

CHAPTER 1

INTRODUCTION

1.1 Introduction

Corporate Governance (CG) is a dynamic process that has undergone many significant developments over the last several decades. Hence, examining the association between CG mechanisms and earnings management (EM) is the primary purpose of the current study. This chapter provides a background on CG issues and their impact on EM practices worldwide, and more specifically study this topic in the Palestinian context. Moreover, this chapter provides an outline of this study. Section 1.2 of this chapter is the background of the study; the problem statement of this study is discussed in Section 1.3. Then in Sections 1.4 and 1.5, the objectives and the questions of this current study are presented. Section 1.6 provides the motivations and significance of this study to illustrate the importance of conducting such research in Palestine. The main contributions of this study are presented in Section 1.7. Section 1.8 represents the structure and outlines of the study, and, finally, the chapter summary provided in Section 1.9.

1.2 Background of the Study

At the end of the previous century and the beginning of the twenty-first century, the world has awoken to a series of global financial scandals with numerous large companies in the United States of America, Europe Union, and some developing countries in Southeast Asia and MENA countries, especially Arab Spring countries and Palestine. For example, Parmalat, Enron, HealthSouth, WorldCom, Xerox, Adelphia,

Tyco, Qwest, and AIG (Ebaid, 2013; Habbash, 2010; Idris et al., 2018; Lopes, 2018; Makhlouf, 2017; Zgarni & Fedhila, 2019). There were many reasons behind these crises, including weaknesses in CG systems and issues related to EM practices (Alghamdi, 2012; Bajra & Cadez, 2017; Kirkpatrick, 2009). Indeed, EM was considered one of the most critical challenges facing CG mechanisms, which is related to the adverse effects of EM on the quality of financial reporting (Alzoubi, 2016; Bremer & Elias, 2007; Jaggi & Tsui, 2007; Saleem et al., 2016). CG issues surfaced after these global financial scandals, these scandals reflecting the failure and the weakness of CG systems (Alareeni, 2018; Shehata, 2015). The quality and the effectiveness of CG mechanisms applied by the companies can mitigate the opportunistic manipulation of reported earnings. Conversely, weaknesses of CG mechanisms can stimulate corporate fraud and corruption and further motivate management to practice EM (Leventis & Dimitropoulos, 2012; Thomas Clarke, 2007; Vafeas, 2005). Therefore, this study focuses on investigating the role of CG characteristics in promoting or reducing EM practices in the non-financial firms listed on Palestine exchange (PEX).

Indeed, matters of CG characteristics, ownership structure (OS), and EM practices have received significant attention from governmental bodies, regulators, auditing and accounting profession, practitioners, policymakers, academicians, and the public. Therefore, interest in CG systems and EM issues has increased, especially following the high-profile corporate scandals in developed countries such as the United States and Europe and some developing countries. During the last two decades, financial distress in these countries has motivated the need for more transparency and credibility for the sake of protecting the interests of stockholders and stakeholders simultaneously (Abbad, Hijazi, & Al-Rahahleh, 2016; Aziz, Mohamed, Hasnan, Sulaiman, & Abdul Aziz, 2017; Fearnley & Beattie, 2004).

Palestine is considered a developing country that needs to enhance its domestic economy by attracting prospective national investors, potential foreign investors, lenders, suppliers, and other participants in business sectors. The PEX is committed to a good CG, and it believes that long-term success is linked to its responsibilities and commitment towards stockholders and stakeholders. As an integral part of its commitments, its CG structure is in line with the Palestinian Corporate Governance Code (PCCG) that the Palestinian Capital Market Authority (PCMA) issued in 2009, which was implemented in the same year. As a component of the national economy, the PEX feels that it must strengthen and develop the PCCG mechanisms. Furthermore, PEX is looking forward to creating a model in this aspect by managing a market that is orderly, fair in structure, transparent, and dispassionate in its information (PEX, 2018). Thereby, the findings of this study will help the PEX to reform the code of corporate governance in Palestine to strengthen the CG effectiveness which may lead to increase the faithfulness of financial reports.

PEX was established in 1997 and became a crucial economic achievement in the wake of the Oslo Peace Agreement, which was signed in 1994. After the Oslo agreement and the establishment of PEX, economic conditions improved due to advancements in the security situation. Consequently, the Palestinian economy has become an attractive destination for domestic and foreign investments. Unfortunately, a few years later, particularly in 1999, the region witnessed an increasing level of violence. Once again, Israel reoccupied the territories under the control of the Palestinian Authority and imposed severe restrictions on the movement of Palestinian people. As a result, the Palestinian economy began to decline in 2000. A strong belief exists that political and economic instability negatively affect investor confidence and weaken the performance of the stock market. So, Palestine provides interesting and

unique institutional features to justify the study of the relationship between CG and EM under such an unstable environment.

Indeed, the Palestinian code of corporate governance was imposed on listed companies in November 2009. This Code consists of groups of CG rules based on valid laws and regulations that are operating in Palestine (West Bank and Gaza Strip). CG rules in Palestine relate BODs and their committees, ownership structures, quality of disclosure, the internal audit function, and the characteristics of external auditing. PCMA was guided by the governance principles promulgated by the International Organization for Economic Cooperation and Development (OECD), as well as other governance rules to be implemented at the regional and international levels (PCCG, 2009). Furthermore, the Code of Palestine deals with aspects of the CG mechanisms such as the arrangement of general assembly meetings, protecting the stockholder's rights, corporate executive management, internal and external auditing, disclosure, and Transparency (PCCG, 2009).

Financial misreporting occurred on a large scale in the late 1990s and the early years of the 2000s. The Enron, WorldCom, and Parmalat scandals the most common scandals in the globe. Those scandals involved managers' manipulation of financial reports, accounting standards, choices, and management decisions. Another method of manipulating earnings was to convert the general expenses to investment expenditures to generate future cash flows. WorldCom was an example of such a misapplication of accrual accounting (Zouari, Lakhel, & Nekhili, 2012).

EM is a process of using flexibility in choosing accounting policies and options that allow managers to influence opportunistically reported earnings, causing the reported income to be greater or smaller than it will be (Zouari et al., 2012). Jaggi and Tsui (2007) found that managers practiced EM to achieve specific goals such as losses

avoidance, cover expectations of the market, and avoiding the breaching of debt contracts. They documented that a high level of EM practices might weaken the quality of reported earnings and mislead stakeholders, especially those who are the primary users of financial reports. The adoption of international accounting standards and auditing standards by the developed countries have failed to provide enough assertions that financial statements are free from EM practices (Pornupatham, 2006). Indeed, Al-khabash and Al-Thuneibat (2009) argued that EM practices have several victims, for instance, investors, whether locals or foreigners, creditors, vendors, regulators, customers, and other potential stakeholders.

Moreover, Chang and Sun (2009) explained that investor confidence was based on the strength of the capital market associated with various oversight tools such as the mechanisms of CG that have received attention in many developing countries. Hence, CG mechanisms play a vital role in encouraging corporations and economies to attract new potential investments, whether these foreigners or locals, and provide appropriate credibility to financial reports. Cornett, Marcus, and Tehranian (2008) argued that CG mechanisms have fundamental impacts on EM practices. However, some academic researchers have argued that the influence of CG varies from country to country regarding the concentration of ownership and various other factors. In other words, the structure of a firm's ownership may provide a vital monitoring tool by affecting the composition of the BOD and related committees. For instance, Wei (2007) confirmed that divergence in CG practices between countries attributed to divergence in the structure of ownership, which, in turn, enhanced CG systems.

Several prior studies have addressed the financial crisis, political matters, and their effect on EM and income smoothing as a tool of EM (e.g., Wang 2011; Attia et al., 2016; Hsiao et al., 2016; Obaidat, 2017; Harymawan & Nowland 2016; Anon 2008;

Filip & Raffournier 2014; Habib et al., 2013). Wang (2011) has investigated the impact of the Persian Gulf crisis in 1990 on oil firms that expected increases in earnings, using accounting accruals to minimize earnings and political sensitivity. He found that oil companies that expected to report profit during the crisis motivated to use negative DAC to reduce earnings during the Gulf crisis. Furthermore, Hsiao et al. (2016) investigated whether US petroleum companies practiced EM during the Arab Spring in 2011. The results of their study showed that these firms engaged in EM practice during the Arab Spring. Obaidat (2017) investigated the impact of the political crises on income smoothing behavior in non-financial firms listed on the Amman Stock Exchange (ASE) during the period 2006-2015. He indicated that the firms tend to practice more EM during the political crisis periods.

Accordingly, several events adversely affected the performance of the companies listed in PEX that occurred in 2008, such as the global financial crisis, the devastating war on Gaza that Israel launched in the third quarter of the year, as well as restrictions imposed on the movements of the Palestinians and goods in the West Bank and Gaza Strip. Consequently, PEX performance went down about 16% compared to the results of 2007 (PEX, 2009). Subsequently, the Arab revolutions (Arab Spring), which have happened in 2011, affected the economics of MENA countries negatively. Thus, this current study focuses on political instability as a factor that might influence the effectiveness of CG in mitigating EM practices in Palestine.

Abu Jamia (2013) documented the economic influences of the Arab Spring on the economies of MENA countries, especially Palestine. He argued that foreign investors fled from the countries affected by the Arab Spring, such as Egypt, Tunisia, Libya, Syria, and other countries, because of unrest political and economic situation. He also found that the volume of Palestinian exports notably declined during the Arab Spring

period. Finally, he recommended that the regulations, law, and PCCG should be updated and reviewed to provide more protection to foreign investments and attract additional local and foreign investors to enter the Palestinian private sector.

The World Bank (2015) said that despite the recorded economic growth in the West Bank in 2014, “the war in Gaza has had a devastating impact on the Palestinian economy, resulting in overall negative growth.” Hence, the 2014 summer war shaved about \$460 million off Gaza’s economy, leading to a 15 percent contraction of its GDP. Overall, the Palestinian economy contracted three percent in 2014 on a per capita basis. A report of the World Bank in 2017 noted that the summer war in 2014 had had severe social and economic consequences and caused the collapse of the Palestinian economy. The annual average of economic growth in 2015 and 2016 was 3.4%, while in 2017, it declined to 0.7% due to political tensions between the Gaza Strip and West Bank. Moreover, Palestine has a developing economy, and the PEX is still emerging and operating in an economically and politically unstable region due to the Israeli occupation. Additionally, Palestine has experienced wars in 2008, 2012 and 2014 by the Israeli occupation, but the most devastating war was in the summer of 2014. Therefore, this political and economic turmoil in Palestine was one motive for conducting this study, as it is possible to generalize its results to neighboring countries because of their environment, which may be similar to the Palestinian environment.

This study used the political unrest as a moderator variable between the relationship of CG mechanisms and EM practices to enable a deeper understanding of the Palestinian context. The sample size of this study involved all non-financial companies listed on PEX during the period from 2011-2018. Thus, financial companies were excepted because of different items in their financial reports. The period of this study will be split into two periods, the first period reflecting the severe crisis that was

from 2011 until 2014, and the other period represents the post-severe crisis from 2015 until 2018.

Few studies have been conducted on CG and EM in developing countries and Palestine in particular (Abdelkarim & Zuriqi, 2020). Therefore, conducting this study may help in bridging the gap through the results that are reached in the environment of Palestine, which is considered a developing country with an emerging Bursa. Therefore, the purpose of this research has two basic dimensions: First, due to the lack of studies on EM in developing countries, especially in Palestine, this study will provide an empirical evidence on EM and CG from Palestine as a developing country. Second, this research investigates whether the political instability play a moderating role in the relationship between CG effectiveness and EM practices in Palestine.

Indeed, effective CG mechanisms such as BOD characteristics, OS, and AC characteristics can mitigate the level of EM (Fama & Jensen, 1983; Jensen & Meckling, 1976; Lin & Hwang, 2010). Prior empirical evidence of this relationship has been found in developed and developing countries (e.g., Abed, Al-Attar, & Suwaidan, 2012; Alves, 2011; Habbash, Sindezingue, & Salama, 2013; Ibrahim et al., 2014; M. Idris et al., 2018; Peasnell, Pope, & Young, 2005; Saleh, Iskandar, & Rahmat, 2007; Mohamed Soliman & Ragab, 2014; Xie et al., 2003; AbuSiam et al., 2018). However, only a few studies have addressed the CG mechanisms and their impact on EM practices in Palestine (Abdelkarim & Amer, 2011; Abdelkarim & Zuriqi 2020). Furthermore, the first study that addressed the relationship between CG characteristics and EM in Palestine was that of Abdelkarim and Amer (2011). The current study addressed the relationship between the EM as a dependent variable and CG characteristics as independent variables. It is worth mention that EM was computed by using Kothari et al. (2005) Model.

Accordingly, this current research is expected to fill the gap in the literature regarding CG and EM in Palestinian non-financial firms listed on PEX, and the quality of financial information and reports might be improved by understanding this phenomenon in the firms listed on PEX. Hassan (2016) reported that no studies addressed the influence of the CG and the quality of financial reporting in Palestine, in which CG is still evolving. The current study examined the CG mechanisms (BOD characteristics, AC characteristics & OS) and their association with EM practices in the Palestinian non-financial companies listed on PEX to fill this void.

The Palestinian business environment has distinct characteristics that make it an entirely appropriate case for this type of research. More specifically, the present study examines the effect of different characteristics of BOD (e.g., independence, size, CEO duality, number of meetings, nationality diversity, and the existence of a remuneration and governance committee); characteristics of AC (e.g., independence, size, and financial expertise) and ownership structure (e.g., ownership concentration, institutional ownership, and foreign ownership) on EM practices in Palestine.

Interestingly, the most common approach used in prior literature to examine the association between CG mechanisms and EM has examined each characteristic individually. Recently, some studies have criticized this approach due to a deficiency in representing the overall quality of characteristics of CG (Fallatah & Dickins, 2012; Makhlouf, 2017; Ramly, 2013). Moreover, mixed results have been found in studies conducted on individual characteristics of CG when using agency theory in explaining the results. Ward et al. (2009) said that individually addressing the characteristics of CG would lead to disregarding the complementary relationship between the characteristics. Based on these arguments, this study uses a composite measure for BOD characteristics

and AC characteristics to examine their relationship with the level of EM activities in the Palestinian context.

BOD in any organization is considered a core internal CG mechanism that aims to make decisions on behalf of stockholders, as well as control the behavior of management to align with the interests and expectations of owners and stakeholders as well. Consequently, the quality of the BOD lies in several characteristics discussed in this study, namely, the board independence, the size of the BOD, the CEO-duality, the frequency of BOD meetings, and the diversity of nationalities among BOD members. In addition, the existence of a remunerations and governance committee can improve the quality of the BOD and its ability to monitor management, and thus contribute to the quality of financial reporting (Chobpichien, Haron, & Ibrahim, 2008; Hoitash, Hoitash, & Bedard, 2009; AbuSiam et al., 2014b).

AC has an extremely important and vital role in CG, as its primary task is to monitor the financial and accounting operations and provide the necessary information with a high level of credibility to the company's stakeholders. (Pincus, Rusbarsky, & Wong, 1989). Karamanou and Vafeas (2005) and Al-Thuneibat et al. (2016) have argued that AC characteristics, such as AC independence, financial expertise, and size, measure its quality. DeZoort, Hermanson, and Archambeault (2002) also argued that AC effectiveness framework could increase considerably if AC characteristics were studied together. Unlike the studies mentioned, this research examines the effect of BOD characteristics and AC characteristics as composite measures on EM in Palestine. Research on this topic is a fertile area for conducting further research, especially in emerging markets such as the PEX.

Ownership structure (OS) is considered among the most critical mechanisms of the CG in the companies listed in stock markets, especially PEX, as an emerging one.

The relationship between top management and OS is a critical issue of CG mechanisms. Several studies addressed the issue of OS; for example, Omran, Bolbol, and Fatheldin (2008) have found that ownership structure is highly concentrated in Arab countries. This finding helps to confirm that the concentration of ownership can be considered as a fundamental characteristic of CG in Arab countries to overcome the weakness of the legal protection of investors. AbuSiam et al. (2018) suggested that a further investigation of the OS variable should include foreign ownership and institutional ownership as important components of OS. Additionally, they also advocated studying more than one sector, such as the services sector or others.

Few studies have been conducted in Palestinian that have addressed the issues of ownership (Abdelkarim & Alawneh, 2009; Abdelkarim & Ijbara, 2010; Anastas, 2017; Dwaikat & Queiri, 2014; Hassan, Naser, & Hijazi, 2016; Kutum, 2015). According to Abdelkarim and Ijbara (2010) showed that ownership concentration existed in the Palestine shareholding companies, which, in turn, led to restrictions in the development of CG mechanisms. Similarly, Abdelkarim and Alawneh (2009) revealed that one of the most critical issues related to PEX performance was the high level of concentrated ownership in the Palestinian listed firms. They also stated that this phenomenon had impacted the fair pricing of stocks negatively; consequently, decreasing the confidence in the PEX. Opening corporate ownership would be expected to attract more foreign investments and, in turn, improves the quality of the CG system. Thereby, this current study investigates the impact of OS (ownership concentration, foreign ownership, and institutional ownership) on EM practices in Palestine.

After reviewing previous literature, this study will have been the first study to employ political effects as a moderator variable in investigating whether it moderates the relationship between BOD and AC quality and EM practices. All previous studies

that have been in Palestine have not examined the effects of political instability in this kind of research. On the other hand, several prior studies have addressed financial crises and political matters and their effects on EM, firm performance, and income smoothing in developed and other developing countries (Attia et al., 2016; Byard, Hossain, & Mitra, 2007; Filip & Raffournier, 2014; Habib et al., 2013; Han & Wang, 1998; Harymawan & Nowland, 2016; Hsiao et al., 2016; Mangena et al., 2012; Nguyen et al., 2013; Obaidat, 2017). Nonetheless, none of them has addressed political instability as a moderating role, which this study does to bridge the literature gap in this regard.

1.3 Problem Statement

The accounting information appearing in the financial reports is supposed to be the mirror that reflects the true picture of the companies' activities and businesses for a specific period, through which the company's position can be assessed and judged on the safety of its financial performance, so that all related parties can take these different rational decisions, and the information may be exposed. This leads to manipulation and distortion by the management, using certain methods and policies in response to the many motives and pressures, which leads to misleading the users of this information. And due to the inability of accounting standards alone to face management practices in manipulating profits. It was imperative to search for ways through which to confront the phenomenon of profit management, especially that it did not cause the downfall and bankruptcy of many companies, and what is known as corporate governance has been activated that works to reconcile the interests of management with the interests of other related parties and conciliate between the interests of management and the interests of other related parties. Credibility and transparency of financial information.

The investment decisions made by users of the financial statements will be influenced by the published earnings, which is the strongest component of the financial statements, in addition to being an indicator of the strength or weakness of the company's performance (DuCharme et al., 2004; Kazemian & Sanusi, 2015; Shawtari et al., 2017). For this reason, managers may have an incentive to manipulate the reported earnings to achieve their desires and self-incentives (Healy & Wahlen, 1999; Yen et al., 2007; Nazir & Afza, 2018). Consequently, the weakness of existing CG mechanisms can facilitate this opportunistic process. On the other hand, having robust CG mechanisms in a company can improve professional conduct in business transactions and reduce the EM opportunities. In contrast, the existence of weak CG mechanisms may encourage manipulation, corruption, and the mismanagement of financial reporting of the business (Leventis & Dimitropoulos, 2012; Outa et al., 2017; Thomas Clarke, 2007; Vafeas, 2005; Zgarni et al., 2016). Thereby, this study examines the impact of CG mechanisms on EM practices to extend the previous literature by new evidence from Palestine as a developing country.

Moreover, the results of EM practice are exceedingly damaging to many parties inside and outside the company and mislead the shareholders by showing them a different picture of the company's reported earnings (AbuSiam, 2015; Beyer et al., 2019; Lo, 2008). The appearance of EM in financial reports led to the bankruptcy of companies like WorldCom and Enron. As a result, many shareholding companies collapsed and lost large sums of money. Thus, the absence of EM in financial reporting can attract potential local and foreign investors to infuse funds in a country because it creates a positive image in terms of the safety and reliability of financial reports, which ultimately leads to a more prosperous and robust economy. As a result, integrity brings confidence, which is a fundamental requirement for an investment destination.

According to the above arguments, the present study will expand the literature by examining the effect of CG characteristics on EM practices in Palestine.

Some financial scandals that arose from some firms listed on PEX, such as Global telecommunication company, Arab Real-estate company, and Arab Concrete Products Company. Remarkably, PEX announced the suspension of trading the shares of Global Com Communications until its conditions were corrected (PEX, 2015). The Palestinian Economic Portal (PEP) (2016) reported that Global Com. had engaged in manipulation actions, including the registration of non-existent assets of about USD 5 million. Before it was listed, the company was evaluated at an amount greater than its size, according to the company's auditor. Likewise, PEX stopped trading the shares of the Arab Real Estate Corporation due to the company's non-compliance with market rules and instructions and the lack of quality of disclosure as well, which constituted violations of shareholders' rights (Wafa, 2016). According to the arguments above, the current study will extend the literature by studying the influence of CG characteristics on the practice of EM in Palestine.

Palestine has an emerging economy suffering from unprecedented political and economic crises that differ from other developed and emerging economies (Hassan & Hijazi 2015; Hassan 2016). Thus, Palestine has experienced sharp financial and political crises that have affected both the public and private sectors and the investment climate. The Palestinian Economic Policy Research Institute (MAS) documented in a 2016 report that the devastating wars launched by the Israeli occupation on Gaza Strip in 2008, 2012, and 2014 resulted in the destruction of the infrastructure, factories, and the productivity of the Palestinian economy, in addition to increasing the degree of political risk to investment decisions (MAS, 2016). The Palestinian unstable Economic and political environment, weak law enforcement, inefficiency of fiscal and monetary

policies to operate and monitor economic activities, direct or indirect restrictions on the investment climate imposed by the occupation authorities have made investment opportunities for companies in Palestine unique and worth to be investigated regarding CG mechanisms and the extent of their impact on EM in Palestine.

Furthermore, this study will extend extant literature to an underdeveloped country with political instability and a weak role of law context by examining a new case from Palestine. Given that accounting standards and their flexibility are one of the EM faces, this study is unique since it provides evidence from a pure International Financial Reporting Standards (IFRS) environment without any previous accounting and auditing traditions. Since 1967, Palestine is under full occupation; there were no operating banks, stock market, investors in securities, or corporations except for the very few that trade in personal transactions. Although the Palestinian land is still under occupation, the Palestinian Authority (PA) has gained some autonomy in the economic, education, health, and other civil affairs since 1994. Before that, no actual reporting for businesses and corporations in Palestine since there was no demand for such services. Even the Israeli income tax collection was based entirely on judgments and refused any reports. Accordingly, accounting and auditing professions were absent. The 1990s saw many banks and other companies began to operate in Palestine. Furthermore, the PNA established the Palestine Exchange (PEX) in 1997 and the Palestine Capital Market Authority (PCMA) in 2004. These two establishments require all listed companies to use the IFRS in preparing financial statements and require auditors to use the ISA in auditing these statements without any previous accounting and auditing traditions.

Moreover, the World Bank had earlier conducted a survey in Palestine that indicated that 45% of the respondents noted that political instability was the biggest obstacle affecting the investment climate and doing business in the West Bank and Gaza

Strip. Also, they found that Palestinian companies did not adequately follow CG principles promulgated by regulatory and supervisory bodies (World Bank, 2010). Based on the facts mentioned above, Palestine is considered a unique environment for studying CG system effectiveness in such an environment and the impact of CG on the practice of EM.

In fact, since the PCCG was launched in 2009, there remains a weak level of compliance for listed companies to implement the code's rules fully, particularly for non-financial companies (Anastas, 2017). PEX (2016) reported that only the banking and financial service sector adheres to a good level of compliance of code's recommendations because of direct and continuous supervision on behalf of the Palestinian Monetary Authority (PMA) over Palestinian Banks' administrative and financial operations. Conversely, the services sector was the least compliant with the rules of CG in Palestine, as documented in Anastas (2017). Because few studies in Palestine show the extent of companies' commitment to PCCG rules, Anastas (2017) suggested that it was necessary to examine the extent of the commitment of companies listed in PEX to PCCG to activate its recommendations and conduct comprehensive reviews to make it more effective. Anastas (2017) has addressed only service sectors, so, the current study will examine the effect of CG attributes on EM in the non-financial companies, which comprises services, industries, and investments sector. Thus, this study proposes that investigating the CG separately may contribute to the improvement of CG characteristics.

Hence, this study is different from others as it will address political effects by employing it as a moderating in the association between EM and CG, and this will be a contribution to fills the gap in the literature. This focus will create a better understanding of the relationships among the variables under review. This study fills a literature gap

by focusing on CG in an emerging market with a volatile economy like Palestine that lacks this type of literature. Also, it will improve the image of the Palestinian economy as a unique case operating under political and economic unrest at the regional and international levels, which will help to achieve preferences for companies that are committed to the rules of CG.

1.4 Objectives of the Study

This study aimed to fill the gap in the existing body of knowledge concerning the mechanisms of CG and their relations with the level of practising EM. This study used individual mechanisms of CG and composite measures to gauge the effectiveness of CG. Therefore, the main objective of this research was to study the impact of CG on EM and determine whether political instability moderate relationship between CG effectiveness and EM in Palestine. The specific objectives are to:

1. Examine the impact of BOD characteristics (size, meetings, independence, board nationality diversity, the existence of remuneration and governance committee, CEO duality), on EM practices in Palestine.
2. Investigate the impact of AC characteristics (AC size, independence, and financial expertise) on EM practices in Palestine.
3. Test the impact of OS (ownership concentration, institutional ownership, foreign ownership) on EM practices in Palestine.
4. Study the impact of BOD quality on EM practice in Palestine.
5. Investigate the impact of AC quality on EM practice in Palestine.
6. Study the impact of political instability on the level of EM practice in Palestine.

7. Determine whether political instability moderates the relationship between CG effectiveness (BOD quality and AC quality) and EM practices in Palestine.

1.5 Research Questions

Considering the above objectives, the study seeks to answer the following seven questions:

1. What is the impact of BOD characteristics (BOD size, meetings, independence, nationality diversity, the existence of remuneration and governance committee, CEO duality) on EM practices in Palestine?
2. What is the impact of characteristics of AC (AC size, independence, and financial expertise) on EM practices in Palestine?
3. What is the impact of OS (ownership concentration, institutional ownership, and foreign ownership) on EM practices in Palestine?
4. What is the impact of BOD quality on EM practices in Palestine?
5. What is the impact of AC quality on EM practices in Palestine?
6. What is the impact of political instability on the level of EM practice in Palestine?
7. Does political instability moderate the relationship between CG effectiveness (BOD quality and AC quality) and EM practices in Palestine?

1.6 Operational Definitions

The key terms of this study are defined in the following table:

Table 1.1: The Operational Definitions

Term	Definition
Palestine	The area is also known as the Holy Land and is sacred among Jews, Christians, and Muslims. Palestine is in the eastern Mediterranean region occupied by Israel since 1948. The Palestinian territories are in the Gaza Strip (along the Mediterranean coast) and the West Bank (the western region of the Jordan River).
Political Instability	Is the occurrence of political unrest or violence in society, such as assassinations, demonstrations, and wars, for example, the wars between the Palestinians and Israel as the occupying power, and most notably in the last decade are the wars of 2012 and 2014. This study measures the political instability as a dummy variable denoted that this study will be assigned “1” for the years from 2011 to 2014 and “0” for the years 2015 to 2018.
Earnings Management	Many accounting rules and standards enable the management of a business to make decisions in accordance with these principles. EM takes advantage of the implementation of accounting principles and produces financial statements that inflate or deflate reported earnings, Fischer and Rosenzweig (1995) define EM as referencing to the conducts of a manager that increase (decrease) the reported earnings of the firm for which the manager is responsible without generating a corresponding increase (decrease) in the long-term corporate profitability of the firm.
Corporate Governance	It is the system of regulations, policies, and procedures by which a corporation is governed and regulated. CG basically includes balancing the needs of the many stakeholders of a business, such as shareholders, senior managers, consumers, suppliers, financiers, the government, and the society. The Cadbury Committee describes CG as a collection of rules regulating the relationships between shareholders, board of officers, directors, lenders, creditors, auditors, governments, staff, and other stakeholders. This study focuses on the characteristics of BOD, AC, and ownerships as a CG Mechanisms.

1.7 The Scope of the Study

As mentioned in the sections above, current study is limited to Palestine Exchange among selected listed companies classified under non-financial sector between the period from 2011 to 2018. Therefore, the CG variables (BOD characteristics, AC, OS)

do concern that BOD meetings, BOD remuneration committee, BOD size, BOD independence, BOD nationality, CEO duality, AC size, AC independence, AC financial experience, ownership concentration, institutional ownership, and foreign ownership. Furthermore, independent variables embrace BOD and AC quality as an aggregate index, while the moderating variable is political instability. Regarding the EM proxy, performance, this study focuses on discretionary accruals calculated by Kothari et al. (2005) Model. In this study, chapter two elaborated the overview of CG situation and EM of the neighboring countries to Palestine. these countries are, Jordan which live under weak political instability because of Syrian crisis, Lebanon suffering from Israel and instable government, and Syria suffers from Arab Spring and continuous fighting. Furthermore, many studies from Africa were utilized in developing hypothesis and results interpretations sections. In general, this research in this area has contributed to the body of CG and EM knowledge, studying EM in Palestine is a challenge due its unique political instability and vibrant economic.

1.8 The Significance and the Motivations of the Study

Several motives prompted this study to be conducted in Palestine, which has a unique political, economic, and social environment. The following were the motives for this study to be done:

First, limited studies have addressed the phenomena of CG and its impact on EM practices in Palestine. Abdelkarim and Amer (2011) have argued that no research has been conducted in Palestine that has addressed CG factors and their relationship with EM. Similarly, Abdelkarim and Zuriqi (2020) documented that there is a severe lack of literature addressing CG and EM in Palestine, and they also argued that only one study had been made in Palestine regarding the issues of CG and EM, which is the study of

Abdelkarim and Amer (2011). Hence, the current study aims to address the relationship between CG and EM by providing new empirical evidence from the Palestinian non-financial companies listed in PEX to fill the gap in this extremely important issue.

Second, the various financial, political, and economic crises, corporate failure, and bankruptcy in many developed and developing countries have led to the development of CG mechanisms. However, the Palestinian economy is distinguished by its own characteristics, as it suffers from a series of continuing political and economic crises. Indeed, the performance of the companies listed on the PEX has been negatively affected by several events that occurred in 2008, such as the global financial crisis and the devastating war on Gaza launched by the Israeli occupation in 2008 and later by Israeli military operations in 2012 and 2014 (PEX, 2018). Thus, these crises formed an incentive for the regulatory bodies to implement a series of economic legislations and reforms, to strengthen the accountability and transparency system. The PCCG was established in 2009 and contains sets of rules to enhance the role of the BOD, ACs, and OS of listed and unlisted companies in Palestine.

Moreover, studies conducted in 2016 by the Palestinian Economic Policy Research Institute (MAS, 2016) and the World Bank (2015) documented that the devastating wars launched by the Israeli occupation of the Gaza Strip in 2008, 2009, 2012, and 2014 destroyed the infrastructure and factories and reduced of the productivity of the Palestinian economy, as well as heightened the degree of political risks in the investment environment and investment decisions. Because of these crises, the effectiveness of CG in Palestine must be under scrutiny, and it is imperative to study the role of CG mechanisms and their influence in mitigating EM practices in Palestine.

Third, the main objective of this study was to examine the relationship between CG mechanisms and EM practices in the non-financial companies listed on PEX,

mainly because most prior studies that have been conducted in Palestine did not address the association between EM and CG. For example, most recent studies such as Asmar et al. (2018) have addressed the CG and disclosure quality, and other studies have addressed the issues of CG mechanisms and firm financial and market performance (e.g., Ghanem & Darweesh, 2017; Kutum, 2015; Dwaikat & Queiri 2014; Hassan et al., 2016). Thus, this study addresses the issues of CG and its relationship with EM practices to fill the literature gap in the Palestinian context.

Fourth, the listed Palestinian non-financial companies constitute about 70% of the total number of companies listed on the Palestine Exchange. Furthermore, there are five sectors listed in PEX, three of the five sectors (industries, services, investments) are investigated in this study, representing the non-financial companies listed on the PEX. The remaining two sectors, which are the banking and insurance sectors, were excluded. The other reason for choosing non-financial firms is that the codes of CG of financial companies are more sophisticated than the PCCG, and clear differences exist between the financial statements of non-financial firms and the financial firms. Finally, the models for detecting EM in non-financial firms are different from those used in financial firms.

Fifth, most previous studies that have been conducted in Palestine have addressed the CG issues by using a limited period like three to five years, for example, Ghanem and Darweesh (2017), Kutum (2015), Dwaikat Queiri (2014), and Hassan et al. (2016). Furthermore, some of these periods were before the issuance of the code in 2009, while the others were after 2009. Thus, the value of this research is by using the time series from 2011 to 2018 to cover a wide range of time as many events happened over a long period. Also, this research addresses the adequacy of CG mechanisms to strengthen the

results and could be generalizable to the other neighboring countries, which may have the same circumstances.

Finally, few studies have been investigated the unrest political situation on the relationship between the Arab Spring crisis and financial crises with EM and income smoothing. For example, these include Wang (2011), Attia et al. (2016), Hsiao et al. (2016), Obaidat (2017), Anon (2008), Filip and Raffournier (2014), and Habib et al. (2013). Palestine offers a unique case with continuous unrest in political and economic environments. Anastas (2017) documented that the investment environment in Palestine is characterized by a high degree of economic and political instability, which may lead to the weakening of regulatory bodies in controlling the private sector.

Kutum (2015) argued that the Palestinian firms listed in PEX need a higher level of regulations to strengthen the CG mechanisms. He also added that Palestine needs more a more robust capital market to enhance compliance with the corporate code by the listed firms. Thus, the potential effects of political events in influencing the CG and its relationship with EM require an exploration of whether political effects play a moderating role in the relationship between the CG mechanisms and EM practices.

1.9 Research Contributions

This thesis extends the existing literature in underdeveloped states characterized by political instability and a weak role for the Law through exploring a new case study from Palestine. Hence, this research uniquely contributes to CG and EM literature for several reasons, as follow:

First, previous studies have suggested that severe political instability adversely impacts the effectiveness of CG mechanisms and OS (Mangena et al., 2012). They also have suggested that further research should be address about the relationship between

CG mechanisms and EM under the political instability, and political theory should be used to capture the political situation effectively. Hence, this study extends the existing CG and EM literature through whether political instability moderate the relationship between the quality of BOD and AC, and EM. Besides contributing to agency theory, this study contributes to prior literature by using political theory. Moreover, the results of this study can be generalized to the other developing countries that have similar political instability with Palestine, such as the Arab Spring countries (Yemen, Syria, Iraq, Lydia, Egypt & Bahrain). The results of this study indicate that users of financial statements, stakeholders, investors, policymakers, PEX, and practitioners should consider the surrounding political environment in Palestine in assessing the extent to which companies practice EM. This will help PEX and PCMA to reform PCCG effectively to be able to constrain EM activities, as well as increasing the quality of financial reports to boost the confidence on PEX.

Second, to the best of the researcher's knowledge, the current study may be the first to study the influence of CG characteristics on EM comprehensively in Palestine. This study uses a new set of data from the environment of Palestine that reflects a different feature that will help in shedding more light on the different institutional aspects of emerging countries. Hence, this study seeks to bridge this gap by examining the impact of CG characteristics on EM. Hence, the results of this study may also be valid for companies in other emerging countries that have similar situations as the Palestinian environment.

Third, Alareeni and Aljuaidi (2014) reported that utilizing the Modified Jones Model in detecting the magnitude of the discretionary accruals (DAC) is ineffective in the Palestinian context. Accordingly, this current study used the Modified Jones Model which has been developed by Kothari et al. (2005) in computing the magnitude of DAC

as the proxy of EM. To the best knowledge of the researcher, the current research is the first attempt to employ the Kothari et al. (2005) model in detecting DAC accruals in the Palestinian non-financial companies listed on PEX.

Fourth, this study adds to the CG and EM literature by examining new variables that have not been tested in prior studies in the Palestinian context. These new variables are BOD and AC quality, BOD nationality diversity, the existence of remuneration and governance committee, foreign ownership, and institutional ownership. Indeed, previous studies have empirically linked EM with the individual characteristics of the BOD, AC and OS. The current study examines the BOD and AC characteristics as a composite measure to capture their combined effect in determining whether they are associated with EM for companies listed on the PEX.

Fifth, these results of this study are useful for regulators, policymakers, current and potential local or foreign investors, academic bodies, future researchers, and other interested parties involved in the PEX by providing them with remarkable indicators regarding the type of controlling stockholder and the CG mechanisms that will protect their interests such as the characteristics of BOD and AC. For example, this study provides outcomes that are beneficial for the regulators and policymakers in Palestine by assessing the quality of CG mechanisms in restricting EM activities and assessing the existing OS in the Palestinian companies. The outcomes of this study will motivate the policymakers and regulators to a comprehensive understanding of agency conflicts in Palestinian companies listed. Therefore, they will be able to strengthen existing regulations and policies to overcome agency conflicts, which controlling stockholders have caused and mitigating the EM activities.

Finally, this study provides valuable insights into the interactions between the BOD and AC quality and the degree of political uncertainty. The results of this current

study may help regulators and policymakers in Palestine, along with their counterparts in other countries with similar environmental features, to review and update CG codes to ensure that the best controls are achieved, thereby attracting more foreign and domestic investments.

1.10 The Outlines of the Thesis

This study consists of six chapters. Chapter one discusses the background of the study, the problem of statement and research questions, research objectives, and research significance and motivations. Chapter two provides an overview of CG and most prominent definitions and discusses the environment of CG around the world, especially in Palestine, and discusses the theories related to CG, mechanisms of CG, and EM.

Chapter three provides EM definitions, types, and models of measurements and then explains the mechanisms of CG. Furthermore, chapter four presents the study conceptual framework and the development of hypotheses, discusses research methodology, research tools, variable measurements, and data analysis techniques.

Chapter five presents the empirical study and findings. Finally, chapter six presents an overview of the study and the implications of the study and recommendations. So, this study extends the literature by presenting further evidence that CG mechanisms hold significant power in mitigating EM practices in the Palestinian context. Table 1.2 illustrated the outlines and chapters' titles of this study.

Table 1.2: The Thesis Outline

Chapter	The Chapter Title
Chapter One	Introduction
Chapter Two	An Overview of Corporate Governance
Chapter Three	Literature Review
Chapter Four	Research Hypotheses and Methodology
Chapter Five	Results and Discussions
Chapter Six	Conclusion and Recommendations

1.11 Chapter Summary

This study examines the impact of CG mechanisms on the practice of EM in non-financial companies listed on PEX. This chapter reviewed the importance of CG and its quality in reducing corporate failure and bankruptcy and the extent of their contributions to the quality of financial reports and reducing EM practices. More specifically, the main purpose of conducting this study was to examine the relationship between CG mechanisms and EM in Palestinian non-financial companies listed on PEX. Indeed, the main reason for choosing Palestine to be the subject of research was its unstable political and economic situation, which provides an appropriate climate for conducting this type of study. This chapter presented the problem statement and the research gaps that this study intends to bridge and clarifies them through the research objectives and answering its questions during the coming chapters. This research looks to achieve multiple academic, practical, theoretical, and professional contributions to enrich previous studies in this field. In the following chapter, an overview of CG in developed and developing companies will be presented. Furthermore, the situation of CG and political instability in Palestine also will be elaborated in detail.