Therefore, the political and economic instability in Palestine is one motive for conducting this study,

as it is possible to generalize its results to neighboring countries because of their environment, which may be like the Palestinian environment.

To sum up, PEX is still emerging and operates in an economically and politically striking region due to the Israeli occupation. Additionally, Palestine faced three wars in 2008, 2009, 2012, and 2014 by the Israeli occupation, but the most devastating war was in the summer of 2014. The PCCG (2009) has not had any review or changes since its launch to meet global and local requirements, and the unstable political and economic conditions have adversely impacted it. This study fills the gaps in previous research by using political instability to investigate whether its effects moderate the relationship of BOD and AC quality and EM practices in Palestine. The sample size of this study involved all the Palestinian non-financial companies listed on PEX from 2011-2018.

## **2.5 Corporate Governance Situation in Palestine**

CG in Palestine has received much attention in the past and has been a hot topic for academics, practitioners, and other stakeholders. This concern is due to the many financial scandals and failures that have occurred in the developed and developing countries in the last two decades and the unstable political environment of Palestine. Accordingly, several laws were issued in Palestine to regulate the actions of the private sector and enhance the application of the PCCG that was issued in 2009. These include the “Monetary Authority Law, Investment Promotion Law, Palestinian Market Authority Law, and the Financial Security Law, Auditing law, Insurance law, and Anti-Money laundering law, Companies Amendment Law for the year 2008” (PCCG, 2009).

The National Committee for Corporate Governance brought forward the PCCG in November 2009. The committee comprised representatives from PCMA, PEX, PMA, economic, legal, and academic bodies, and other regulators and stakeholders. The rules

of CG aim to enhance the quality of BODs, create a competitive and strong private sector, maximize firm wealth and profitability, and boost the confidence of all those concerned. Furthermore, the power of CG helps in improving the investment climate and extending the stock market for the sake of enhancing the competitiveness of the economy through company staff confidence and ability in the country confrontation in danger. The code applies to the public shareholding companies; The PCCG covers the following vital aspects of CG, such as BOD and its committees, general assembly committee meetings, stockholders' compatible rights, corporate management, auditing, disclosure, and transparency. The PCCG consists of three main groups of rules, as mentioned below:

First: These rules are based on mandatory legal texts, so companies must apply these rules by force of law.

Second: These rules are based on the international principles and do not conflict with the legislative texts in Palestine; Hence, applying these rules is voluntary.

Third: These rules are based on international principles, and there is a conflict between these rules and the legislative texts in Palestine. Hence, the text of legislation must be amended to comply with international principles and legislation text in Palestine.

According to PCCG (2009), the number of BOD members must range from 5 members to 11 members. The code also advises the BOD members not to be involved in any executive function in the company to identify authorities and responsibilities.

According to PCCG (2009), the BOD should have at least two independent members.

An independent member is defined as a person who has no other relationship with the company and is not influenced by any external considerations.

The PCCG (2009) said that independent members should possess the minimum required characteristics, such as at least a bachelor's degree and appropriate experience in the company field of work or industry. Also, an independent member must not work in a firm for at least three years before starting his or her membership and have no financial interests with the company except for membership compensations. Moreover, an independent member must have no relative relationship to the second degree with any manager of the top management. Finally, his or her participation must not have a bearing on a company's capital nor a partner to another stockholder.

All Middle East countries have codes of CG (Salloum et al., 2014), and forming an AC is voluntary in majority of these countries (Bremer et al., 2011). Similarly, the forming of the AC is also voluntary in Palestinian listed or non-listed firms. According to the PCCG (2009), the BOD should also form two more committees: the remuneration committee and governance committee, besides an AC. An AC committee should be established to aid the BOD in carrying out duties and responsibilities. The composition and work of the three committees mentioned above is explained as follows.

First, according to PCCG (2009), the BOD should establish an AC to ensure transparency and determine the level of the risk of the company. The AC should comprise at least three directors; one of them must be independent and have financial or accounting experience or qualifications to assess the risks that face the company. Based on the PCCG (2009), the chairman of the AC must be a resident of Palestine and a non-executive director.

Second, the BOD of the public shareholding firms listed on PEX should form a remuneration committee. This committee should have at least one independent member of the BOD. This committee should be established for the sake of helping BOD to set a remuneration policy according to the BOD and top management members.

Furthermore, the chairman of the remuneration committee must attend the meetings to answer questions that the stockholders raise (PCCG, 2009).

Third, the governance committee plays a vital role in Palestinian firms listed on PEX. A governance committee should be formed by the BOD non-executive directors to control the application of CG rules. Also, the governance committee serves the role of the remuneration committee in companies that do not have a remunerations committee.

To enhance the CG mechanisms in Palestine, according to the PCCG (2009), the Palestinian listed firms must hire external auditors. An external auditor must have many attributes. He or she must be licensed and have no relationship with the company. In addition, an external auditor should possess sufficient qualifications and professional experience to carry out his or her tasks professionally and independently. Furthermore, the external auditor should not have any financial interest with a company and must not own any investments from the firm.

Many studies have addressed the issue of CG characteristics and their relationship with EM practices. Prior studies have focused on the relationship mentioned above using specific CG variables (e.g., BOD characteristics, AC characteristics, OS). However, some recent empirical studies have investigated the same relationship by using a broader measurement of CG characteristics. Bekiris and Doukakis (2011) have suggested that the use of CG characteristics as a summed score to include as many individual measurements of governance in an index as possible. Studies that measure BOD characteristics as an index are very few because the approach is considered as the new (Bekiris & Doukakis, 2011). While most prior studies conducted in Palestine have used the characteristics of CG individually, this study is the first work in Palestine that

uses an aggregate measure for the quality of AC and BOD to create a comprehensive understanding of the CG situation in the Palestinian context.

A review of prior studies conducted in Palestine reveals that few studies have addressed the relationship between CG and EM in Palestine (Abdelkarim & Zuriqi, 2020). Furthermore, most studies that addressed CG issues in Palestine have ignored political instability as a factor that can influence firm performance, disclosure quality, and EM practices.

This study addressed the impact of political instability as an independent variable that might influence EM practices to bridge this knowledge gap. Unlike prior literature, political instability is used as a moderating role in the relationship between BOD and AC quality and EM practices in Palestine to create a more in-depth analysis and to understand the environment of Palestine. In past studies, agency theory has been addressed as the leading theory conducted in Palestine. In contrast, this current study tests the validity of political theory in the Palestinian context.

Concerning the measurement of EM, the most widely used model in capturing EM is the Modified Jones (1995) model. Previous works documented that the Modified Jones Model works better in detecting EM in developed states (Dechow et al., 1995). Recently, increasing empirical studies that have documented that the Modified Jones Model is inappropriate in the context of Asian companies (Yoon & Miller, 2002; Yoon, Miller, & Jiraporn, 2006) in the context of Palestine (Alareeni & Aljuaidi, 2014). Accordingly, Alareeni and Aljuaidi (2014) documented that the Modified Jones Model is ineffective in capturing DAC in Palestine as an emerging economy. Thus, this study addressed the performance-matched model in detecting EM, which Kothari et al. (2005) originally developed to calculate the magnitude of EM.

## 2.6 Chapter Summary

The economic and political situation in Palestine seems a unique environment for conducting as such a study. Despite the instability of the political situation in Palestine, it has an emerging stock market and a CG code to protect the interests of stockholders and other stakeholders. During the last ten years, Palestine has suffered from a series of unusual events that have affected the national economy and PEX, such as the devastating war on the Gaza Strip in 2014 and the other wars in 2012 and 2008. The economy of Palestine was also adversely affected by the revolutions of the Arab Spring (e.g., Syria, Egypt, and Tunisia in 2011) and affected by the global financial crisis of 2007-2008. In this context, this study examines the relationship of CG mechanisms with EM in the Palestinian context.

This chapter defines the CG according to the most common and comprehensive definitions to reach a good understanding of the CG issue. This chapter presented a brief overview of the climate and the environment of CG in developed countries in which global financial scandals have occurred. The example of the United Kingdom was introduced as an example of an advanced country due to its vital role and contributions in the development of governance principles in the past 30 years.

This chapter discussed the environment of CG in developing countries and how the mechanisms of governance have developed in these countries in the last 20 years. Researchers have targeted Malaysia from the South Eastern Asian countries and Jordan from MENA countries to study CG topics. CG mechanisms in both countries have developed rapidly and have become the best models for developing countries. Overall, this chapter provided an overview of CG development in developing countries such as Malaysia and Jordan. Moreover, this chapter provided a brief perspective on the background of the Palestinian political and economic situation, relevant regulations, and

monitoring devices related to the Palestinian context. The next chapter discusses previous literature on the relationship between CG mechanisms and EM practices.

