

CHAPTER 3

LITERATURE REVIEW

3.1 Introduction

The previous two chapters have drawn the outlines of the questions of this present study, namely, an introduction to the research and an overview of CG. The questions of the current study have been identified according to the problem statement and research objectives to fill the research gaps. Hence, to develop and test the hypotheses of this study, it is necessary to discuss the most relevant underpinning theories based on the conceptual framework and review the most relevant literature. Thereby, this chapter reviews the prior literature most related to the impact of the CG mechanisms (BOD characteristics, AC characteristics, and OS) and EM practices. The chapter presents an overview of political instability to explore its influence on the relationship between CG quality and EM practices. So, the structure of this chapter is as follows.

The theoretical background of this current study is presented in Section 3.2. In Section 3.3, the literature most related to CG mechanisms and EM is discussed in detail. EM definitions, issues, and models of measurement are presented in Section 3.4. An overview of the political instability and economic situation in Palestine is illustrated in detail in Section 3.5. Section 3.6 elaborates on the benefits of the panel data approach, while Section 3.7 presents a summary of this chapter.

3.2 Theoretical Background

This section elaborates on the underpinning theories of the CG and their relationship with EM. A review of the prior literature indicates that most related prior

studies have used several theoretical frameworks to analyze the association between the characteristics of CG and the magnitude of EM. The leading theory used to explain these relationships is agency theory, which is widely used in this type of research. On the other hand, political theory will also be used in this current study. Political theory is addressed to explain the influence of the political instability on the EM practices. Moreover, the political theory is used beside the agency theory to explain the effects of political instability on the relationship between BOD and AC quality and EM practices.

3.2.1 Agency Theory

The most widely used theory on the topics of CG and EM is agency theory, and a large number of researchers in academic fields such as political science and sociology, economics, business administration, accounting, finance, and marketing have utilized it (Clarke, 2004). Well-known scholar 18th century scholar Adam Smith was the first one who shed light on the agency problems. Berle and Means (1932) elaborated upon Smith's perceptions, but Jensen and Meckling (1976) presented the first detailed articulation of the agency theory. In their work, they have defined agency as a contractual relationship between one individual or more called as the principal (owner) and another person appointed as the agent (manager). In this context, an agent is appointed to manage the day-to-day operations of a company and perform services on behalf of the interests of the principals. Hence, the agency theory explains the relationship between owners and firm management (Al-Shammari & Al-Sultan, 2009).

Regarding to the Islamic perspective of agency theory, Quran (the holy book of all Muslims in all over the world) and Sunnah of Prophet Mohammed SAW have guidelines of the relationship between people to people, Business to business, buyer to buyer, buyer to seller, seller to seller, and other parts to organize these relations to

reduce conflicts and end it. So, the perceptions of conventional and classical agency theory are in the line with the perspectives of Islamic agency theory. Hence, Wakalah is a noun derived from the word Wakalah, which has several meanings, one of which is to execute a duty on behalf of another. Wakalah is a contract in which Al-Muwakkil (principal) appoints a party to serve as his Wakil (agent) to carry out a mission on his behalf (Khalid & Sarea, 2020). Islamic agency theory urges partners to practice respect, gratitude, patience, tolerance, and belief not only in economic reward / outcome as in traditional stewardship theory but also in spiritual rewards. Lying, fraud, manipulation, and evasion, in contradiction to Islamic teachings, should be avoided and avoided as much as possible.

Islamic agency theory uses the Qur'an and hadith to define and frame the practices of economic relations in financial and non-financial institutions (Khalid & Sarea, 2020). Information inconsistency exacerbates the agency problem, as the manager cannot fully access the agent's information; Information asymmetry will not occur when the two parties are on good terms with God. The agent knows that he must provide the managers' best interest. Both parties believe that God is fully aware and that all their actions will be responsible for them in the hereafter; Therefore, both of their actions and decisions must comply with the obligations faithfully undertaken as stipulated in the agency contract (Khalid & Sarea, 2020).

The agency theory has focused on the problems that are related to stockholders and managers. One critical question raised was the conflict in the interests and benefits between stockholders and the managers (Jensen & Meckling, 1976). McGuigan et al. (2006) argued that agency problems would be clearly appear when the interest of stockholders and managers are incompatible. For example, the primary goal of stockholders is to inflate the profit to maximize their wealth. However, sometimes a

deep conflict will occur between managers and the stockholders because of this goal. This divergence between ownership and corporate management generates interest conflicts between managers and owners, which results in costs connected with resolving these conflicts (Jensen & Meckling, 1976). In other words, an agency problem appears when principals force managers to maximize the wealth of the principals instead of acting in the self-interest of managers.

Based on the agency theory, managers are usually more concerned with their self-interests rather than the interests of stockholders. For instance, managers may be motivated to buy luxurious offices and other lavish items and proper compensations, while the stockholders pay all the costs. However, owners can protect interests by creating appropriate motivations for the managers (Alghamdi, 2012). Agency theory proposed several mechanisms that ought to be employed to confirm that managers will seek to fulfil the best results that are compatible with the interests of other stakeholders (La Porta et al., 1997)

Jensen and Meckling (1976) have suggested that certain agency costs are incurred in reducing agency conflicts. They said that agency costs comprise monitoring cost, bonding cost, and residual loss. Monitoring costs are related to hiring an appropriate manager or external auditors who will control the behavior of top management. Another cost is the bonding cost related to the contracting process to guarantee that the agents make rational decisions that will support the stockholder's wealth. A third cost is a residual loss, which is the agency loss associated with the imbalance between monitoring and bonding costs.

This study focuses on the monitoring roles of BOD, AC, and OS as a mechanism that mitigates agency conflicts, which, in turn, leads to constraining the EM level. The BOD acts on behalf of the stockholders and represents their interests through overseeing

managerial functions. In this context, Zahra and Pearce (1989) have argued that agency theory is the most comprehensive theory that clarifies the duties of the BOD and highlights the importance of their controlling role. Consistent with this theory, Hung (1998) has also argued that agency theory is a convincing theory for explaining the monitoring role of the BOD.

Furthermore, prior literature is motivated by the proposition that, if the agency problems between owners and managers are correctly managed, a firm will perform better and be more efficient (Reddy, Locke, & Scrimgeour, 2010). Moreover, agency theory has posited that several mechanisms should be used to provide results that are consistent with the interests of stockholders and improve the performance of companies, which, in turn, reduces agency conflicts in the business (La Porta et al., 1997).

Typically, CG characteristics are divided into two well-known categories, which are internal and external characteristics. Internal CG characteristics contain AC, BOD, and OS, while the external mechanisms comprise external audit attributes (Reddy et al., 2010). In this regard, this study focuses on internal CG mechanisms, which are BOD characteristics, OS, and AC characteristics. Moreover, the current study will employ agency theory to explain the association between CG mechanisms and EM practices.

In the context of agency theory, stockholders can construct monitoring systems from various perspectives. Fama and Jensen (1983) have suggested that any such system should be able to separate management decisions from controlling the decision to eliminate agency costs. Core et al. (1999) proposed that weaker CG mechanisms lead to more significant agency issues. Therefore, a more robust CG system can limit the privileges of the top management, which ignores the best interests of stockholders, thereby decreasing the agency costs. Similarly, a large number of previous studies such

as Williamson (1988), Fama and Jensen (1983), and Fama (1980) have argued that effective CG mechanisms might mitigate opportunistic managerial behavior.

Furthermore, agency theory has suggested that CG mechanisms such as BOD characteristics, AC characteristics, and OS play a vital role in enhancing financial reporting quality and firm performance (Alghamdi, 2012). Consequently, agency theory has expected that the BOD might improve the integrity of financial reporting by monitoring top management (Peasnell et al., 2005). In terms of AC, the agency theory perspective proposes that the critical roles of AC are to monitor the quality of financial reports and prevent fraudulent actions of accounting statements (Klein, 2002). Additionally, based on the theory, greater ownership can assist BOD in enhancing its mentoring function (Yen et al., 2007).

The BOD quality is considered as an essential mechanism that may reduce agency problems. Agency theory has focused on the several characteristics of the BOD (size, meetings, independence, CEO-duality, BOD diversity, and the BOD committees). Moreover, this theory also asserts the importance of electing independent directors to the BOD (Makhlouf et al., 2017). According to the tenets of agency theory, independent directors are more credible than non-independent ones when it comes to monitoring companies (Fama & Jensen, 1983b). Furthermore, independent directors are motivated to make credible, objective, and unbiased judgments on a firm's financial decisions, which, in turn, increases the quality and faithfulness of financial reports. The agency theory perspective has suggested that BOD independence will increase by the existence of a higher proportion of outside members on the BOD (Abed et al., 2012).

Similarly, Uwuigbe et al. (2014) and Waweru and Prot (2018) found an inverse association between BOD non-executive directors and EM practices. That means the more independent directors lead to a lower level of EM. This finding was consistent

with the results in previous studies (e.g., Fama, 1983; Fama & Jensen, 1983; Johnson, Daily, & Ellstrand, 1996; Peasnell et al., 2005; Shah, Butt, & Hasan, 2009). These studies have found that the more independent directors on the BOD lead to the more effective monitoring of management actions and behaviors. Hence, the presence of independent directors can increase the transparency of financial reporting, boost disclosure practices, and lead to a more effective BOD (Armstrong et al., 2014 & Saona, Muro, & Alvarado, 2019). Several studies have found that companies whose BODs were managed by outsiders are more likely to be in a better position to monitor the financial transactions of firms and mitigate managerial discretion than firms that are not managed by outsiders (Cornett et al., 2008; Jaggi & Tsui, 2007; Crutchley et al., 2007; Türegün, 2018). Consistent with the perspective of agency theory, Saona et al. (2019) observed that the higher participation of outside directors, the lower the level of EM. They demonstrated that the independent directors are less biased in their opinions than internal directors because of the lack of personal interest in the company. As a result, uninterested outside directors are more likely to stifle managerial opportunism and EM.

Moreover, from the agency theory perspective, a larger BOD size leads to reducing agency problems (Ghosh et al., 2010; Alves, 2011; Alareeni, 2018), and BOD members should have sufficient education and experience to strengthen the monitoring function and accurately assess management actions. Based on the agency theory perspective, Rahman and Mohamed Ali (2006) assumed to create an effective CG, the positions of chairperson and CEO position have to be separated. They also stated that a CEO with dual or more powers could easily engage in EM to accomplish personal incentives.

Agency theory forecasts that lower levels of insider ownership imply a poor alignment of interests between management and stockholders (Jensen & Meckling,

1976). That is, managers with little ownership may have more motivation to manage accounting items for the sake of increasing earnings-based compensation, comfortable contractual constraints, or avoid debt covenants (Healy, 1985). Insider ownership is a way to restrict the opportunistic behavior of managers, and thereby, the relationship between insider ownership and the level of DAC is predicted to be associated negatively (Warfield et al., 1995). On the other hand, Cornett et al. (2008) said that high levels of insider ownership might motivate insiders to make value-maximizing decisions, leading to an increase in EM. In fact, Jensen and Meckling (1976) argued that a higher level of ownership concentration could minimize agency problems by reducing agency costs and mitigating the imbalance between the interests of stockholders and managers.

Indeed, the internal mechanisms of CG (e.g., BOD, AC, and OS) and the external mechanism of CG (e.g., external audit quality) do not work independently. However, they interact with each other to influence the quality of financial reporting results (Sharma et al., 2011). Additionally, the agency theory argued that a high level of insider ownership leads to a better CG system, which also drives a high financial reporting quality (Ballesta & Garcí'a-Meca, 2005). Consistent with the agency perspective, Warfield et al. (1995) have presented evidence that managerial ownership has an adverse association with EM practices.

In conclusion, agency theory is the most common theory used by CG and EM in literature. The agency theory supposed conflict of interest conflict between owners and managers of the firm, and also suggested a clash between minority shareholders and majority shareholders (Ball, 2013; Bao & Lewellyn, 2017). Agency theory offered many solutions to mitigate the clashes between principals and agents and between shareholders themselves. CG mechanisms are the main instruments of agency theory in mitigating the conflicts mentioned above. Relatedly, shareholders usually tend to

appoint a strong and effective BOD to run the business and control the management to meet their expectations, such as maximizing profit and restrict the opportunistic behavior of the managers, which leads to manipulating actions to decrease EM levels. Consequently, a BOD is required to form committees to assist it in monitoring the management such as AC, the remunerations committee, and the governance committee. So, agency theory is the most used theory relevant to this study as it explains the opportunistic behavior of management, which is very important for interpreting the incentives of EM practices. Besides this, agency theory also realized the importance of the role of the BOD, the ACs, and the OS to mitigate agency costs and EM practices and boost the quality of financial reporting.

3.2.2 Political Theory

Agency theory is considered the most common theory used by the majority of prior CG literature to EM and firm performance in both developed and developing countries. Fama and Jensen (1983) and Jensen and Meckling (1976) posit that managerial agency costs are the product of the separation between ownership and control of a business. So, to reduce agency costs to improve performance and financial reporting, stockholders can deploy a set of CG mechanisms, including, for instance, BOD structures and OS (Filatotchev & Nakajima, 2010). Aligned with most previous studies related to CG and EM, this study has drawn upon agency theory to capture the relationship between CG mechanisms and EM practices in Palestine effectively.

On the other hand, only employing the agency theory perspective in this study might not be informative because it cannot adequately capture the political context in which the study is conducted. Hence, in developing the hypothesis, this study integrated

the perspectives of the agency theory with the views of the political theory of CG (Gourevitch, 2003; Roe, 2003).

According to the political theory views, Roe (2003), Gourevitch (2003), and Pagano and Volpin (2005) have proposed that the social and political circumstances in any country affect a company in several fundamental ways. They have elaborated that the extent to which the government influences the companies and how they react with the political and social environment to protect current and prospective investors is essential. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) have argued that agency problems may be minimal due to a robust legal system, which, in turn, protects investors' rights because active and well-functioning courts can step in and rescue investors from management abuse.

Accordingly, Berglöf and Claessens (2006) and La-Porta et al. (1998) have argued that, when legal systems do not operate effectively and strictly, CG systems might replace weak legal systems restricting the ability of managers to either misuse or confiscate stockholders' wealth. Furthermore, Berglöf and Claessens (2006) argued that the absence of an effective legal system due to political instability might lead to impairing the quality of CG. An effective CG will constrain the ability of managers to abuse the wealth of stockholders. In other words, agency costs depend on the political and social pressures in any country (Mangena et al., 2012).

In this context, political and social pressures affect the nature of agency costs in any country. Companies will react defensively to political and social pressures by reshaping OS, which, in turn, will reconfigure CG structures and BODs in ways that are appropriate to fend off political and social threats, improve oversight on management as well as improve corporate performance (Mangena et al., 2012).

According to the advocates of political theory as mentioned above, the efficiency of the governance structure is not only limited to internal factors, but also on its relevance to social stability. Social unrest - riots, strikes, wars, the promise of political stability, unrest, political chaos, unstable government, weak laws, and regulations. This would increase agency costs and conflicts between the parties involved. According to a review of previous studies, increasing agency costs lead to increased earnings manipulation due to the reflection of political instability on firm financial performance, which could be an incentive for managers to manipulate the reported income.

Based on the arguments, Palestine suffering from many political instabilities such as, the Israeli occupation procedures, the political and geographical division between Gaza strip and west bank, weak governments in Gaza and west bank, the absence of Palestinian legislative council which in turn leads to weaken the public monitoring and low quality of laws and regulations, and finally the blockade imposed on Gaza Strip since 2006. So, political theory utilized in this current research to support the perspective of agency theory in interpreting the results of empirical resulted emerged from this study.

So, in this current study, two empirical models have been developed to investigate the relationship of CG towards EM in Palestine. The first model is the main one, which examines the relationship of CG characteristics individually with EM. In this model, agency theory is used to develop the hypothesis and explain the results. In the second model, which is the moderating one, the political theory is used to develop the hypothesis of this model besides the agency theory.

3.3 Corporate Governance Mechanisms

The concept of CG provides mechanisms used to reduce agency costs, which can increase based on a conflict of interests between the stockholders and managers (Uwuigbe et al., 2014). Hence, CG mechanisms became one of the most effective devices in terms of the business agenda. Conflicts of interest have been among the most significant issues regarding the agenda of business for more than thirty years internationally, as numerous corporate failures have occurred in several firms around the globe (Kasim, Hashim, & Salman, 2016; Okpala, 2012). Global financial crises that occurred over the last several decades, including Enron, WorldCom, Lehman Brothers, Arthur Anderson, and others, have negatively affected the reputation of accounting as well as the financial reporting and auditing profession (Alareeni, 2018; Griffin, Lont, & Sun, 2009). In their wake, financial scandals reduce the confidence of stakeholders in the quality of financial reporting systems. Consequently, many CG codes have been proposed to rebuild investor confidence after a series of global financial crises (Wan, Wasiuzzaman, & Salleh, 2016).

CG rules have recently become one of the most significant issues discussed in world economies. Applying these rules has become a vital matter for both public and private firms in making new rules for CG like enriching assurance and raising transparency to protect investors, bankers, and creditors to reducing corruption and motivate foreign investment (Haddad, Jamil, & Sufy, 2011). This chapter's main objective is to provide a comprehensive review of the most pertinent prior literature of CG mechanisms, especially that related to BOD and AC characteristics and OS. An overview of EM concepts and motivations is presented, and the most common models of EM will be provided. Furthermore, this chapter discusses the association between political instability effects, BOD effectiveness, and AC quality and EM practices.

3.3.1 BOD Characteristics

The theory of agency posits that, in the separation of a company's stockholders and management, the management is an agent for the interests of stockholders (Jensen & Meckling, 1976). The BOD is the top level of the pyramidal management and several responsibilities that include overseeing senior management that approves financial reports and constraining the manipulation of accounting information manipulation (Almasarwah, 2015). It is widely accepted that BOD is the most effective actor in the mechanisms of CG (Koufopoulos, 2018). The BODs' primary responsibility is the oversight of executive management and fulfilling the expectations of stockholders and stakeholders (Hillman & Dalziel, 2003; Daily et al., 2003; Brandes et al., 2016; Boivie et al., 2016). The BOD fundamentally exists for monitoring, hiring, and firing, compensating management, and voting on strategic decisions to increase the wealth of stockholders (Baldeus et al., 2014). Bhojraj and Sengupta (2003) indicated that the duties of the BOD include measuring and monitoring management performance and protecting the interests of stockholders. Good CG undoubtedly provides the BOD with reasonable incentives to achieve its purposes and achieve excellent performance in oversight, restraining distortion, and manipulation, reducing information asymmetry (Sánchez-Ballesta & García-Meca, 2007).

Often differences exist in the role of BOD in a family business, large business, and small business. For example, Schulze, Lubatkin, and Dino (2003) studied 883 family firms in the United States. They reported that a BOD was generally passive in family firms and did not the proficiency of managers efficiently. However, Fama and Jensen (1983) concluded that in a large company, the BOD was providing a system for decision making and, as such, the board was responsible for mentoring and enriching the performance of the management. Prior studies have found that numerous

characteristics like CEO-Duality, BOD size, BOD independence, BOD capital, and directors compensations can impact the successful performance of the BOD in its duties (Gkliatis, 2014). Additionally, the BODs play an essential role in CG systems in Palestine under the influence of the unstable political situation.

The following sections discuss several main factors impacting the performance of the BOD in Palestine. These include the size of BOD, the number of meetings, independence, diversity of nationalities, CEO-duality, and BOD governance committee. As in other contexts, these are essential and applicable elements in the Palestinian institutional environment.

3.3.1.1 BOD Size

The size of the BOD is a vital factor in the structure of a BOD (Chaganti, Mahajan, & Sharma, 1985). Chaganti et al. (1985) pointed out that the size of the BOD can range from small (5 to 6 members) to exceedingly large (30 plus members). However, determining the appropriate number of BOD members has been widely debated in previous studies (e.g., Lipton and Lorsch, 1992; Jensen, 1993; Yermack, 1996; Dalton et al., 1999). Lipton and Lorsch (1992) and Jensen (1993) have argued that a small BOD can exercise and adopt a controlling role effectively. Moreover, Jensen (1993) suggested that the BODs should be small in size to be more effective in improving a firm's performance. He also argued that BODs that exceeded (7 or 8) members were less efficient because of high levels of internal struggle and would give a CEO more control.

Others have examined this issue as well. For example, Lipton and Lorsch (1992) thought the BOD size should not be more than ten members and suggested that the optimal size should range from 8 to 9 members. When a board exceeded ten members,

it became more difficult for them to voice their opinions and ideas in the available limited time. On the other hand, many previous studies have argued that a larger BOD would provide better monitoring ability and more effective decision making (Almasarwah, 2015; Coles et al., 2008; Koufopoulos & Gkliatis, 2018; Pfeffer, 1973; Anderson et al., 2004). Pfeffer (1973) argued that larger BOD would provide a company with better resources and more expertise. Also, larger BODs prevent a CEO from engaging in opportunistic activities against the interests of stockholders (Koufopoulos, 2018). Nevertheless, some argue that a small board is more efficient and can control this behavior (Chaganti et al., 1985).

Consequently, size is considered an essential attribute related to the effectiveness of a BOD. Some argue that a larger board has more resources than a small one to oversee financial and managerial performance. Additionally, monitoring within this context means that a large BOD has more extensive expertise and experience that can lead to the increased disclosure of vital matters to stakeholders (Upadhyay & Sriram, 2011). In contrast, some believe that a smaller board increases social cohesion and participation, and because of this, the performance of such boards is boosted (Koufopoulos et al., 2018).

Previous studies that have examined the size of the BOD have produced mixed results. Some previous studies have said that larger BOD size is associated with a lower level of EM practices (e.g., Habbash, 2011; Klein, 2002; Xie et al., 2003; Uwuigbe et al., 2014; Khalil & Ozkan, 2016). Uwuigbe et al. (2014) pointed out that companies with large boards are more likely to be effective in mitigating the practices of management earnings than small boards as larger boards might have more independent directors and more financial experience. In a study of Egyptian companies, Khalil and Ozkan (2016) argued that the size of BOD was negatively associated with EM practices

in the Egyptian non-financial listed companies. This result showed that a large board was more effective in reducing EM practices. The reasons given for this relationship were that larger BODs benefit from more outsiders serving on the BODs as well as increasing the diversity of experience (Klein, 2002; Xie et al., 2003).

Al-Othman and Al-Zoubi (2019) conducted a study in Jordan by using 33 industrial listed companies on ASE from 2011 to 2017. They have found a positive association between the BOD size and earnings quality measured by Richardson et al. (2001) model, which was used to detect EM practices. They found that a high level of EM meant low earnings quality. They suggested that future research should utilize another model to measure earnings quality and other BOD characteristics, such as the number of BOD meetings, to enrich the understanding of the topic.

Abdelkarim and Zuriqi (2020) investigated the relationship between several CG characteristics and EM practice in Palestine measured by the Modified Jones Model (1995). They used data from 33 non-financial companies listed on the PEX from 2015 to 2016; they have found an insignificant association between BOD size and EM practices. They proposed that future studies that should be done on CG and the EM that consider more than two years of historical data in Palestine. They affirmed that all companies listed on the Palestine Stock Exchange should adhere to PCCG (2009) to enhance trustworthiness, transparency and disclosure of actual financial performance to improve the performance of the stock exchange.

In summary, the literature mentioned above that examined some characteristics of the BOD and their relationship to EM has considered the size of the BOD a decisive factor that may affect the practice of EM. This research has had mixed results. Accordingly, some believe that with the increase in the size of the BOD will increase board effectiveness, based on the argument that a larger BOD will increase expertise,

gender and nationality diversity, and the number of independent directors. On the other hand, others believe that a small BOD can enhance the effectiveness of the BOD, as it can more efficiently and provide better communication among members.

3.3.1.2 BOD Frequency of Meetings

The frequency of BOD meetings is another characteristic associated with the effectiveness of BOD, which is measured by the number of BOD meetings held annually (Vafeas, 1999). Overall, a higher frequency of BOD meetings is seen as contributing to the effectiveness of the BOD and its monitoring function, particularly related to the issues concerning the financial reporting process, resulting in improved transparency and the quality of the annual financial reports. From the perspective of agency theory, a board that exhibits better diligence in discharging its charges will promote a better level of stewardship by the BOD. Thereby, directors who meet less frequently are less likely to perform their supervision functions effectively (Lipton & Lorsch, 1992).

Some prior studies have found a negative association between the frequency of BOD meetings and EM practices (e.g., Ebrahim, 2007; Gulzar & Zongjun, 2011; Vafeas, 1999; Xie et al., 2003; Chen et al., 2006). Xie et al. (2003) argued that, when a BOD conducts irregular meetings, this might motivate management to engage in EM practices. When BOD meetings are infrequent, the BOD cannot carry out its duties effectively related to EM practices. So, Xie et al. (2003) found a negative association between the number of meetings held annually and the level of EM. Furthermore, Chen et al. (2006) revealed that a higher number of BOD meetings lead to fewer fraudulent acts, which was regular meetings would provide an appropriate amount of time to the directors to identify and resolve potential problems. Gonzalez and Garcia-Meca (2014)

conducted a study conducted in Latin American firms based on a sample of non-financial firms listed from 2006–2009. The results showed that more regular meetings result in a more active board in monitoring the management, resulting in fewer manipulative actions.

On the other hand, several researchers have found no relationship. For example, Bajra and Cadez (2017) studied the relationship between the quality of BOD and internal audit function and EM practices in the EU companies cross-listed in the United States' stock markets from 2000 to 2013. They found that regular meetings were not related to EM practices at statistically significant levels. So, BOD meetings did not serve as a deterrent to EM practices in these companies. Additionally, Ahmed (2013) examined BOD characteristics, and EM measured using the Modified Jones Model using data from seventy-first firms listed in Bursa Malaysia from 2001 to 2005. He has found no relationship between the number of BOD meeting and the EM level. He explained this by arguing that the BOD members in Malaysia might not prefer to attend extra meetings, influencing their effectiveness.

Concerning South-Eastern Asian countries, Ngamchom, (2015) investigated the influence of BOD effectiveness on EM practices in Thailand by using panel data of listed firms in the Thai stock exchange from 2009-2013. He found that the more frequent BOD meetings were positively related to EM practices, which meant that more BOD meetings failed to reduce EM practices in Thai listed companies. He argued that when a BOD meets too many times annually, this would lead to spending too much time spent on unrelated activities rather than in monitoring and observing the performance of the management. Similarly, Abusiam (2015) examined the impact of BOD characteristics on EM practices using the Kothari et al. (2005) model. He used the panel data of all industrial companies listed on ASE from 2009 to 2013. He found a

positive association between the number of BOD meetings and EM practices in Jordanian industrial listed firms.

In summary, studies that have examined the impact of the number of BOD meetings on EM have produced mixed results. Some argued that BOD meetings had a positive role in providing more time for BOD members to discuss a company's conditions and monitor the actions and behaviors of management. Others have found that frequency either had no effect or was associated with EM.

According to PCCG (2009), a BOD should meet regularly at least six times annually to carry out its duties and monitoring functions effectively. A review of the previous studies that examined the impact of the number of BOD meetings on EM was limited in the MENA and Palestinian context. Therefore, this issue impeded generalizing the results of these studies. Therefore, further examination is needed to determine whether the number of BOD meeting has been effective in reducing EM, especially in Palestine (Abdelkarim & Zuriqi, 2020). Therefore, this study examines the effect of the number of BOD meetings on EM practices in Palestine. Accordingly, this study predicts that as the number of meetings increases, the effectiveness of the board of directors will increase, and fewer meetings will help executives seize the opportunity to exercise an opportunistic role to serve their self-interest and thus increase EM activities.

3.3.1.3 BOD Independence

The independence of the BOD in this study refers to the proportion of the non-executive directors in the BOD. Independent members in the BOD often can make independent judgments in areas in which a potential conflict of interest might exist (Abdelkarim & Zuriqi, 2020). A large percentage of previous studies that have

examined the relationship between CG and EM have concluded that a negative relationship was present between the proportion of independent directors in the BOD and DAC (Abdelkarim & Zuriqi, 2020; Dimitropoulos & Asteriou, 2010; Habbash, 2011; Idris et al., 2018; Klein, 2002; Peasnell et al., 2005; Xie et al., 2003; Niu, 2006).

For example, Xie et al. (2003) conducted their study in the United States, have found that the firms that have BOD with a larger proportion of independent directors was more effective in constraining managers from engaging in EM practice. Furthermore, Klein (2002) found a negative association between the proportion of non-executive directors in the BOD.

Agency theory has posited that the inclusion of outsiders on the BOD would allow the BOD to be more effective in overseeing managers, and, therefore, would affect firm performance positively (Jermias & Gani, 2014). In the same context, an independent chairperson incentivizes BOD members to monitor the management of a firm effectively.

CG prior literature has addressed the issue of BOD independence (Armstrong et al., 2014; Al-Rassas & Kamardin, 2015; Chi, Hung, Cheng, & Tien Lieu, 2015; Idris et al., 2018; Iraya, Mwangi, & Muchoki, 2015; Khalil & Ozkan, 2016; Uwuigbe et al., 2014; Abata & Migiro, 2016). Liu et al. (2015) investigated the relationship of BOD independence and financial performance of Chinese listed companies. They found that BOD independence was positively associated with a company's performance at a significant level. Armstrong et al. (2014) documented that BOD non-executive members affected the level of transparency. This finding meant that more BOD independence led to a higher level of transparency in a company.

Concerning Jordan, Idris et al. (2018) examined the moderating impacts of family ownership on the relationship between BOD independence and EM. Using industrial

companies listed on the Amman Stock Market (ASE) from 2009 to 2014, this study found a negative association between board independence and EM, suggesting that the higher percentage of board independence was related to more effective monitoring to mitigate EM practices. In contrast, Khalil and Ozkan (2016) using panel data of 125 non-financial listed in Egyptian from 2005 to 2012. They found that non-executive directors were not sufficient to constrain opportunistic EM in the Egyptian context. In Latin America, Gonzalez and Garcia-Meca (2014) shown a weak negative association between BOD independence and EM practices. They suggested a possible explanation for this result was that the BODs in these countries are mainly formed of major stockholders as well as company executive management members, which might facilitate the EM process.

Chi et al. (2015) examined the association between BOD independence and EM practices based on a sample of 379 listed high-technology companies over seven years in Taiwan. They found that the proportion of independent members on the board was a leading factor in reducing EM practices in Taiwan family firms. Relatedly, the results suggested that BOD independence was vital for an emerging market to minimize activities of EM as an opportunistic behavior. Iraya et al. (2015) investigated the association of CG with EM practices of firms listed on the Nairobi Security Exchange. By using a sample of the 49 listed firms from 2010 to 2012, they found that EM practices were negatively associated with BOD independence, the concentration of ownership, and the size of the BOD. In Palestine, Abdelkarim and Zuriqi (2020) documented no statistical relationship between non-executive directors and EM in the non-financial listed companies in the PEX. They added that this result might be because it was doubtful that the non-executive directors were genuinely independent.

In summary, the independence of the BOD is among the most essential characteristics of the board, as it was addressed in most previous studies. The argument is that independent members effectively contribute to the representation of stakeholders on the BOD and enhance CG concepts and mechanisms. They are also more able to monitor executive managers to reduce the practice of EM.

In Palestine, PCCG (2009) stated that all members of BOD should have no executive burdens in the company. Based on the scarcity of studies that have examined the independence of the BOD and its relationship to EM in Palestine, this factor should be studied in the context of Palestine. Accordingly, this study anticipates that the more non-executive members in the BOD are more likely to constrain EM in Palestine.

3.3.1.4 BOD Nationality Diversity

Although a relatively large number of foreign members serve on the BODs in emerging markets, few studies have addressed the impact of diversity of nationality (the presence of foreign members) on the effectiveness of the BODs and the performance of companies (Darmadi, 2011). Previous studies have shown that BOD members with high human and social capital effectively carry out different duties and responsibilities (Jermias & Gani, 2014). Gkiliatis (2014) has stated that the BOD capital is often classified into two categories, which are social and human capital. They determined that the resources that individual directors bring to BOD are primarily a function of their human and social capital. Hillman and Dalziel (2003) defined the term human capital as the knowledge, experience, reputation, and skills that the directors of the board possess.

The nationality of BOD members is considered BOD human capital and also an important factor in dealing with the stakeholders and protecting their interests.

Furthermore, foreign members may also affect the quality of BOD decisions, as they often possess a high level of personal competence and knowledge (Estelyiova & Nisar, 2012). Moreover, Oxelheim, and Randøy (2003) have argued that having foreign members on the BOD can provide a competitive advantage for a company by accessing international networks. Other than that, the BOD foreign members provide a greater diversity of knowledge and experience (Makhlouf et al., 2017). In the developing markets, where corporate capital flows often come from foreign sources, the nationality of their BOD members or management team members may be diversified. However, scholars rarely research the relationship between the diversity of nationality and firm performance (Makhlouf et al., 2017). Similarly, very few studies have addressed nationality diversity and its impact on EM.

From the agency theory perspective, more diversification of BOD leads to a more considerable improvement in management monitoring functions because BOD diversification leads to a more BOD independence, which would reduce agency costs (Carter, Souza, Simkins, & Simpson, 2007). The resource dependency theory suggests that BOD diversity will provide the BOD with the necessary skills, information, legitimacy, and access to key components (Makhlouf et al., 2017). Therefore, various directors will provide unique information to management and improve their decision making (Ibrahim & Hanefah, 2016).

Some studies have addressed the nationality diversity of BOD, such as Du, Jian, & Lai (2017), Ibrahim and Hanefah (2016), and Makhlouf et al. (2017), Hooghiemstra et al., 2015). Du et al. (2017) used a sample of Chinese listed firms to explore the role of foreign members in the BOD in constraining managers in practising EM. They have found that foreign directors are associated negatively with EM practices at a significant level. Ibrahim and Hanefah (2016) used panel data to examine the influence of BOD

diversification characteristics on CSR disclosures in Jordanian companies listed in ASE. They found a positive relationship between foreign directors in the BOD and the level of CSR disclosure.

Similarly, Enofe, Iyafekhe, and Eniola (2017) targeted to investigate foreign directorship in relation to EM in non-financial firms quoted in the Nigeria Stock Exchange as at 2014. The study found that while foreign board members are not statistically relevant, they are negatively linked to EM activities in Nigerian firms. This implies that certain proportion of foreign members setting in the board will provide cross ideology that can encourage or discourage EM practices. In effect, the board should be made up of people of various ethnicities, tribes, and races, making it impossible to agree on EM practices.

On the other hand, Hooghiemstra et al. (2019) examined the impact of the presence of a foreign BOD member on EM by using a sample of 3,249 firm-year observations representing 586 non-financial listed Nordic companies headquartered in Denmark, Finland, Norway, and Sweden, from 2001 to 2008. They found that the increasing numbers of foreign directors on the BOD will lead to an extremely higher level of EM practices. They claim that foreign BOD members are more likely to be unfamiliar with local rules and/or that their participation renders the board vulnerable to language problems, reducing board effectiveness. They recommended that it might not be essential to appoint a foreign director to the BOD.

A review of the previous literature found a dearth in studies that have examined the nationality of board members in developing countries, especially Palestine. Additionally, previous studies have produced mixed results concerning the relationship between BOD nationality diversity and EM. This study addresses the role of the non-Palestinian members in the BOD to extend the previous literature by offering unique

evidence from Palestine as a developing country under political instability, which is an unpreferable climate for foreigners.

Indeed, the PCCG (2009) encourages shareholding companies listed on PEX to diversify the BOD and include members of varying backgrounds to make the BODs more effective in carrying out their duties. A review of the prior literature of CG in Palestine shows that the current study is the first to explore the relationship between the proportion of nationality diversity members in the BOD and EM practices in Palestine. Accordingly, this study anticipates that the more non-Palestinian members in the BOD would be more likely to constrain EM in Palestine. As for the diversity in the nationality of the members of the BOD, Palestinian companies are required to disclose the nationality of the members of the BOD, and this feature has been addressed because of its importance, as the PEX seeks to attract foreign investors, which enhances the confidence of investors, whether foreign or local, in investing in companies listed on the PEX. It increases the efficiency of the stock market and the level of competition, as this market operates under an exceptional circumstance, which is political instability.

3.3.1.5 Existence of Remuneration and Governance Committee

The existence of a remuneration and governance committee is considered as a mechanism of the BOD to encourage the management to run a company in the interests of stockholders. Besides, this committee plays a vital role in monitoring the work of the executive and non-executive directors and ensuring that managers pursue the stockholder's best interests (Saravanan, 2012). Previous studies that have addressed the effectiveness of remuneration committees are rare because most prior studies think that this committee possesses no direct influence on a company's performance or the quality of financial reporting (AbuSiam et al., 2014b).

Some prior studies have addressed the topic of the remuneration committee and its role in the firm. Laux and Laux (2009) found an association between the committees established by BOD and EM practices. Sun et al. (2009) indicated that a compensation committee would enable active monitoring, which, in turn, leads to constraining management from controlling and practising EM.

Several studies have been conducted in the Kingdom of Saudi Arabia (KSA). For example, Habbash (2011) reported an insignificant association between remuneration committees and the DAC level. In the same KSA context, Alghamdi (2012) found no relationship between remuneration committees and EM practices.

AbuSiam (2015) conducted a study in Jordan by using the panel data of 64 Jordanian industrial listed companies on the ASE from 2009 to 2013. He claimed that his study was the first work in the Jordanian context that had examined the relationship between the presence of a remunerations and nominations committee and EM practices. Using the Kothari et al. (2005) model in detecting the magnitude of DAC, he found a negative relationship between the remunerations committee and EM, but not at a significance level as he expected. He said that one possible explanation was that the remuneration committee was still new in the CG system in Jordan and needed time to mature.

In Palestine, remuneration and governance committees should be formed to monitor the implementation of CG rules. Based on prior studies conducted in Palestine, the current study is the first work in Palestine investigating the influence of a remuneration and governance committee on EM. According to the PCCG (2009), BOD committees can conduct meetings with members of executive management or block holders to consult about the topics that need to be discussed to assist the BOD in performing their duties effectively, which, in turn, will help in reducing agency costs

and conflicts. Hence, the current study addressed the remuneration of a factor of BOD characteristics for the sake of examining its impact on EM in Palestine.

3.3.1.6 CEO-Duality

CEO duality is a situation in which one person handles the role of CEO and chairman handled. The separation of the role of chairman and CEO is crucial, according to the agency perspective (Balagobei & Udayakumara, 2017). A duality situation grants a CEO a golden opportunity to dominant or influence BOD decisions and, therefore, weaken the independence of the BOD and their ability to monitor the executive. The separation of the position of CEO and the chairman gives one director the authority to run board meetings and speak on behalf of the BOD. This separation also allows a CEO to focus on issues such as operations, strategy, and organizational questions, while the chairperson concentrates on supervising management and CG issues. (Larker & Tayan, 2016). In the United States and the United Kingdom, the separation of the position of Chairman and CEO has become compulsory (AbuSiam, 2015).

A person working as chairperson and CEO has a significant influence upon and stature among the board members and can restrict the functions and monitoring function of the board (Harrison, Torres, & Kukalis, 1988). Moreover, Beatty and Zajac (1994) argued that agency theorists support the separation of the position of chairman with that of CEO. They also suggested that if a company includes combines these roles that the decisions and choices they make will not maximize the wealth of stockholders as they expected (Higgs, 2003). The separation of the roles of CEO separation and the chairperson is regarded as a condition to avoid conflicts of interests between constituencies corporate and management because it improves the ability of BODs to control (OECD, 2004). The combination of both jobs can adversely influence the BOD

and result in poor effectiveness (Daily & Dalton, 1993). CG systems typically recommend separating the position of CEO from that of chairman.

AbuSiam et al. (2014b) assumed a potential relationship between CEO duality and EM practices, saying that such a relationship might be positive. But, AbuSiam (2015) found that the separation between CEO and chairman seat was positively associated with EM practices in the Jordanian industrial companies listed on the ASE. He claimed that some of chairpersons in Jordan might be lack independence and have a low level of knowledge of company operations. In contrast, Uwuigbe et al. (2014) found that CEO-duality had a significant and positive effect upon EM practices for Nigerian firms listed. Iraya, Mwangi, and Muchoki (2015) subsequently found that CEO duality can lead to raising EM.

Indeed, several studies have documented that CEO-duality is one of the most common BOD characteristics examined for its impact on EM practices. As the separation between the position of Chairman and CEO in the United States and the United Kingdom has become compulsory, the investigation of the effect of CEO-duality on EM may be limited, making studies pay less attention to this than other characteristics in those countries (AbuSiam, 2015). In Palestine, the separation of the two positions remains optional. However, the PCCG (2009) recommended that separating these roles is to ensure that a CEO has no significant authority that could lead to his behaviour being opportunistic. In line with the agency theory perspective, this current study anticipates that the separation between the positions of Chairman and CEO will have a positive role in restricting EM in Palestinian companies listed on PEX.

3.3.2 Audit Committee Characteristics

An AC plays an essential role in assisting the BOD in carrying out its duties and responsibilities. Khlif and Samaha (2014) and Samaha and Abdallah (2012) have suggested that the presence of AC in the company is essential to meet the needs of investors for complete and relevant information. Indeed, ACs provide several benefits for companies, such as strengthening the monitoring effectiveness on top management, increasing voluntary disclosure, and making a fair assessment of top management decisions and behaviors (Allegrini & Greco, 2013). Furthermore, an AC aids BOD in effectively monitoring the procedures reporting to alleviate EM. An effective AC ought to be able to curb EM engagements (Alia et al. 2020 & Sharma & Kuang 2014).

The primary function of AC is to monitor the processes of preparing financial reports, which, in turn, might mitigate agency problems between the management and stockholders. Another primary function of the AC is to stop the issuance of fraudulent accounting statements (Klein, 2002); and promote communication between the external auditors and top management (Alghamdi, 2012). AC cooperates with the external auditors for the sake of reducing the potential manipulation that management might do. Hence an external auditor will be provided with the necessary, reliable, and credible information (Alia et al., 2020).

The prior studies that have addressed AC effectiveness have been addressed some of the main characteristics for measuring the effectiveness of AC such as AC size, independence, and accounting and financial expertise (Almasarwah, 2015; Bronson et al., 2009; Salloum et al., 2014; AbuSiam et al., 2014a).

Thus, this study addresses three main characteristics of AC that are elaborated in the following sub-section.

3.3.2.1 Audit Committee Size

The size of an AC is an essential characteristic, and is viewed as important in the composition of an effective AC. Several CG codes and prior studies have suggested the number of AC members required to run the committee effectively. For example, the CG Code of the United Kingdom (2010) says that the BOD should establish an AC of at least three independent non-executive directors. This rule is consistent with the rules of the code of corporate governance in Palestine, which indicated that the members of AC should be all non-executive members, and the size ought to be at least three members (PCCG, 2009).

Prior studies have aimed to investigate the relationship between AC characteristics and firms' financial performance, which have produced varying results related to the size of the AC. Some studies found that a large-sized AC loses focus and becomes less participative than a smaller-sized committee (Salloum et al., 2014). Xie et al. (2003) have found that a smaller-sized AC tends to be more efficient than a larger-sized committee. Still others have found that a larger-sized AC is more effective and efficient in monitoring the process of financial reporting (Ghosh et al., 2010). On the other hand, Al-Najjar (2011) reported that a larger ACs might offer more strong monitoring resources on the top management and increase the quality of the financial reports and faithfulness of the reporting.

Handayani & Ibrani, (2020) examined the impact of AC characteristics on EM by utilizing a quantitative approach with a sample of manufacturing firms listed on the Indonesia Stock Exchange from the period 2016 to 2018. The characteristics of the AC consist of an AC that has expertise in accounting, and an independent AC. The results suggested that the expertise of AC members in accounting has no impact on EM. The independent AC has no effect on EM. The profits monitoring is untouched by the

independent AC. The creation of an independent AC has not been able to deter EM; it is likely that their existence is limited to compliance with current laws, leaving them unsuccessful in constraining the presentment of EM activities.

According to previous studies, AC size is one of the significant attributes that contribute to its quality or effectiveness. Hence, AC size might influence the monitoring of EM so that EM does not appear in the financial reports aggressively. Accordingly, based on the above discussion, this study addressed AC size to explore its impact on EM in Palestine.

3.3.2.2 Audit Committee Independence

AC independence typically refers to non-executive members of an AC, which numerous previous studies have addressed. The independence of an AC usually is associated with the effectiveness of AC (Hamid, Othman, & Rahim 2015). Moreover, non-executive members are often seen as an essential attribute in increasing the quality of financial reporting (Dimitropoulos & Asteriou 2010; Siagian & Tresnaningsih 2011). Furthermore, Al-Najjar (2011) has been indicated that firms with lower performance often appoint non-executive directors on the AC in order to improve the quality of financial reports. Moreover, firms with more non-executive directors, large boards, and more insider ownership would have increased audit independence.

So, AC independence is a crucial characteristic of AC, which has been used in several previous studies. The independence of an AC usually is associated with the effectiveness of AC (Hamid, Othman, & Rahim, 2015). Moreover, independence could be an essential attribute to increasing the degree of the quality of financial reporting (Dimitropoulos & Asteriou 2010; Siagian & Tresnaningsih 2011). Similarly, Davidson et al. (2005) reported that non-executive directors on the AC play a critical role in

reducing the manipulation of behaviors and EM practices. On the other hand, Hamdan, Mushtaha, and Al-Sartawi (2016) found no relationship existed between earnings quality and AC independence.

Hamdan, Mushtaha, and Al-Sartawi (2017) investigated the association between the characteristics of AC and earnings quality (EQ) by using panel data from industrial firms listed on ASE from 2004 to 2009. They found that AC size and ownership were negatively associated with EQ, whereas no relation existed between AC independence and EQ. Furthermore, they reported an insignificant relationship between AC expertise and EQ, while AC annual meetings were positively associated with EQ.

3.3.2.3 Audit Committee Financial Expertise

Accounting and financial expertise of members of the AC are considered vital characteristics in performing the duties of an AC. In the United States, the Sarbanes–Oxley Act of 2002 defined the financial experts as the members of an AC that they hold the experience and have accounting qualifications as a certified public accountant (CPA, CFA) or have sufficient experience in related fields such as an auditor or chief financial officer or similar functions (e.g., CEO, CFO) SOX (2002). Also, a financial expert serving as a member of an AC should hold the following attributes: 1) sufficient knowledge of GAAP and financial reporting system, 2) experience in the processes of financial statement preparation or audit, 3) experience in internal accounting controls functions, and 4) high level of knowledge of AC duties. Additionally, SOX (2002) mandates that an AC includes at least one member as a financial expert.

Prior studies have given considerable attention to the financial expertise and knowledge of AC members as evidence of committee effectiveness. Mustafa and Ben Youssef (2010) have conducted a study to investigate the relation between AC financial

expertise and AC independence. They have found that a combination of independence and financial expertise of someone serving on the committee leads to reducing fraudulent actions related to a company's assets. Abernathy et al. (2014) argued that an AC, which includes a member with accounting expertise, contributes to the effectiveness of the committee by improving financial information timeliness.

By reviewing previous studies that have dealt with the characteristics of AC, the contradictory results of these different studies are not surprising because the presence of an AC without making ensuring its effectiveness does not guarantee either the adequacy of monitoring procedures or the ability to detect and reduce the magnitude of EM. In Palestine, an AC should consist of at least three members through the non-executive members of the BOD, and at least one member of the committee should be a financial expert (PCCG, 2009).

3.3.3 Ownership Structure

OS as a familiar terminology as one of the important CG mechanisms and includes ownership components, ownership concentration, and separation of ownership. The ownership component refers to the identity and the type of stockholder. Ownership concentration refers to the number of ordinary shares that a holder owned. Separation of ownership refers to the separation of control rights and cash-flow rights of a large stockholder (Hu & Zheng, 2015). The concentration of OS differs from one country to another. Several countries have widely held and dispersed ownership, while others have shares concentrated in the hands of block holders. Ownership is widely dispersed in the United States and the United Kingdom (Berle & Means, 1932; LaPorta et al., 1999).

This current study will focus on the characteristics of OS, such as ownership concentration, institutional ownership, and foreign ownership. These characteristics are appropriate for investigation in the Palestinian context because the concentration of ownership is apparent in Palestinian corporations. So, in the context of Palestine, the ownership structure is concentrated (Dwaikat & Queiri, 2014). Thereby, the ownership structure in Palestine largely diverges among institutions, families, individuals, and foreigners. Hence, this study utilized 3 main factors of ownership structure in Palestine as elaborated in the upcoming sections.

3.3.3.1 Ownership Concentration

The existence of large stockholders in a corporation is typically used to measure concentrated ownership (Thomsen & Pedersen, 2000). Porta et al. (1999) and Hassan et al. (2016) argued that a conflict between majority and minority stockholders exists due to agency problems that emerge by ownership concentration. Subsequently, high ownership concentration provides an opportunity for majority stockholders to use a company's resources at the expense of minority stockholders (Shleifer & Vishny, 1986). For example, Djankov et al. (2008) demonstrated that concentration of ownership could be found in some developed countries in Europe, Arab states (Palestine, Oman, Jordan, Egypt, and Tunisia), and in Eastern Asia (Claessens et al., 2000; Omran et al., 2008). Fan and Wong (2002) argued that concentrated ownership was related to low earnings quality in East Asian countries.

Some prior studies have found an adverse relationship between EM practices and the concentration of ownership because the largest stockholders may be the prominent owners of the business (Warfield et al., 1995; Ding et al. 2007; Teshima & Shuto, 2008).

Conversely, Sarkar, Sarkar, and Sen (2008) found that the presence of controlling stockholders on the board increased EM in India.

Several studies have examined Malaysia. For example, Yunus et al. (2011) found that ownership concentration was associated with weak accounting conservatism. Rahman and Mohamed Ali (2006) found that concentrated ownership impacted BOD independence. They documented that BOD independence was not related significantly with higher ownership concentration. On the other hand, Kamardin and Haron (2011) demonstrated that most Malaysian companies were family firms. That is evidence that there is a high ownership concentration in Malaysian companies, which may lead to more effective monitoring techniques, which, in turn, will strengthen alignment between large and minority stockholders. Unlike Malaysia, Klai and Omri (2011) studied the association between CG mechanisms and the quality of financial reports. They found that ownership concentration minimizing the quality of financial reports in the firm listed in the Tunisian stock exchange.

Several studies have examined the context of Palestine. For example, Abdelkarim and Alawneh (2009) showed that OS in Palestinian firms was concentrated, and Ahmad (2010) reported that “inside ownership by managers and members of board diverge between 54% for foreign banks and 22% for national banks, while 29% of national banks are owned by families, and 25% of foreign banks are owned by families” (p. 61). Dwaikat and Queiri (2014) investigated the relationship between the OS and the performance of 31 companies listed on the PEX from 2008-2012. The results revealed that ownership concentration was significantly and negatively associated with firm performance. Additionally, Abdelkarim and Alawneh (2009) indicated that ownership concentration negatively affected firm financial performance in Palestine listed

companies. Hence, the current study will address the concentration ownership in Palestine to investigate its impacts on EM practices.

3.3.3.2 Institutional Ownership

According to the agency theory perspective, institutional ownership would enhance the monitoring system in controlling management behaviors. Ping and Wing (2011) have argued that the large stockholders will benefit more from a robust monitoring system than small stockholders. Moreover, large stockholders such as institutional owners will more vigorously and effectively carry out the monitoring function on management behavior than BOD members who are small or non-shareholders of a company (Shleifer & Vishny, 1986). In other words, a high level of institutional ownership will reduce agency problems, which, in turn, will protect the rights of small stockholders (Naser et al., 2006) and increase the monitoring of a firm's overall performance (Crutchley et al., 1999).

Accordingly, Carleton et al. (1998) have argued that the effectiveness of business will increase due to an increase in institutional ownership, which leads to enhancing the monitoring system on the corporations. Several prior studies have found that the level of EM will decrease due to a high proportion of institutional ownership in the firm. For example, Almasarwah (2015) conducted a comprehensive study in Jordan and investigated CG mechanisms and their relation with the level of EM practices. He found a negative relationship between the percentage of institutional ownership and EM.

However, Gurbuz and Aybars (2010) and Jaafar and El-Shawa (2009) found that mixed results have been produced from investigating the association between firm financial performance and ownership held by institutional investors. While some studies observed a positive and significant relationship between the two variables, some

studies have reported a negative and significant relationship between them (Haniffa & Hudaib, 2006; Rose, 2007). Hence, the current study will address the institutional ownership in Palestine to explore its effects on EM practices.

3.3.3.3 Foreign Ownership

Several prior studies have examined foreign ownership and its relationship with EM as an essential mechanism of effective CG. One argument is that foreign owners usually have more varied experiences rather than their local counterparts. Therefore, foreign owners can monitor management behavior more effectively than these counterparts due to their experiences. Subsequently, based on a high level of foreign ownership, the quality of the financial reports will increase, and agency costs will be reduced (Hassan et al., 2016).

Driemeier, Wallsten, and Xu (2006) have argued that a higher proportion of foreign ownership makes the firms more innovative and creative compared with the firms that have a lower proportion of foreign ownership. In addition, Chung, Ho, and Kim (2004) indicated that foreign investors are more effective in restricting the opportunistic behavior of management and also mitigating EM practices. In Jordan, Alzoubi (2016) has found that the Jordanian listed firms with less ownership from foreign investors are more likely to engage in EM practices. Whereas in China, Ji et al. (2015) found no significant association between the proportion of foreign investors and the quality of earnings in Chinese listed companies.

In Palestine, foreign owners whether individual or institutional investors are essential for PEX as an emerging market working under a complicated political situation. Foreign investors provide the Palestinian stock market with various experiences and innovative ideas to maximize the productivity and overall performance

of the listed firms. Indeed, the PEX performance has developed much over the last two decades; however, it still needs fundamental CG reforms and comprehensive disclosure (Hassan et al., 2016). The high degree of ownership concentration in the Palestinian firms has affected firm performance negatively. Consequently, the Palestinian economy suffers from a liquidity shortage. This shortage will cause a lack of confidence in the PEX. Hence, the Palestinian economy needs to open up to attract additional foreign investments and, in turn, improve the quality and effectiveness of CG (Abdelkarim & Alawneh, 2009).

3.3.4 Board of Directors' Quality

As mentioned earlier in this study, the BOD is considered as the most important mechanism of internal CG. BOD played a monitoring role in dealing with agency problems (Chobpichien et al., 2008; Lefort & Urzúa, 2008). Fama and Jensen (1983) have suggested that the BOD role may mitigate a company's agency problems by using its authority to monitor management in seeking to reap its benefits. Furthermore, Weir et al. (2002) have argued that BOD as a core mechanism of internal CG and will directly affect ensuring adequate gains for stockholders and protecting the interests of stakeholders against the self-interests of managers.

However, the studies that have been conducted to examine the association between individual characteristics of the BOD and EM practice have found mixed results. One reason for this may be due to individually employing CG mechanisms and ignoring the notion that the effectiveness of any mechanism is based on its interactions with the other mechanisms (O'Sullivan et al., 2008; Ward et al., 2009). Moreover, the argument has been made that it is much better to examine the CG mechanisms as a

collection of mechanisms protecting the interests of stockholders because they complement each other.

Consequently, many recent CG studies have recommended research to address overall CG mechanisms as a composite measure (See, for example, Fallatah & Dickins, 2012; O'Sullivan et al., 2008; Ramly, 2013; Ward et al., 2009). Therefore, a BOD's effectiveness depends on its characteristics. For example, Chobpichien et al. (2008) have suggested that BOD size and independence, CEO duality, and frequency of meetings are fundamental mechanisms to measure BOD quality, which compel management to disclose more information to inside and outside parties.

O'Sullivan et al. (2008) conducted a study in Australia to examine the function that a company's CG framework plays in the decision to voluntarily disclose forward-looking information in the annual reports of Australian firms from 2000 to 2002. The results of this study were that the overall efficacy of the CG mechanisms was positively related to the disclosure of forward-looking information. In another study, Dhaliwal et al. (2006) examined the association between the effectiveness of BOD and accruals quality. This study measured the quality of a company's BOD by using the most used BOD characteristics: BOD size, BOD independence, directors' ownership, and CEO-Chair duality. The study witnessed that the strength of BOD led to an increase in the quality of accruals.

AlQadasi and Abidin (2018) addressed the role of ownership concentration in the relationship between CG mechanisms and audit quality in Malaysia. The study dealt with a composite of CG mechanisms and gave each factor a score ranging from 1 to 10. The study found that firms with a higher ownership concentration were less likely to ask for extensive auditing. However, the concentration of ownership played a minor role in the positive relationship between internal CG and audit quality.

Concerning Jordan, AbuSiam (2015) addressed five characteristics of BOD (BOD size, meetings, independence, presence of a remuneration and nomination committee, and CEO-duality) to establish a score to represent the BOD effectiveness. Then he examined the influence of BOD effectiveness in EM practices. According to the perspective of agency theory, AbuSiam (2015) found a negative association between the effectiveness of BOD and EM practices in Jordan.

Garcia-Torea et al. (2016) analyzed whether a BOD that effectively addresses stockholder interests also proved to be effective in ensuring the interests of the rest of the company's stakeholders for companies across the world. They measured the BOD quality according to the stockholder viewpoint and tested whether it is adequate for the stakeholder perspective. The study showed that effective BODs were more likely to address the interests of both the stockholders and the rest of the firm's stakeholders. Hence, they proposed a measure of BOD quality by combining several BOD characteristics into one group.

In summary and based on the prior studies mentioned, an aggregate measure of the quality of BOD might give a comprehensive image of its effectiveness as a tool of CG. It is widely argued that a more effective BOD might improve its monitoring role in protecting the interests of stockholders, which, in turn, reduces agency conflicts and costs. Accordingly, the assumption that a high score of a composite BOD measure of quality might be related to reduced EM practices. Consequently, the current study establishes a score of the BOD quality by using six factors of BOD characteristics, namely, size, independence, meeting frequency, CEO non-duality, the existence of remuneration and governance committee, and nationality diversity. So, this study aims to investigate whether the quality of BOD as a composite measure is effective in reducing EM in the Palestinian companies listed on the PEX.

3.3.5 Audit Committee Quality

An effectiveness AC is considered as the backbone of the monitoring of financial reports. Indeed, the importance of the effectiveness of the AC has become clear after recent major accounting scandals and corporate frauds. The independence and financial expertise of AC members are the required keys to improve the quality of an AC (Lisic, Neal, Zhang, & Zhang, 2016).

The AC plays a fundamental role in the monitoring of and consulting with the management in implementing internal accounting control systems and preparing financial statements. The primary job of AC is to oversee a firm's financial reporting process. The AC conducts regulatory meetings with a firm's external auditors and CFO to review a corporation's financial statements, audit processes, and internal controls (Klein, 2002; Pincus et al., 1989; Sun, Liu, & Lan, 2011).

Furthermore, AC with an appropriate level of independent and financial knowledge might increase the quality of financial statements. Consistent with the perspectives of the agency theory, independent directors who are non-executives of the company are an essential quality that contributes to an AC's effective monitoring function (Fama & Jensen, 1983). To sum it up, the quality of financial expertise and independence of members possesses can influence a committee's effectiveness in ensuring the quality of financial reporting and the oversight function of an AC.

Many prior studies have studied AC characteristics individually to examine their relationship with EM and earnings quality. However, these studies have had mixed results. One argument for these mixed results is that examining AC characteristics in isolation from each other's has led to unclear results because they function in concert with each other. Thus, DeZoort et al. (2002) have suggested that it is better to study the characteristics of AC as a group by combining them into a bundle to measure AC

effectiveness. Ward et al. (2009) also argued that investigating the mechanisms of CG as a group rather than as individual components would be a better course of action in future studies.

Early on, Abbott & Parker (2000) used a composite measure to examine AC effectiveness and its relation with selecting an external auditor for firms in the United States. They found that the results of the study were significant when employing the composite measure instead of using separate measures. In the United Arab Emirates (UAE) context, Hassan et al. (2017) added to the prior studies that have addressed the association between AC effectiveness and BOD characteristics and OS in the UAE non-financial listed firms. They used a composite measure of four proxies: AC size, independence, financial/accounting expertise, and frequency of meeting to measure AC effectiveness. The study found that AC effectiveness as a composite was positively associated with BOD size and independence, while the relationship with CEO duality was negative.

Furthermore, using a sample of listed banks in Gulf Cooperation Council Countries, Al-ebel (2013) examined the association between the level of AC effectiveness and intellectual capital disclosure. He employed the main characteristics of AC, including size, independence, meetings, and financial expertise. These measures were combined into a composite measure to compute effectiveness as an overall score. The findings of the research showed a positive relationship between the effectiveness of AC and intellectual capital disclosure.

In terms of Jordan, AbuSiam (2015) established a composite measure to AC effectiveness by using four characteristics of AC, namely AC size, meetings, independent and financial expertise. He found that AC effectiveness as an aggregate

measure was negatively associated with EM practice at a significant level in Jordanian companies.

Following these prior studies, this current study intends to investigate the influence of AC quality in reducing the level of EM practices in Palestinian non-financial companies listed on PEX. A composite measure was used as a proxy for the quality of AC by using three factors of AC characteristics, namely, AC size, independence, and financial expertise. This study anticipated that EM practices might be at the lowest level when the quality of AC increases.

3.4 Earnings Management

Earnings are considered the most critical and sensitive element for the users and stakeholders of financial reports in making decisions about a corporation. Executive management may have an opportunity to manipulate earnings to practice EM (Pappas, 2015; Degeorge et al., 1999). In most prior studies, practicing EM is included earnings manipulation, modification, adjustment, and smoothing. Much EM literature has tried to understand why managers manipulate the reported earnings, how they do so, and the consequences of this opportunistic behavior (Dechow & Skinner, 2000; Schipper, 1989; & Healy & Wahlen, 1999). Accordingly, EM takes place when managers use their discretion by using the accounting tools and policies to manipulate some elements of financial position statements and income statements. Such manipulations have perhaps misled some financial statement users and other stakeholders (Wu, 2014).

EM appears in several forms and includes a vast number of fraudulent activities. This section will provide a general overview of EM and what may motivate managers to practice it. In fact, various motivations drive the company's management to practice EM. Alia et al. (2020) said companies are using it to smooth income, raise stock prices,

restrain debt covenant, reduce labor union influence by negotiating with them, manage acquisitions, maximize management wealth, import relief, and bonus schemes. Hence, this section will discuss the prominent definitions of EM, explain the classification of EM practices, clarify the objectives of EM, and identify EM types, also discuss some incentives for EM.

3.4.1 Earnings Management Definitions

EM studies have strongly attracted the interests of academics, practitioners, regulators, particularly after the well-known accounting scandals of Enron, AIG, WorldCom, Lehman Brothers, and Nortel. Although much prior literature has tried to define EM, the issue of EM still opens for future research and needs more investigation to reach a comprehensive concept. The most prominent definitions of EM are discussed in detail in this section.

Copeland was one of the first scholars to shed light on earnings manipulation and income smoothing. He has motivated academic bodies to engage in future research on such issues. Copeland defined EM as the intentional maximization or minimization or smoothing of net profit that occurs when managers use their discretion to make accounting choices or to design financial transactions for the sake of manipulating the reported net income (Copeland, 1968). Schipper (1989:92) offered one of the most common definitions who observed that “By EM I really mean disclosure management in the sense of a purposeful intervention in the external financial reporting process, with a view to obtaining private gain for stockholders or managers.” Similarly, Alia et al. (2020) said that EM activities do not reflect the actual financial data reported in the financial reports. Therefore, EM practices may prompt misleading decisions, which in turn drive to low-quality financial reporting that may affect stakeholders trickly. They

also argue that the reason which motivates the management to engage in EM that differs across financial periods and companies.

Healy and Wahlen (1999) argued that EM practices would occur when managers used their judgment on financial statements to prevent the disclosure of a company's actual economic performance for the sake of misleading some stakeholders or gaining benefit from the adjusted figure. Consistent with this definition, the current study views EM as the opportunistic behavior of management.

Vasilescu (2014) explicated the definition of Healy and Wahlen (1999). He claimed that this definition refers to the judgment that managers use in preparing financial reports. Managers can defer several accounting items such as revenues and expenditure associated with depreciation expense (straight-line or accelerated depreciation methods), working capital management (purchases and receivable policies, inventory valuation methods, inventory levels), research and development expenses, and advertising or maintenance expenditures. Hence, the definitions of Schipper (1989) and Healy and Wahlen (1999) are concerned with the opportunistic behavior of managers in preparing financial statements and also engaging in EM practices to gain benefits and improving financial performance to change the behavior of some stakeholders for their interests.

Walker (2013) defined the EM process as “the use of managerial discretion over (within GAAP) accounting choices, earnings reporting choices, and real economic decisions to influence how underlying economic events are reflected in one or more measures of earnings” (p. 446). Walker (2013) documented that his definition of EM was broader than prior definitions and did not assume that all EM practices were bad. The definition concentrated on legal accounting choices that were not considered a fraudulent violation of GAAP. Unlike previous definitions, Walker (2013) presumed

that his definition did not consist of fraudulent accounting choices, although the prior academic studies often noted that high levels of EM practices often preceded a fraudulent process. Walker (2013) said that income smoothing was considered one of the many forms of EM practices. Before around 1980, most published research on EM was related to the income smoothing process. However, from 1980 onwards, the EM term has grown instead of income smoothing has become more prevalent.

Another common definition of EM was that Davidson et al. (1987), cited in Schipper (1989) who said that EM was “a process of taking deliberate steps within the constraints of generally accepted accounting principles to bring about a desired level of reported earning” (p. 92). Fields, Lys, and Vincent (2001) demonstrated that EM practices happened when executive managers employed their discretion over accounting numbers, with or without restrictions. Such discretion can be opportunistic.

The abovementioned definitions reveal that accrual-based EM takes place when managers control their reported earnings using the exploitation of the accounting discretion related to GAAP (Tabassum, Kaleem, & Nazir, 2015). Subsequently, Generally Accepted Accounting Principles (GAAP) themselves provide some room for discretion, including accounting choices and estimations for management to report firm economic and financial performance. Earlier studies that dealt with the issue of EM provide evidence to support the fact that managers use accounting estimates that permitted in accordance with GAAP to manipulate DAC either to inflate the reported income at the end of the year or reduce it by doing excessive accounting provisions and reserves (Beneish, 2001; Dechow & Skinner, 2000; Fields et al., 2001; Healy & Wahlen, 1999).

3.4.2 The Types of Earnings Management

According to prior literature, EM has been classified into several types and methods. Commerford et al. (2016) and Alia et al. (2020) said that EM is distributed into two kinds. The first kind is named "Accounting-EM," which relies on the use of accounting estimates, policies, and accruals. EM is paramount to comprehend the accounting accruals and their impact on measurements of a company's performance (Schipper, 1989). The second form of EM among the strategic timing of investing, financing, and operating decisions called 'real-based EM' (Alia et al., 2020). The following sections describe the most common methods in detail, namely accrual-based EM, real-based EM, and classification-shifting EM.

3.4.2.1 Accrual-Based EM

Much prior literature has extensively addressed the accrual-based EM (e.g., Schipper 1989; Zang, 2012; Healy and Whalen 1999; Alia et al., 2020; Fields et al. 2001). This literature has distinguished between non-discretionary accruals and DAC. Hence, it is imperative to explain the differences between both of them. Jones (1991) argued that the non-discretionary accruals appear from factors that are not under the scope of managers' control. For instance, the growth of sales leads to an increase in the balance of accounts receivable and bad debts.

In contrast, DAC appears from factors over which managers have control (Jones, 1991). So, any resulting accruals would be discretionary whether managers targeted to affect the reporting expenses by manipulating the rate of bad debts for the sake of allowance of doubtful accounts. Under GAAP, managers can manipulate accounting earnings, as they have the choice between accounting policies that treat accounting events differently (Alsultan, 2017). For example, alternative treatments for accounting

events can change reported income without any cash flow consequences. According to Teoh et al. (1998), there are three kinds of methods that managers could use under accrual-based EM. These are as follows.

First, Accounting Method Choice: According to this method, managers can postpone and advance the recognition of expenses and revenues to increase reported income. For example, a straight-line method typically minimizes depreciation expenses compared to the accelerated depreciation method in the first years of depreciation. Alsultan (2017) noted that if new management intended to defer revenue recognition for continuing long-term projects to enhance its reputation, the completed-contract method might be conducted, as, in this method, revenue is only recognized at the completion of an enterprise. In contrast, the percentage completion method permits revenue recognition as a percentage of the work completed during the reported year.

Second, Accounting Method Application/Discretionary Estimates: Managers can influence the reported income even after choosing an accounting method among the application of accounting principles. Accounting standards allow managers to practice their discretion in estimates. For instance, the residual values of disposal assets and asset lives of depreciable assets and interest rates capitalized for leases and pensions.

Third, Accounting Method Timing: As managers have discretion over how accounting events are recognized, they also have discretion over when they are recognized. For example, they have discretion over how much to write off in terms of bad loans and impaired assets.

3.4.2.2 Real Activities-Based EM

A small amount of literature examines how managers temper real transactions to deform reported earnings (Zang, 2012). Many studies regarding real activities-based

EM explored managerial discretion through R&D expenses (Baber et al., 1991; Dechow & Sloan, 1991; Bushee, 1998; Zang, 2012). Other forms of real EM practices that have been searched contain reducing advertising costs (Cohen, Mashruwala, & Zach, 2010), repurchasing the common stocks (Hribar, Thorne, & Johnson, 2006), profitable assets' sales (Herrmann, Inoue, & Thomas, 2003), reduction of sales prices, derivative hedging, debt-equity swaps, and securitization (Zang, 2012).

Roychowdhury (2006) said that accrual-based EM does not have any cash flow effects, unlike real activities-based EM, which directly affects a company's current and future cash flows. According to Alhadab et al. (2015), managers often practice real activities-based on EM instead of accrual-based activities for various reasons. First, accrual manipulations are more likely to come under the scrutiny of regulators and auditors. Second, accrual manipulations may lead to accounting and financial fraud that expose the management to litigation risk. Third, changes in accounting methods and policies are accumulated in the balance sheet statement. Managers may convert the type of engagement in EM from accruals-based EM to real-based EM in the current period when accrual earnings are utilized widely in previous periods. Managers can engage in real EM through a range of operating decisions.

3.4.2.3 Classification-Shifting-Based EM

The process of converting core expenses to non-recurring expenses to inflate core profitability is termed Classification-shifting-based activities. Managers use this method to practice EM (Mcvay, 2006). Several prior studies have investigated EM. For instance, Mcvay (2006) found that special items include expenses that have been shifted from core expenditures opportunistically in the context of the United States. Similarly, based on the UK context, Athanasakou et al. (2009) determined that a small proportion

of the core expenses can be reclassified to include other non-recurring items to reduce the gap between reported income and the income expected by analysts. Zalata and Roberts (2016) found that UK companies manipulated earnings by classifying some expenditures as non-recurring items, whereas they should classify them as recurring.

Moreover, Zalata and Roberts (2016) also found that strong internal CG constrains classification-shifting activities and that companies with more independent directors, longer tenure of directors, and an effective AC can reduce the engagement of classification-shifting activities. They found the three characteristics of an AC that prevent these activities were the existence of financial specialists on the committee, more frequent meetings of the AC, and directors with longer tenure. Roychowdhury (2006) has argued that, if managers can manipulate accruals throughout the year, they may face difficulties manipulating them when the end of the year approaches. Thus, managers might resort to another channel for earnings manipulation, like classification shifting.

3.4.3 EM Models and Common Measurements

During the past thirty years, numerous studies have been conducted in detecting EM practices by using several models, methods, and measurements. Hence, the previous literature of EM attempted to invent a simple approach for detecting EM practices. Subsequently, several mechanisms have been generated in accounting studies such as single accruals or specific accruals that McNichols and Wilson (1988) presented. Dechow, Sloan, and Sweeney (1995) and Jones (1991) were the first to present aggregate accruals.

The statistical distribution of earnings changes and earnings was presented by Burgstahler and Dichev (1997), the determination of thresholds by Degeorge et al.

(1999), the discretionary revenues model that Stubben (2010) developed, and finally, the informativeness of the earnings model (Easton & Harris, 1991). On the other hand, several studies have tried different methodologies to study EM phenomena like questionnaire surveys or structured interviews.

McNichols (2000) has argued that the primary and most commonly used approaches by the literature of EM are specific accruals, total accruals, and the distribution of earnings. According to McNichols (2000), specific accruals suppose that the profit involves cash flow and total accruals. So, the manipulation of profit values may lead to the manipulation of accruals values as well. Total accruals are across companies and across time and provide the opportunity to explore other explanatory variables such as auditors and the mechanisms of CG. The third method, which DeGeorge et al. (1999) and Burgstahler and Dichev (1997) developed, examines the statistical properties of earnings to detect behavior that affects earnings.

The current study conducted the aggregate approach models for detecting EM practices. The main reason for choosing this approach is because it was the most common and widely used to detect EM in prior literature (Ibrahim et al., 2014; Idris, Abu Siam, & Nassar, 2018; Abdelkarim & Zuriqi, 2020; Diri et al., 2020). The other reason was that the data required for using this approach are available in the Palestinian environment.

3.4.3.1 The Aggregate Accruals Approaches/Models

3.4.3.1.1 The Healy Model (1985)

The Healy (1985) model is regarded as the first model that tried to detect EM practices through addressing the basic methods of aggregate accruals (computed totally through logged assets) as it attempts to compare a period of non-discretionary accruals

measures. Furthermore, Healy (1985) indicated that practicing EM systematically may take a position within overall periods. Healy (1985) defined accruals as the differences between the cash flow from operations and reported earnings. Thus, the DAC for a specific period is computed as follows:

$$(3.1) \quad EDA_{it} = TA_{it} / A_{it-1}$$

where:

EDA_{it} = The measurement of DAC of the period.

TA_{it} = The aggregate accruals of the period.

A_{it-1} = The overall assets at the starting of the period.

3.4.3.1.2 The DeAngelo Model (1986)

The DeAngelo (1986) model attempts to avoid the weakness and deficiency of Healy's (1985) model. DeAngelo (1986) assumed that DAC computes the differences between total accruals in the preceded period as well as the total accruals in the present period, as it is shown below:

$$(3.2) \quad EDA_{it} = (TA_{it} - TA_{it-1}) / A_{it-1}$$

where:

EDA_{it} = The amount of DAC for the period.

TA_{it} = The total accruals for the current period.

TA_{it-1} = The total accruals for the prior period.

A_{it-1} = The total assets for the prior period.

3.4.3.1.3 The Jones Model (1991)

The Jones' (1991) model was developed to measure non-discretionary accruals, including new factors such as equipment, property, and plant factor to control any challenges and changes in the non-discretionary accruals that emerged from depreciation expenses and proceeded from changes in the activities of companies. The model is calculated as follow:

$$TAC_{it} = \alpha (1 / TA_{it-1}) + \beta_1 (\Delta REV_{it} / TA_{it-1}) + \beta_2 (PPE_{it} / TA_{it-1}) + \varepsilon_{it} \quad (3.3)$$

where:

TAC_{it} = the aggregate accruals.

TA_{it-1} = the book value of total assets of firm i at the end of year $t-1$.

$\Delta REV_{it} / TA_{it-1}$ = the sales revenues of firm i in year t less revenues in year t scaled by TA_{it-1} ,

PPE_{it} / TA_{it-1} = The gross property, plant, and equipment of firm i at the end of year t , scaled by TA_{it-1} ,

$\alpha \beta_1 \beta_2$ = the estimated parameters.

ε_{it} = the residual.

Jones' (1991) model has attracted many academic researchers for several reasons. For instance, Subramanyam (1996) indicated that the Jones Model was more developed than others. Also, the Jones model, which is associated with cross-sectional studies, can provide more control than functioning it with a series of time studies. Moreover, Dechow et al. (1995) observed that the model of Jones was the most suitable model to detect EM practices effectively.

3.4.3.1.4 The Modified Jones Model (1995)

Dechow et al. (1995) focused on the shortcomings of Jones's (1991) model and have provided a more effective model for detecting EM practices. Dechow et al. (1995) believed that the Jones (1991) model ignored the manipulation of revenues manipulating, which is deemed as a non-discretionary action. Subsequently, the Modified Jones (1995) Model considers the changes in revenues that are adjusted for changes in receivables and property, plant, and equipment. In other words, the Modified Jones (1995) Model regresses aggregate accruals on gross property, plant, and equipment and changes in cash revenues to offer coefficients that will be employed to compute unmanaged accruals as follows:

$$TAC_{it} / A_{it} = B_0(1/A_{it-1}) + B_1((\Delta REV_{it} - \Delta REC_{it}) / A_{it-1}) + B_2(PPE_{it} / A_{it-1}) + \varepsilon_{it} \quad (3.4)$$

where:

TAC_{it} = Aggregate accruals.

TA_{it-1} = the book value of total assets of company i at the end of year $t-1$,

$\Delta REV_{it} / TA_{it-1}$ = sales or revenues of company i in year t less revenues in year $t-1$ scaled by TA_{it-1} , ΔREC_{it} = the change in account receivables.

PPE_{it} / TA_{it-1} = gross property, plant, and equipment of company i at the end of year t scaled by TA_{it-1} ,

$\alpha \beta_1 \beta_2$ = estimated parameters.

ε_{it} = The residual

Several studies have examined the performance of the models of discretionary accruals. They have presumed that the Jones' model, especially the modified one, is the most suitable one because it can detect EM practices (Habbash, 2010). Even though

both models were represented as time series. Subramanyam (1996) compared both models based on time series and cross-sectional data. He documented that the Jones' model, particularly the modified one, was more effective in terms of cross-sectional data than in time-series data to detect EM. More importantly, in cross-sectional data, the Jones model can control for years as well as it is well-influencing (AbuSiam, 2015). Hence, the cross-sectional models are categorized and described by including larger samples and observations; yet, the Jones model does not propose the stationarity of the discretionary accrual models (Subramanyam, 1996). More interestingly, the cross-sectional model suggests that the model of discretionary accrual is associated with every firm in a particular industry, regardless of its strategy or the phase of its lifecycle. In other words, if a company within an industry is not homogeneous within the industry, then the discretionary accrual model may include error measurement (Dechow et al., 1995).

3.4.3.1.5 The Kothari et al. (2005) Model

Several studies have discussed the performance of this approach in terms of computed EM. For instance, Dechow et al. (1995) proposed that the estimated results from the Jones model expose that DAC was positively and significantly related to return on assets (ROA). To settle performance issues associated with misrepresentation and misspecification, scholars such as Kothari et al. (2005) and Bartov, Gul, and Tsui (2001) have excluded the influences of such associations among the company's performance and DAC through portfolio or firm-matched methods to modify the DAC.

On the other hand, a pioneering study that Kothari et al. (2005) suggested that the DAC that is measured by the modified Johns model might include several errors of measurements of DAC once such a model disregarded the role of performance of a firm.

Hence, the DAC has been computed by the residuals of the cross-sectional model as follow:

$$TAC_{it} = \alpha (1 / TA_{it-1}) + \beta_1 (\Delta REV_{it} - \Delta REC_{it}) / TA_{it-1} + \beta_2 (PPE_{it} / TA_{it-1}) + \beta_3 ROA_{it-1} + \varepsilon_{it} \quad (3.5)$$

Subsequently, Kothari et al. (2005) indicated that there are two methods to obtain the performance of the companies in the computed DAC. The first was matching each firm-year observations with other firms from similar industries and the ROA of the closest year to the current year. Second, performance alternatively included in ROA can be included in the DAC regression as additional variables. The second approach is used in this current study due to its small sample size.

The original Jones's (1991) model and the Modified Jones Model (Dechow et al. 1995) are the most frequently used models in previous literature to measure EM practices. Kothari et al. (2005) argued that measuring EM without controlling for a firm's performance will lead to misspecifications in the EM model. So, recent studies (e.g., Alsultan, 2017; Chang & Sun, 2009; Dai, Dharwadkar, Shi, & Zhang, 2017; Habbash et al., 2013; Idris et al., 2018; Ji et al., 2015; AbuSiam et al., 2018) have preferred to use DAC as Kothari et al. (2005) suggested to avoid problems of misspecification and heteroscedasticity issues that arose in preceding models. Therefore, this current study follows the studies mentioned above in using Kothari et al.'s (2005) model to compute the magnitude of DAC as a proxy for detecting EM practices.

3.4.3.2 Measuring Total Accruals

Total accruals is a most common measure in differentiating between DAC and non-discretionary accruals. Total accruals comprise discretionary and non-discretionary accruals. Healy (1985) defined discretionary accruals as “adjustments to cash flows selected by the manager” for the sake of affecting reported net profit (p. 89.) Healy (1985) and DeAngelo (1986) said that non-discretionary accruals in the event year were based on the total accruals in the estimation year. Both studies have suggested that the practices of EM occur only in the event year. To sum it up, the discretionary accruals are representative of EM that managers can manipulate opportunistically. Conversely, managers cannot determine non-discretionary accruals because they are not under their control (AbuSiam, 2015).

Several studies have addressed the DAC in detecting EM practices (Kothari et al., 2005; Teoh et al., 1998; Becker et al., 1998). To compute DAC, the total accruals must be first computed. Indeed, the total accruals can be calculated by two approaches: the balance sheet approach and the cash flow statement approach. Both approaches will be elaborated in the next section.

3.4.3.2.1 Balance Sheet Approach

The balance sheet approach is most widely employed by prior accounting literature (Dechow et al., 1995; Healy, 1985; Kothari et al., 2005). The balance sheet approach is calculated, as below:

$$TAC_{it} = \Delta CA_{it} - \Delta Cash_{it} - \Delta CL_{it} + \Delta DCL_{it} - DEP_{it} \quad (3.6)$$

where:

ΔCA_{it} = Change in current assets for firm i in year t .

$\Delta Cash_{it}$ = Change in cash and cash equivalents for firm i in year t .

ΔCL_{it} = Change in current liabilities for firm i in year t .

ΔDCL_{it} = Change in debt included in current liabilities for firm i in year t .

DEP_{it} = Depreciation and amortization expense for firm i in year t .

3.4.3.2.2 Cashflow Statement Approach

Several prior studies have used this approach (AbdulRahman & Mohamed Ali, 2006; Almomani & Ayedh, 2017; Becker et al., 1998; Gounopoulos & Pham, 2018; Juhmani, 2017; Klein, 2002; Latif & Abdullah, 2015; Xie et al., 2003). Under this approach, total accruals are computed as the equation below:

$$TAC_{it} = N.I_{it} - CFO_{it} \quad (3.7)$$

where:

TAC_{it} = Total accruals for firm i in year t .

$N.I_{it}$ = Net income or Earnings before extraordinary items for firm i in year t .

CFO_{it} = Cash flows from operating activities for firm i in year t .

Based on most prior studies, the cashflow from operational activities approach is better than the balance sheet approach because the cashflow approach eliminates any expected errors when computing the total accruals (Almomani & Ayedh, 2017; Gounopoulos & Pham, 2018; Juhmani, 2017; Latif & Abdullah, 2015; Idris, 2012; AbuSiam, 2015). Therefore, this study uses the cashflow from operating activities to measure the total accruals.

3.5 Overview of Political and Economic Situation in Palestine

Palestine (West Bank & Gaza Strip) is considered one of the MENA countries characterized by a high degree of political and economic instability. Furthermore, Palestine has been under the Israeli occupation from 1948 until the present, which is considered the longest occupation historically. The Israeli occupation has damaged the Palestinian economy due to its dependency on the Israeli economy (Abdelkarim, 2017). Moreover, the economy of Palestine is classified as an emerging economy with low productivity, investment, and limited competition because of the high degree of political instability and ongoing wars (World Bank, 2014). Political instability in the West Bank and Gaza Strip has created a barrier to the economic and investment climate, which, in turn, has reduced economic growth rates and also the productivity of the private sector in Palestine (World Bank, 2014). During the current decade, a series of political events has decreased economic development. In this section, the political and economic situation in Palestine will be reviewed in some detail.

The Palestinian National Authority (PNA) was founded, according to the Oslo Accord (1993), to govern Palestinian occupied territories, including the West Bank, East Jerusalem, and Gaza Strip. The PNA assumed civil responsibility for most of the population residing in the West Bank and Gaza Strip. Nevertheless, Israel, as the occupying Power, maintained full and tight control over the Palestinian territories (World Bank, 2017). Indeed, the Oslo Accord was viewed as a partial solution to the Palestinian issue until a final resolution was reached, which has not yet occurred. Until a lasting and comprehensive peace agreement is reached, the Palestinian economy will continue to perform under the influence of political instability due to the procedures of the Occupation Power. Accordingly, political instability is a significant threat to current

and potential investors and is a significant reason that the private sector has not worked for many years (World Bank, 2015).

After the Oslo agreements, the expectation was that the Palestinian economy and the private sector would improve significantly, and they would be attractive to local and foreign investments. Unfortunately, the Palestinian economy has suffered more since the Oslo agreement due to Israeli control of the Palestinian Economy (Abdelkarim, 2017). Despite that, the annual growth of the Palestinian Economy recorded a 9% average annual growth from 1994 until 1999 due to large inflows of private and public capital and increased private investment. (World Bank, 2017). Five years after the Oslo accord in 1999, no comprehensive peace and the ultimate solution was reached between the Israeli occupation and PNA. Hence, the Palestinian territories witnessed an increasing level of violence, as Israel reoccupied the Palestinian territories (Gaza & West Bank) and imposed strict restrictions on the movement of Palestinian citizens. The second intifada was launched in 2000. So, the Palestinian economy since that year was down warding, which in turn increasing the economic instability and negatively affected investor confidence (Hassan et al., 2016).

After the outbreak of the second Intifada, the annual growth rate declined to an annual average of -9%. The events of the second intifada affected the Palestinian economy adversely (Al-Aqsa Intifada), and substantial losses occurred for listed companies on PEX due to the closure of geographical areas and poor political conditions. In addition to this, the decrease in investments, whether local or foreign. A few years later, growth improved to the annual average of 8% from 2008 to 2012 due to large amounts of donor funding, which was approximately equivalent to 32% of the Palestinian GDP in 2008.

Furthermore, the 2014 war in Gaza and the extreme decrease in donors' funds led to severe instability in the economic conditions in Palestine. The 2014 war in Gaza had severe social, political, and economic consequences that had devastating impacts on private sector activities, causing the Palestinian economy to trend downwards. However, growth had slowed even before the war due to a significant decrease in donor assistance. As a result, real GDP growth slowed to an annual average of 2% between 2013 and 2016 (World Bank, 2017).

The spark of the Arab Spring revolutions ignited in Tunisia in 2010, and later on, these revolutions spread to other Arab countries in 2011, especially Libya, Egypt, Jordan, Algeria, Bahrain, Yemen, and Syria, countries that had been subject to economic, social and political repression. These developments led to a change in the regimes in many countries, but despite a change in the systems, instability remains in some of these countries (Ghosh, 2015). Palestine shares the unstable economic and political conditions with Arab Spring states due to the continuous Israeli practices against the Palestinians and the Palestinian economy (Ghanem, 2013).

Therefore, political instability is considered a primary factor influencing the performance and volatility of stock markets (Mnif & Kammoun, 2015). Accordingly, in 2011, which was the year of the Arab Spring, the Al-Quds Index fell to 12.7 points lower than in 2010. The indicators of the investment sector fell (10.48%), as did the industrial sector (1.45%), the services sector (1.15%), and the insurance sector (3.65%), while the banking sector index increased by 0.72 % (PMA, 2011).

The year 2012 witnessed several political events like the conflict that happened after the assassination of one of the Palestinian leaders and the ongoing closure and restricted movements of goods, services, and people, and the continuous division between the Gaza Strip and West Bank. These challenges may have caused a slowdown

in economic growth and political instability leading to an inappropriate investment environment for potential investors. The PEX has documented that the real GDP recorded a growth of 5.9% in 2012 in Palestine, which was lower than the growth rate in the previous year. Similarly, Al-Quds Index decreased during the first three quarters of 2012, while it recorded a slight increase in the fourth quarter of the same year (PEX, 2012).

This slowdown increased in 2013 (PEX, 2013). The data shows that the real growth rate in 2013 was only 2.1%, while the growth rate was 5.9% in 2012 compared to 12.2% in 2011 (PMA, 2013). This slowdown was due to political and economic instability and the weakness of the private sector, considering the declining performance of the public sector. Additionally, Israeli procedures prevented the achievement of high and sustainable levels of economic growth. Likewise, the continuous economic blockade that Israel imposed on the Gaza Strip negatively affected the movement of trade and all aspects of the economy in general (PEX, 2013; PMA, 2013).

The year 2014 witnessed destructive conflicts in the Gaza Strip, which led to massive damage to the infrastructure of the sector, and the flow of regional and international aid, reconstruction funds, and taxes due to the Palestinian Authority slowed. All these factors weakened the Palestinian national economy. These and other factors also led to a lower-than-expected performance of the stock price of many listed companies, as the Al-Quds index decreased by 5.48% by the end of 2014 (PEX, 2014 & PMA, 2014).

Table 3.1: Main Economic Indicators of the Palestinian Economy, 2011 to 2018

Indicator	2011	2012	2013	2014	2015	2016	2017	2018
Output and Prices	(Annual percentage change)							
Real GDP (2004 market prices)	12.4	6.3	2.2	-0.2	3.5	4.7	3.1	0.9
Real Per capita GDP	9.1	3.1	-0.8	-3.1	0.5	2.1	5.1	-1.7
Inflation rate	2.9	2.8	1.7	1.7	1.4	-0.2	0.2	-0.2
West Bank	3.5	4.1	3.1	1.2	1.3	-0.1	0	0.4
Gaza Strip	0.6	0.5	-0.8	2.9	1.8	-0.9	0.1	-1.3
Unemployment Rate	(Percentage of the labor force)							
Palestine	20.9	23	23.4	26.9	25.9	26.9	28.4	30.8
West Bank	17.3	19	18.6	17.7	17.3	18.2	18.7	17.6
Gaza Strip	28.7	31	32.6	43.9	41.1	41.7	44.4	52.1

Source: Palestine Monetary Authority (2018)

Based on the data presented in Table 3.1, the real GDP rate decreased significantly from 2011 to 2014, and the annual inflation ranged from a high of 2.9% to a low of 1.7%. Table 3.1 also indicated that the unemployment rate continued to grow in both the West Bank and the Gaza Strip, reaching a high in 2018 due to mass destruction in infrastructure and factories (World Bank, 2014). The real GDP growth fluctuated from 2011 to 2018 during episodes in which conflicts and political instability occurred.

Such fluctuations align with the results of academic studies. For example, Aisen and Veiga (2011) used panel data from 169 countries from 1960 to 2004 to investigate the influence of political instability on economic growth. They found a negative association between political instability degree and GDP growth rate. This result aligns with what occurred in Palestine in 2014, a year of heightened political instability.

Indeed, the World Bank reported that the 2014 war on Gaza had a disastrous impact on the economy of Palestine, which led to a negative growth rate. The 2014 war shaved about \$460 million off Gaza's economy, leading to a 15% contraction of its GDP. Moreover, the annual average of economic growth in 2015 and 2016 was 3.4%, while in 2017, it declined to 0.7% due to political tension and division between the Gaza Strip and West Bank.

Watts and Zimmerman (1978) have suggested that management, which is facing adverse political and regulatory actions, was more likely to manipulate earnings for the sake of reducing the company's profitability. This political cost theory perspective proposed that the higher the political costs, the more likely managers are to use accounting policies. Indeed, previous empirical prior studies have reported that companies are likely to respond to periods of heightened political scrutiny by reporting abnormal income-decreasing accruals (Byard et al., 2007; Cahan, 1992; Han & Wang, 1998; Monem, 2003). Watts and Zimmerman (1986) have assumed that firms are likely to manipulate accounting information for the sake of reporting lower reported earnings in periods of high political instability according to the political costs' hypothesis.

Han and Wang (1998) examined to what extent the Persian Gulf crisis in 1990 affected the EM behavior of the oil and gas industry companies. They found that petroleum-refining companies were likely to be affected by political action and used abnormal accruals and reported less earnings due to their political sensitivity. However, they did not tend to report less reported income and income, decreasing EM due to lower political sensitivity.

Similarly, Byard et al. (2007) found that even though large refining petroleum companies engaged in EM income-decreasing accounting immediately after the Rita and Katrina hurricanes, smaller companies did not engage in downward EM. Accordingly, Hsiao, Hu, and Lin (2016) investigated the impact of Arab Springs on US gas and oil companies. This study found that overall, USA gas and oil firms engaged in income-decreasing EM during the event year of the Arab Spring.

Mangena, Tauringana, and Chamisa (2012) examined whether the financial performance of firms was affected by CG mechanisms during high political instability from 2000 to 2005 in Zimbabwe. They used political theory beside of agency theory to

explain the issues of CG under severe political instability. They divided the period into two panels, pre- and post-presidential election as 2000 to 2002 and 2003 to 2005, respectively. They found that BOD size, managerial ownership, and the concentration of ownership had increased drastically after the presidential elections. Moreover, they found a positive relationship between BOD size and the concentration of ownership and firm performance in the post-presidential election period. To sum it up, the findings revealed that the larger BOD size and concentration of ownership were more critical in political and economic instability. Their findings were in line with the results in previous studies that the external business environment is a main factor affecting the relationship of board size and the structure of ownership on company performance (Coles et al., 2008; La Porta et al., 1998).

Attia et al. (2016) studied companies in Tunisia. Their study aimed to expand the previous literature with evidence from emerging economies through testing the hypothesis of political costs, as emerging economies are characterized by government interventions and weak protection of property rights, as well as by political and economic instability, especially the Arab Spring countries. Based on the sample of all non-financial firms listed in the Tunisian stock market from 2007 until 2011, they found that the magnitude of DAC increased in the period after the revolution, characterized by a highly unstable period.

The unrest political and economic situation in Palestine during the current decade makes this topic a unique area to be investigated to bridge the gap in previous research. Therefore, the political and economic turmoil in Palestine among the primary motives for conducting this study, as it might be possible to generalize its results to neighboring countries because of their unstable environment due to the consequences of the Arab Spring and civil disputes that may be similar to the Palestinian environment. This study

is the first work to address the political instability and to test its impact on EM practices in Palestine, and to investigate its influence on the relationship between CG effectiveness and EM. For fulfilling this purpose, agency theory and political theory are used. While the theory most used in previous studies is agency theory, this current work is the first to use political theory besides agency theory to capture the impact of political instability on EM and its role in strengthening or weakening the effectiveness of CG. So, this study investigates the influence of political instability on EM practices in Palestine. This study anticipates that the magnitude of the EM level will be high in a period of severe political instability.

3.6 Chapter Summary

This chapter discusses the underpinning theories related to CG and EM issues. Agency theory was used as the main theory to explain the relationship between independent variables and the dependent variable. For the moderating effect variable, political theory is employed. Prior literature has been reviewed from various reliable resources to answer the research questions and achieve the objectives of the study. The chapter elaborated that this study would use the agency theory as the main theory to examine the relationship between CG mechanisms and EM based on prior literature. Moreover, political theory will be used to study the moderating effects of political circumstances and the environment. Also, the chapter has interpreted the issues of EM, included prominent EM definitions and its types, the motivations for practising EM, and the most common models used in detecting EM. Furthermore, this chapter also focus on the political situation and illustrated how it affects the economic growth and the performance of PEX. Finally, this chapter elaborated the benefits of using panel data approach which will be used in this study.