Paper

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Article Type: Research Paper/Literature Review/Systematic Review/General View/etc.

A Descriptive Analysis of Corporate Governance Mechanisms and Earnings Management in Palestine

Abstract:

Research aims: The article aims to describe corporate governance (CG) characteristics and the extent of earnings management (EM) practices in non-financial firms listed on the Palestine Exchange from 2011 to 2018.

Design/Methodology/Approach: The study employed the quantitative methodology. Collected data were summarized quantitatively using descriptive analysis with the aid of STATA 14. CG data were retrieved manually from published annual financial reports, while financial data for the calculation of EM were collected from Thomson ONE.

Research findings: Listed non-financial firms in Palestine only moderately complied with the Palestinian code of corporate governance. Some Palestinian firms have established an audit committee, which is one of the most important mechanisms of corporate governance.

Theoretical contribution/Originality: The findings provide insight into CG and EM in Palestine for regulators and policy makers.

Practitioner/Policy implication: The results can assist policy makers to strengthen existing regulations and update the current code of CG or introduce new policies to mitigate EM.

Keywords: Corporate Governance, Earnings Management, Descriptive Analysis, Palestine.

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Introduction

The world has seen in recent decades global financial scandals that resulted in the collapse of giant corporations in both developed and developing markets, such as Europe, the United States, Southeast Asia, and Middle East and North Africa (MENA), especially those affected by the Arab Spring and continued conflict. These companies form an inexhaustive list, including Parmalat, Enron, HealthSouth, WorldCom, Xerox, Adelphia, Tyco, Qwest, and AIG (Idris et al., 2018; Lopes, 2018; Zgarni & Fedhila, 2019). The causes of their collapse were mostly poor corporate governance (CG) systems and earnings management (EM) practices (Aljadba, Nawai, & Laili, 2021). Indeed, EM is one of the most important obstacles to financial reporting quality (Alzoubi, 2016). To mitigate such practices and other opportunistic behaviors of managers and to improve financial reporting quality, it is imperative that firms implement CG mechanisms. Without appropriate CG mechanisms in place, managers will be incentivized, by their own opportunistic behavior, to carry out EM practices, which may lead to higher likelihood of corporate financial fraud (Leventis & Dimitropoulos, 2012). In light of this issue, this article provides descriptive statistics of CG characteristics and EM practices in non-financial firms listed on the Palestinian Exchange (PEX). The findings are expected to be useful to identify CG mechanisms that still need improvement and to reveal the level of EM practices among Palestinian non-financial firms.

Palestine is a developing country that must attract local and foreign investors to improve its economy. To accomplish this, PEX should do at least two measures: improve the performance of listed firms and enhance financial reporting quality. These two measures are realized by reforming the current Palestinian Code of Corporate Governance (PCCG) issued by the Palestinian Capital Market Authority (PCMA). The output this paper is expected to contribute to this effort. It can assist the PEX, PCMA, policy makers, and other stakeholders to collaborate to reform the PCCG, so as to strengthen CG effectiveness and eventually the quality of financial reports.

Since its introduction in 2009, only a small proportion of listed firms, especially non-financial ones, have fully complied with the PCCG (Anastas, 2017). Compliance is satisfactory only among firms in the banking and financial services sector. This is partly possible because of the continuous direct supervision of the Palestinian Monetary Authority (PMA) over the administrative and financial operations of Palestinian banks (PEX, 2016). The services sector, on the other hand, is the least compliant sector. Studies on the commitment of firms to comply with the PCCG remains limited. Therefore, it is necessary examine the extent to which Palestinian listed firms are committed to implement the code's regulations and conduct comprehensive reviews to increase the code's effectiveness (Anastas, 2017). Anastas examined only the services sector, and so this article examined listed non-financial firms, which comprises the services, manufacturing, and investment sectors. Additionally, studies on CG and EM practices in Palestine are still limited (Abdelkarim & Zuriqi, 2020 & Aljadba, Nawai, & Laili, 2019). This paper can fill this gap. This paper aims to provide empirical evidence on EM practices and CG characteristics among non-financial firms listed in Palestine from 2011 till 2018.

Literature Review

The PCCG first came into effect in November 2009, obligatory only for listed firms. It comprises a set of CG rules based on applicable laws and regulations in Palestine (West Bank and Gaza Strip). The rules are related to the board of directors (BOD) and its committees, ownership structure, disclosure quality, internal audit functions and external audit characteristics. The development of the PCCG was guided by the governance principles of the Organization for Economic Cooperation and Development (OECD) and other governance rules at the regional and international levels (PCCG, 2009). The Code also provides recommendations for CG mechanisms, such as general meetings, protection of shareholder rights, management of corporate executive, internal and external audit, disclosure, and transparency (PCCG, 2009).

Investor confidence is correlated with the market strength and oversight tools, such as CG mechanisms, of the capital market (Chang & Sun, 2009). CG mechanisms are essential to enhance financial reporting quality and credibility, thereby attracting local and foreign investors. CG mechanisms also influence EM practices (Cornett, Marcus, & Tehranian, 2008), but the effect varies from a country to another due to certain factors, for instance ownership concentration. Ownership structure may serve as an important monitoring tool and influence how CG mechanisms are implemented, for instance the composition of the BOD and its committees. Different ownership structures across countries contribute to different CG practices, which in turn can enhance or weaken CG systems. Aljadba, Nawai, and Laili (2022) called for the review and update of corporate governance laws and regulations and the PCCG to attract more local and foreign investors to the Palestinian economy and protect them.

Research Methodology

The research sample was selected using the following criteria. First, only non-financial firms listed on PEX were included. Second, the firms must not be suspended or stopped trading throughout the sample period (2011–2018). Third, firms with incomplete reports were excluded. Table 1 summarizes the research sample. There were 48 listed firms on PEX in 2018. There were 33 firms in the non-financial sectors of industries, services, and investment. After excluding 15 financial firms and four non-financial firms due to incomplete data (missing annual reports), the final sample was 29 firms. This is summarized in Table 1.
CG data of the sample firms were collected from their 2011–2018 annual reports (secondary data) published on the PEX website. Each firm publishes two files on PEX. The first contains the three financial statements (balance sheet, income statement, and cash flow statement) and several financial ratios. Financial data related to EM and the control variables was collected from Thomson ONE. Where data of a firm is missing,

they were manually collected from the firm's annual report. The second file contains non-financial data, such as board characteristics, ownership structure and audit committee characteristics. These were collected manually.

Table 1: Research population and sample

Description	No. of Firms
Firms on PEX as of 2018	48
Less: Financial listed firms	(15)
Non-financial listed firms as of 2018	33
Less: Non-financial listed firms with missing reports	(4)
Final sample	29
Total firm-year observations (2011–2018)	232

Result and Discussion

Descriptive Statistics of Earnings Management

Table 2 shows the results of the descriptive analysis. The mean discretionary accruals were 0.0617, with a maximum value of 0.7639. This mean value is consistent with past studies in the Jordanian context, e.g., Idris et al. (2018), AbuSiam (2015), and Abbadi et al. (2016). In Egypt, Rahman and Mohammed Ali (2006) found a mean of 0.066, while Bassiouny (2016) found its mean and maximum to be respectively 0.042 and 0.862. These findings indicate that the DAC in Palestine is approximate to that in neighboring countries.

Table 2: Descriptive Statistics of the Dependent Variable - EM

N	Mean	Std. Deviation	Minimum	Maximum
232	0.0617	0.0734	0.0000	0.7639

EM data of all sample firms were collected for a period of eight years (2011–2018) (Table 3). On average, EM in 2017 was the highest throughout the sample period. Nonetheless, the low standard deviations indicated that there was little divergence between the EM measurements and mean EM across the years. There were also outliers in some years, as the maximum and minimum values diverged significantly from the means.

Table 3: Descriptive statistics of EM from 2011 to 2018

Year	N	Mean	Std. Deviation	Minimum	Maximum

2011	29	0.0667	0.0544	0.0041	0.2663
2012	29	0.0609	0.0585	0.0026	0.2301
2013	29	0.0523	0.0449	0.0006	0.1901
2014	29	0.0448	0.0389	0.0042	0.1460
2015	29	0.0663	0.1008	0.0015	0.5326
2016	29	0.0534	0.0393	0.0012	0.1327
2017	29	0.0832	0.1376	0.0011	0.7639
2018	29	0.0657	0.0532	0.0000	0.2329
Total	232	0.0617	0.0734	0.0000	0.7639

Note: ANOVA F =0.74, p = 0.6399, indicating no significant difference in EM throughout the sample period. It is thus unnecessary to include year as a categorical variable in the analysis.

Descriptive Statistics of the Control Variables

Table 4: Descriptive Statistics of The Control Variables

Variables	N	Mean	Std. Deviation	Minimum	Maximum
FIRMAGE	232	24.05	15.384	2	73
CASHFLOW	232	0.0386	0.0892	-0.5306	0.3672
GROWTH	232	0.0326	0.1488	-0.5814	1.2468

Note: FIRMAGE = The number of years since the firm was established. CASHFLOW = The net cash flow from operating activities divided by total assets. GROWTH = Change in total assets divided by lagged total assets.

The mean, maximum, and minimum values of firm growth were respectively 24.05, 1.2468, and -0.5814. These results are consistent with findings in Indonesia (M = 0.040, Max = 1.225, Min = -0.411) (Harymawan and Nowland, 2016). The mean age of the sample firms was 24 years. This is almost similar to Egypt, where Bassiouny (2016) found the mean firm age to be 27 years. However, it differs from 140 Greek listed firms, whose mean age was 34 years (Koufopoulos & Gkliatis, 2018).
There sample firms experienced a shortage of cash flow, as indicated by the mean cash flow from operating activities (M = 0.0386). This becomes clearer when compared to listed non-financial Saudi firms, whose mean cash flow, as Alsultan (2017) found, was 0.1067. This gap indicates that relative to Palestinian firms, Saudi firms are more capable of generating operating cash flow. A likely reason for this is the more conducive and stable business environment in Saudi Arabia compared to Palestine.

Descriptive Statistics of BOD Characteristics

The second set of findings were obtained from the descriptive analysis of six BOD characteristics (Table 5). The means of these characteristics were mostly < 1, except for board size and frequency of meetings.

Table 5: Descriptive Statistics of BOD Characteristics

Variables	N	Mean	Std. Deviation	Minimum	Maximum
Descriptive Statistics of Continuous Variables					
BODSIZE	232	8.79	2.222	5	15
BODMEET	232	5.92	1.49	2	12
BODINDEP	232	0.88	0.17	0	1
BODND	232	0.16	0.21	0	0.875
Descriptive Statistics of Dichotomous Variables					
BODRE_GC	232	0.33	0.472	0	1
CEO_DUAL	232	0.19	0.39	0	1

Notes: BODSIZ = Number of members on a board. BDMEET = Frequency of annual board meetings . BODINDEP = Proportion of independent directors to BOD size. BODND = Proportion of foreign directors to BOD size. BODRE_GC = Dummy variable: "1" for a company with this committee and "0" otherwise. CEO_DUAL = Dummy variable: "1" if the CEO is also the chairman and "0" otherwise.

Table 5 shows that the mean size of the board was 8.79 members, *SD* = 2.222. This is consistent with a recommendation from Lipton and Lorsch (1992), that a board should be comprised of eight to nine members to ensure its effectiveness in carrying out its duties. In fact, this mean is consistent with PCCG's recommendation of five to 11 members in a board, which suggests that the sample firms generally complied with the Code, at least in terms of board size. The finding is also in line with past studies in Palestine, which found that the average board size to be eight to nine members (e.g., Asmar et al., 2018; Yousef M. Hassan & Hijazi, 2015; Hassan & Hijazi, 2015; Hassan, 2016; Kutum, 2015; Dwekat, Mardawi, & Abdeljawad, 2018; Abdeljawad & Masri, 2020). Firms in Jordan (e.g., Makhlouf et al. (2018) and AbuSiam (2015)) and Malaysia (Rahman and Mohamed Ali (2006)) also have eight directors, on average.

The BOD of the sample firms approximately met six times per year. This practice aligns with the recommendation of the PCCG. It is also consistent with other studies in the Palestinian context (Abdeljawad & Masri, 2020; Asmar et al., 2018; Kutum, 2015). Compared to firms in the developed market, however, the meeting frequency of Palestinian firms is still low. The BODs of Firms in the United States (Xie et al., 2003) and the United Kingdom (Habbash et al., 2010) approximately meet eight times a year. More frequent BOD meeting strongly indicates BOD effectiveness (Vafeas, 1999).

Table 5 shows that BODs of the sample firms were mostly independent, as indicated by the high proportion of non-executive directors (*M* = 0.88). This suggests that at least 88 percent of board directors are non-executive. However, this is still not aligned with the PCCG, which recommends that the BOD be entirely comprised of non-executive directors. Mean BOD independence is relatively similar to other studies in the Palestinian context, e.g., Zaid, Wang, and Abuhijleh (2019), Falah (2017), Kutum (2015), Dwekat et al. (2018), and Abdeljawad and Masri (2020), who found the proportion of non-executive directors to be between 71–92 percent.

Table 5 also shows that most board members are Palestinians (*M* = 0.84), while only 16 percent of them were of another nationality. This is consistent with Jordanian firms, as

Ibrahim and Hanefah (2016) and Makhlouf (2017) found, where only 10–11 percent of their directors are non-Jordanian. This study is the first to examine the proportion of foreign directors in Palestinian firms. The proportion is good considering that PEX is still developing and heavily affected by political instability. It is also aligned with the PCCG's recommendation to establish a board with directors of diverse expertise, experience, and origin to enhance its effectiveness.

This study is the first to examine the committee of remunerations and governance (BODRE&GC) in Palestine. Table 5 shows that only one-third of the sample firms have established this committee. This is lower than Jordanian firms (50%), as AbuSiam (2015) revealed. This finding suggests that the sample firms have not complied with the PCCG, which recommends the establishment of this committee to assist the BOD perform its responsibilities effectively by enhancing the quality, credibility, and transparency of financial and administrative transactions.

Table 5 shows that CEO duality was present in only 19 percent of the sample firms, while the remaining 81 percent separated the roles of the CEO and board chairman. This means that 19 percent of the sample firms did not comply with the PCCG, which recommends the separation of the two posts.

The mean CEO duality is consistent with Zaid et al. (2019), who found that CEO duality was present in 19 percent of listed Palestinian firms in 2013–2016. Other studies in the Palestinian context found comparable figures., e.g, Dwekat et al. (2018) (17.5%), Abdelkarim and Zuriqi (2020) (18%), and Abdeljawad and Masri (2020) (19%). Hassan (2016) found a much smaller proportion of CEO duality in Palestine, 13 percent. In summary, CEO duality is not present in most listed Palestinian firms.

Descriptive Statistics of AC Characteristics

The third set of findings was obtained from the descriptive analysis of audit committee (AC) characteristics (Table 6). The values of all variables ranged between zero and one except for AC size, whose minimum and maximum values were two and five members. The upper part Table 6 shows the descriptive statistics for all firms in the sample, while the lower part only includes firms with AC. The table shows that almost half of the sample firms (47.5%) have established an AC. This is consistent with Alia et al. (2020), who similarly found that 47 percent of listed non-financial Palestinian firms have an AC. This finding suggests that these firms have complied with the recommendations of the PCCG.

Table 6: Descriptive Statistics of the AC Characteristics Variables

Variables	N	Mean	Std. Deviation	Minimum	Maximum
Descriptive Statistics of the AC Characteristics for the whole Sample					
ACSIZE	232	1.48	1.595	0	5
ACINDEP	232	0.34	0.476	0	1
ACFEXP	232	0.30	0.460	0	1
Descriptive Statistics of the AC Characteristics for the Firms with AC					

ACSIZE	111	3.17	.464	2	5
ACINDEP	111	0.875	0.224	0	1
ACFEXP	111	0.330	0.316	0	1

Note: ACSIZE = Total members of AC. ACINDEP = Proportion of non-executive directors to AC size. ACFEXP = Share of AC members with financial expertise to AC size

Table 6 shows that the mean AC size for the sample was 1.48 members, with a minimum of zero and maximum of five members. The mean and minimum value suggest that some firms have yet to establish an AC, as its formation is still voluntary. The mean AC size for firms with AC was 3.17 members. These results are consistent with findings from Palestine, e.g., Asmar et al. (2018) and EL-Nabi (2016), Jordan (AbuSiam (2015)), and the United Kingdom (Habbash, 2010), who found that the mean AC size was around three members. The findings also indicate that more than half (52.5%) of the listed non-financial firms have not complied with the recommendation of the PCCG to establish an AC (Alia et al., 2020).

Table 6 also shows that AC independence for the entire sample was still low, *M* = 0.34. On the other hand, the mean AC independence for firms with an AC was 87 percent. Additionally, the maximum and minimum values of AC independence was 100 percent and 0 percent. The results suggest that some firms have complied with the recommendation of the PCCG as on average, financial experts comprised one-third of the ACs of the firms.

Some firms did not appoint any financial experts in their AC or did not have an AC, hence the minimum value of zero for ACFEXP. This can be attributed to the fact that AC remains optional for listed firms. The mean AFCEXP here is consistent with Salem (2018), who found that around 30 percent of Palestinian firms have financial experts in their AC. However, it is still below other countries, for instance Jordan, where financial experts constitute around 41 percent of the AC of listed firms (AbuSiam, 2018).

Descriptive Statistics of Ownership Structure Variables

Table 7: Descriptive Statistics of the Ownership Structure Variables

Variables	N	Mean	Std. Deviation	Minimum	Maximum
OWNERCONC	232	0.5718	0.2435	0.0000	0.9286
INSTIOWNER	232	0.5681	0.3037	0.0000	0.9588
FOREOWNER	232	0.2477	0.2798	0.0000	0.9241

Note: OWNERCONC = Percentage of stockholders who own more than 5% of the total shares, INSTIOWNER = Percentage of ordinary shares held by institutional investors to total equity, FOREOWNER = Percentage of ordinary shares held by foreign investors to total ordinary shares.

The final set of variables discussed in this paper was ownership structure (Table 7). The values of the variables ranged between zero and one with small standard deviations. Mean ownership concentration (OWNCONC) was 57.18 percent, indicating high ownership concentration. In other words, the listed firms may be controlled by a few investors. For Palestinian firms, Hassan (2016) found that mean ownership concentration was 2.6 investors, while the maximum and minimum values were seven and zero. The table also shows that the maximum and minimum values were 100 percent and zero, which means that some firms were not controlled by blockholders. This finding is consistent with Abdelkarim and Zuriqi (2020), who found that ownership concentration is present in 57 percent of listed non-financial Palestinian firms. They also found that the minimum value of ownership concentration is zero, indicating the dispersion of ownership among stockholders. Dwekat et al. (2018), on the other hand, found the mean ownership concentration to be 65 percent, which is almost similar to the finding of this study. In the United Arab Emirates and Jordan, Hassan et al. (2017) found that ownership concentration is 51 percent on average. Taken collectively, these findings suggest that ownership concentration is a characteristic of Middle Eastern markets.

Table 7 also shows that institutional investors constituted more than half (56%) of investors in the sample firms, whereas foreign investors (FOREOWNER) only owned 25 percent of the outstanding shares. These mean values are consistent with other research in Palestine, e.g., Hassan et al. (2016) and Zaid et al. (2020), who found that institutional and foreign owners make up around 48–52 percent and 25–27 percent of all investors. Ijbara & Khoury (2009), meanwhile, found that mean institutional ownership in Palestine is 43 percent, which is close to this study. According to Saleh, Abdul, and AbuBakar (2018), foreign ownership in Palestine is still minimum, both in terms of quantity and role. This is likely caused by political unrest in Palestine, which creates a risky investment environment that discourages foreign investors.

Conclusion

The findings generally indicate that the CG characteristics and EM practices of Palestinian non-financial firms are approximately similar to those in neighboring countries. However, the maximum values were quite high, and so policy makers, accountancy bodies, and regulators must work together to mitigate EM practices in Palestine.

There was a shortage of cash flow from operating activities among the sample firms, which is likely caused by the unstable business environment. The BOD size of the sample firms is consistent with the recommendations of the PCCG. In this aspect, the firms are generally compliant with the PCCG. They also comply with the PCCG in terms of board meeting frequency, as on average the BOD of the sample firms met six times a year. The BODs of the firms were mostly comprised of non-executive directors. This is a positive finding as it indicates that the BODs of Palestinian firms are highly independent. It also aligns with the PCCG's recommendation to establish a BOD entirely comprised of non-executive directors. The proportion of foreign directors on the BODs of the sample firms is relatively good, considering PEX is still developing and under continuous political instability.

Most of the sample firms have not complied with the PCCG recommendation to establish a remuneration and governance committee. This committee is necessary to assist the BOD in performing their duties by enhancing the quality, credibility, and transparency of financial and administrative transactions.

CEO duality was not an issue among the sample firms, as it was present in only 19 percent of them. This means that 81 percent of the sample firms have complied with the PCCG, which requires the separation of the offices of the CEO and board chairman.

AC remains voluntary for listed firms, and this explains why more than half of the sample firms (52.5%) have yet to establish an AC (Alia et al., 2020). This also means that they have not complied with the PCCG. AC independence was also only found in 34 percent of the sample firms. Some firms have not appointed any financial experts into the AC, while some firms have not established an AC. This situation is perhaps because AC is optional for listed non-financial firms in Palestine.

Finally, the study has descriptively examined the ownership structure of the sample firms. The values of the variables ranged between zero and one with small standard deviations. Mean ownership concentration (OWNCONC) was 57.18 percent, indicating high ownership concentration. In other words, the listed firms may be controlled by a few investors. more than half (56%) of investors in the sample firms, whereas foreign investors (FOREOWNER) only owned 25 percent of the outstanding shares. This is likely caused by political unrest in Palestine, which creates a risky investment environment that discourages foreign investors.

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