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The impact of institutional setting on earnings quality and corporate governance in Bahrain: An exploratory study

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A thesis submitted to the University of Nottingham in fulfilment of the requirements for the degree of Doctor of Philosophy

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Abstract

Prior research defines and measures earnings quality and documents the relationship between corporate governance and earnings quality; however, these measures and relations differ across countries. Agency theory predicts that managers negatively affect the quality of financial reports, and so corporate governance mechanisms have to be used to enhance the quality of financial reports, while institutional theory suggests that financial reporting and corporate governance practices result from coercion by regulators, who impose these practices to improve companies' effectiveness or because they wish to imitate international best practice. Therefore, this thesis investigates different aspects of earnings quality and determines to what extent corporate governance practices can affect the quality of reported earnings in Bahrain. To achieve these objectives, secondary and primary data were collected and analysed.

The findings of the primary data analysis reveal that earnings are used for valuing the companies and debt contracts, and for determining managers' compensation. The findings also indicate that high-quality earnings are sustainable, consistent, repeatable and predictable. Moreover, four main factors determine the quality of reported earnings: "firm characteristics", "corporate governance mechanisms", "macroeconomic condition" and "enforce the financial reporting regulations". Furthermore, five incentives that motivate managers to manipulate reported earnings received strong support from the survey respondents. These were: "to influence stock price"; "to influence executive compensation"; "to avoid violation of debt covenants"; "because there is inside pressure to hit earnings benchmarks"; and "because senior managers fear adverse career consequences if they report poor performance". The existing rules and regulations are adequate; however, more guidance on their implementation is needed.

The findings of secondary data analysis reveal that the expectation that corporate governance practices will enhance the quality of reported earnings was, to a large extent, found to be inaccurate in Bahrain. Moreover, the interviews raised many interesting issues in relation to the effects of corporate governance variables. These findings include: the lack of Board of directors independence, the influence of government on companies' decisions, and the appointment of incompetent board members. Therefore, the findings are not consistent with the assumptions of agency theory that these corporate governance practices can reduce agency costs by aligning the interests of owners with those of the company. However, institutional theory can also be used to interpret these findings. Institutional theory views these practices as resulting from coercion by regulators, who impose these practices to improve the companies' effectiveness, or simply to imitate international best practices.

This study enhances the concept of earnings quality and corporate governance practices by providing new and interesting evidence from a Middle Eastern and Arabic country that has a business environment and regulation system that are different from those of countries considered in the literature. Moreover, this study uses mixed-methods research to provide more insights into the application of financial reporting and corporate governance practices. The findings of this study should be useful for regulators and policy makers in improving the quality of corporate governance mechanisms and reducing the incidence of earnings management in order to improve the quality of reported earnings in Bahrain.

Declaration

I hereby confirm that the work presented in this thesis is my own and original work. I declare that the material of this thesis has not been submitted either in whole or in part for the award of any other degree or diploma at this or any other university.

Abdulla Aljalahma **15/4/2019**

ACKNOWLEDGEMENTS

IN THE NAME OF ALLAH, THE MOST MERCIFUL, THE COMPASSIONATE

Thanks first and last to the Almighty Allah who gave me the strength and perseverance to endure this challenging task. Nothing can be accomplished without His help.

I would like to express my deep and sincere gratitude to my supervisors, Dr. Jing Chen, Dr. Ahmed Derbala and Professor Jane Frecknall-Hughes: I could not have completed the study without their directions and inputs. I am also deeply indebted to Professor Elisabeth Dedman, my former supervisor, for her guidance during the first two and a half years of my PhD. Besides my supervisors, I would also like to acknowledge the constructive criticisms and suggestions offered by my internal assessors: Professor Andrew Stark and Dr. Kemi Yekini.

I am grateful to the University of Bahrain for granting me the opportunity to conduct and complete this research, as well as for its financial support throughout the study.

My deepest gratitude goes to family and friends who have provided continuous support, especially to my parents for their prayers and to my two brothers and sister.

I owe my wife and two beloved children, Khalid and Faisal. My wife has been my companion throughout this long journey far from home and has always offered a comfortable environment for me. Whenever I was uncertain of my future, she trusted me and encouraged me to aim high. Khalid and Faisal always bring me happiness. They are my greatest inspiration and motivation.

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Chapter 1: Introduction

1.1 Introduction

This thesis explores earnings quality and investigates its association with corporate governance mechanisms in Bahraini firms. Specifically, it explores the definition, characteristics, measures, and determinants of earnings quality. Then, using data collected from non-financial firms listed on the Bahraini Stock Exchange, it examines the relation between earnings quality and corporate governance mechanisms, which were implemented in Bahrain in 2011 as part of a reform plan.

This thesis explores earnings quality using semi-structured interviews and questionnaire survey to obtain the perceptions of different stakeholders. In addition, it investigates the role of corporate governance in improving the quality of reported earnings using four proxies for earnings quality: persistence, predictability, smoothness, and abnormal accruals.

The remainder of this chapter is organised as follows. Section 1.2 presents the background, motivation, and objectives of this study. This will assist in identifying the research questions, which are discussed in section 1.3. The research methodology is summarised in section 1.4. Section 1.5 outlines the intended contribution. Section 1.6 concludes the chapter by describing the structure of the remainder of this thesis.

1.2 Background, motivation and objectives

Earnings is a measure of a firm's performance and a key information for different users of financial reports (Lev, 1983). The quality of earnings is of interest to those who use financial reports for decision making and contracting purposes (Armstrong, Guay, & Weber, 2010). For example, the users of financial statements refer to earnings figures to help them to evaluate management's performance, to estimate "earning power" or other amounts they perceive as "representative" of the long-term earning ability of an enterprise, to predict future earnings, or to assess the risk of investing in or lending to an enterprise (Statement of Financial Accounting Standards No. 1, paragraph 47). Therefore, it is important for the reported earnings to be reliable, relevant, and free from manipulation. Low-quality reported earnings can mislead users and lead them to make wrong decisions (Schipper & Vincent, 2003).

Agency theory suggests that conflicts of interest between agent and principal arise due to a divergence of interest and asymmetric information. Managers, as agents, prepare financial reports to discharge their stewardship; and principals use the provided information to reward the agents (Jensen & Meckling, 1976). However, the use of financial information provided by these reports, such as earnings, in contractual agreements may provide incentives for managers to manage earnings, which will result in low earnings quality. Therefore, to mitigate the problem and align the interests of managers with those of shareholders, monitoring mechanisms such as corporate governance should be installed (Shleifer and Vishny, 1986). Good governance mechanisms can control and monitor a manager's opportunistic behaviours and thus reduce information asymmetry between managers and shareholders (Rezaee, 2004).

Recent financial scandals have taught us many lessons. They have brought awareness of the need for more transparency and credibility, and raised the importance of corporate governance to protect stakeholders. Therefore, corporate governance initiatives have been established to improve earnings quality. These governance mechanisms assist in reducing the agency costs resulting from the separation of ownership and management interests. Examples of these initiatives include: principles proposed by the Organisation for Economic Co-operation and Development (OECD), guidance provided by the International Corporate Governance Network (ICGN), and the Guidance on Good Practices in Corporate Governance Disclosure produced by the United Nations.

Many studies have documented the relationship between earnings quality and different corporate governance mechanisms (Gaio & Raposo, 2014). However, prior studies show that the impact of corporate governance on earnings quality varies from one country to another, according to the characteristics of the institutional setting. Researchers find, for instance, that the mechanisms of corporate governance are influenced by the country's culture, ownership structure, the legal system, business environment and other contextual factors (Leuz & Wysocki, 2016; Isidro, Nanda, & Wysocki, 2016).

Scholars claim that accounting and corporate governance are social and institutional practices, and these practices interact with the institutional context (Miller, 1994; Hopwood, 2000; Aguilera & Jackson, 2003; Potter, 2005). There are calls in the accounting literature for financial reporting to be studied within its broader social and institutional setting (Arnold, 2009; Hopwood, 2000; Power, 2009; Wysocki, 2011; Hopper et al., 2017) and, similarly, for studies of corporate governance to consider its institutional context (Aguilera & Jackson, 2003; Dedman & Filatotchev, 2008; Filatotchev et al., 2013). However, the institutional environment has been largely ignored within the literature that covers financial reporting and corporate governance.

Researchers argue that financial reporting and corporate governance practices vary between countries. These variations result from the differences in their: ownership structure, financing system, colonial inheritance, accounting profession, economic development, legal system, culture, history, geography, religion, language, political system, and social climate (Gray, 1988; Nobes, 1998; Nobes and Parker, 2010). Thus, although financial reporting and corporate governance practices have been standardised to some extent internationally, they still differ from one national institutional context to another.

However, little research has tried to capture the effect of these contextual characteristics on earnings quality and its relationship with corporate governance mechanisms (e.g. Abdul Rahman & Ali, 2006). Therefore, this study attempts to fill gaps in the literature by exploring earnings quality and investigating its association with corporate governance mechanisms in Bahrain. Bahrain is a developing country with an emerging capital market. It has some unique characteristics, such as the ownership structure and culture, which have an impact on these financial reporting and governance practices.

Bahrain depends on oil exports as a main source of income. However, the oil-exporting countries, including members of the Organization of the Petroleum Exporting Countries (OPEC), do not have control over oil price and the quantity of production anymore. Consequently, oil has become an unstable source of income. Therefore, Bahrain has started reform that aims to diversify its sources of income and reduce its oil-dependency. It has sought to enhance its profile in the international market and to attract foreign investment. Two of these changes have been the adoption of international corporate governance in 2011 and of financial reporting practices and standards in 2001, and, in light of the discussion above, some of the contextual factors applying in Bahrain would be expected to have affected their implementation.

What makes Bahrain uniquely interesting to study are the particular institutional characteristics that impact the implementation of these practices and standards and consequently the quality of earnings and corporate governance mechanisms. There are differences between Bahrain and the developed countries where these practices and standards were developed, and where most studies of the adoption and implementation of these practices and standards have been conducted. Bahrain's culture and institutional environment are strongly influenced by Arab-Islamic values and Bedouin (tribal) traditions. Moreover, the legal system in Bahrain reflects Islamic concepts of ownership and business culture in general, and it is understood in terms of collectivist benefits. Furthermore, the ownership structure in the Bahraini market plays an important role, as the government and a few dominant families ownership in firms are common (Al-Shammari et al., 2008; Jaber, 2000). This kind of ownership makes the corporate governance challenge more of a conflict between majority and minority shareholders. In addition, the government is involved heavily in Bahraini markets as both regulator and shareholder. The political system in Bahrain has an implicit influence over the whole business environment.

Accordingly, this study has two main research objectives. The first involves understanding earnings quality in Bahrain. This will include understanding: the usage of earnings, the definition of earnings quality, measures and characteristics of earnings quality, the impact of standard setting on earnings quality, techniques used to manage earnings and the motives behind them, the red flags used to detect earnings management, and the determinants of earnings quality. The second research objective is to examine the role of corporate governance mechanisms in improving earnings quality in Bahrain.

1.3 Research questions

The main aim of the study is to explore earnings quality and to determine the extent to which corporate governance mechanisms can improve the quality of earnings in Bahrain. To achieve the aforementioned aim and objectives, this study should answer the following research questions:

- How can earnings quality be defined in Bahrain? What are the characteristics of high-quality earnings in Bahrain? What factors can influence the quality of reported earnings in Bahrain? What policies or regulations promote high-quality earnings in Bahrain? What are the indications for low-quality earnings in Bahrain?
- To what extent do corporate governance mechanisms improve earnings quality in Bahrain?

1.4 Research methods

Previous studies of corporate governance and financial reporting have mainly relied on a positivist methodology (and mainly used a quantitative research approach); however, these studies could not examine the functionality of corporate governance and financial reporting practices along with their interactions with the institutional environment. Researchers have called for further studies that provide insights into the application of corporate governance and financial reporting practices by adopting an in-depth qualitative research approach (Parker, 2007; McNulty et al., 2013).

This study adopts pragmatism as its philosophical approach. Pragmatism argues that the most important determinant of the research methodology adopted is the research questions. The pragmatism perspective confirms that it is perfectly possible to integrate different positions that are highly appropriate for the study (Saunders et al., 2009). Pragmatism is particularly suitable for mixed-methods research (Creswell & Plano Clark, 2011).

Financial reporting and corporate governance are viewed as social practices. Therefore, in order to gain a better understanding of the processes and outcomes of adopting and implementing these practices, a mixed research methodology is required. Qualitative research is able to explore the relevant issues within the institutional setting, which can provide a rich explanation for the phenomena under investigation. Therefore, semi-structured interviews were conducted to gain insights into issues related to the quality of reported earnings in Bahrain. Following the interviews, a questionnaire survey was used to seek perceptions of different aspects of the quality of reported earnings in Bahrain to supplement the information gathered from the interviews and to gain further insights. Finally, the primary data were used to develop hypotheses regarding the relationship between corporate governance and earnings quality in Bahrain, and these hypotheses were then tested using secondary data.

1.5 Intended contribution

This study will contribute to both the financial reporting and the corporate governance literature and knowledge in several ways. It will provide a theoretical contribution through the exploring of the potential impact of corporate governance on the quality of financial reporting from an institutional perspective. The study will shed light on how corporate governance practices affect the quality of financial reports, taking into consideration the contextual or environmental factors that shape these practices. It will improve our understanding of the institutional factors that influence financial reporting and corporate governance practices, which in turn affect the quality of reported earnings. Moreover, it will provide suggestions that institutional theory can complement agency theory in describing a number of financial reporting practices. It will show how using institutional theory to describe corporate governance practices in developing countries like Bahrain is more appropriate than using agency theory alone. Furthermore, this study will explore the influence of some interesting corporate governance mechanisms, which have been investigated little in the literature, on earnings quality. Examples of these mechanisms include: the presence and independence of a remuneration and nomination committee, and existence of political connections within the board of directors.

This study is also expected to contribute to the methodological development in the field of financial reporting and corporate governance. It will provide a practical example of how qualitative and quantitative research approaches can be combined and integrated to investigate a specific phenomenon. Although many researchers supported the combination of research approaches in financial reporting, research has been dominated by positivism and the use of mostly quantitative approaches (Modell, 2005; Parker, 2007).

In addition, this study will contribute to the debate on whether it will be possible to harmonise accounting practices and monitoring mechanisms globally. This research will indicate that the efficiency of these practices and monitoring mechanisms differ from one context to another. The reasons for these differences are the contextual characteristics such as legal or regulatory system, accounting infrastructure, business structures, political system, and social and cultural system.

1.6 Structure of the thesis

This introductory chapter has already provided the background to the topic, and the motivation for the study and the research gaps. In light of these gaps, two research objectives and questions have been specified. The methodology and contributions have been briefly discussed. The remainder of this thesis is structured as follows.

Chapter 2 provides an overview of the Bahraini institutional environment. It describes the development of the capital market, the legal system, the financial reporting environment and the development of a code of corporate governance. Chapter 3 presents a review of the literature on earnings quality. It discusses the usage, definition, measures, and determinants of earnings quality, as well as the incentives and techniques used to manage earnings. Then it highlights the research gaps in the literature. Chapter 4 presents a review of the literature on corporate governance and in particular its role in improving earnings quality. It reviews the findings of previous studies to identify how monitoring mechanisms, corporate governance mechanisms and external auditing constrain earnings management and improve the quality of reported earnings; it also highlights the research gaps in the literature. Chapter 5 explains the theories that are related to financial reporting and corporate governance practices and that have been drawn upon in this study. Chapter 6 sets out the methodology adopted in this study. It includes a consideration of the philosophical assumptions, research design and research approach. In addition, it presents the two research phases (qualitative and quantitative) and the procedures followed in collecting and analysing the data. It also explains the hypotheses development based on prior literature. Chapter 7 presents the empirical evidence from the semi-structured interviews and questionnaire survey that are used to answer the research questions concerning different issues related to the quality of reported earnings in Bahrain. Chapter 8 presents the evidence, obtained from the secondary data, for the relationship between earnings quality and corporate governance mechanisms in Bahrain. Chapter 9 summarises the whole thesis. It revisits the research questions, makes some comments on the methodology, and summarises the findings. It presents the study's theoretical and practical contributions, discusses the study's limitation, and suggests areas for future research.

Chapter 2: Overview of Bahrain

2.1 Introduction

It has been argued that accounting in any country is shaped by its environment (Miller, 1994; Hopwood, 2000). Since financial reporting is one of the accounting practices that can be defined as a socio-economic practice, environmental factors that affect managers are also reflected in reporting practices. Factors affecting reporting practices that have been identified in the literature include: business ownership, financing system, colonial inheritance, accounting profession, economic development, legal system, culture, history, geography, religion, language, political system and social climate (Gray, 1988; Nobes, 1998; Nobes and Parker, 2010).

The purpose of this chapter is to explain the Bahraini environment, as it is the context in which this research is undertaken. Accordingly, this chapter is organised as follows. In section 2.2 describes the location, history, peoples and the system of government of Bahrain. Bahraini culture is presented in section 2.3. The economic system and the capital market are discussed in section 2.4. In section 2.5, an outline of the Bahraini legal system is provided. The financial regulatory authorities are presented in section 2.6. Section 2.7 discusses the financial reporting environment, and covers the sources and scope of regulations, the enforcement process and the development of a code of corporate governance. Concluding remarks are given in section 2.8.

2.2 Background of Bahrain

The Kingdom of Bahrain is an independent Islamic Arab state. It gained its independence in 1971 from Great Britain. Bahrain is also home to expatriates who profess Christianity and Hinduism. It is a developing country in Asia, and Manama is the capital city. The modern state of Bahrain dates back to 1783, when the Bani Utbah tribe led by Al Khalifa invaded it from their base in Al Zubarah (Qatar).

Figure 2.1 Map of Bahrain

As Figure 2.1 shows, Bahrain is an archipelago of 36 islands lies in the middle of the Arabian Gulf, between Saudi Arabia and Qatar. It is linked by a causeway (25 kilometres) to Saudi Arabia. Bahrain's land area is approximately 765.3 square kilometres. It has a rapidly growing population (Table 2.1), which was estimated to be 1.43 million in November 2017. Bahrainis constitute approximately 46% of the total population. The local currency is the Bahraini dinar, which is equivalent to £2.02 or US$2.65 (November 2017). The official language is Arabic, while English is used as the business language.

Table 2.1: Bahrain's population, 2005–2016

Year	Total Population	Population Growth (annual %)
2005	889,168	6.90
2006	958,414	7.50
2007	1,035,891	7.77
2008	1,114,590	7.32
2009	1,185,029	6.13
2010	1,240,862	4.60
2011	1,278,269	2.97
2012	1,300,217	1.70
2013	1,315,411	1.16
2014	1,336,397	1.58
2015	1,371,855	2.62
2016	1,425,791	3.81
2017	1494074	4.68
2018	1569439	4.92

The World Bank: World Development Indicators (as of July 2019)

Bahrain is a constitutional monarchy. The current King, Hamad bin Isa Al Khalifa, has appointed his eldest son as the crown prince. The King appoints the government as well. The Bahraini parliament, called the National Assembly, is a bi-cameral legislature, with the Chamber of Deputies (the upper house), with 40 members, elected by universal suffrage, and the Shura Council (the lower house), also with 40 members, appointed by the King. Legislative authority is vested in the King and the National Assembly. Legislation must be passed by a majority in both houses and must be ratified by the King. Executive authority is vested in the King and the Council of Ministers and individual ministers. The Council of Ministers is appointed by the King. The judiciary is divided into two branches: the Shari'a Law Courts and the Civil Law Courts. The Shari'a Law Courts have jurisdiction over issues related to the personal status of Muslims, while the Civil Law Courts deal with civil, criminal and commercial cases, as well disputes related to the personal status of non-Muslims.

Bahrain is a founding member of the Gulf Corporation Council (GCC), whose six member states are among the fastest growing economies in the world through their oil and gas revenues and an investment boom that is backed by these revenues. The GCC was established in May 1981 by six Arab oil-exporting countries: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE. These states share similar socio-cultural characteristics in terms of language, religion and economic system, and they face similar challenges. The motive for establishing the GCC was to increase the collective security of these states during the Iran–Iraq War (1980–1988) and to increase socio-economic cooperation. The initial incorporation of the GCC was effected by the 1981 GCC Economic Agreement, which addressed, among other things: the creation of a free-trade area; the adoption of a common foreign trade policy; a common market, with mobility of capital, commodities and labour; and the coordination of domestic economic policy (Al-Kuwari, 2007).

2.3 The culture of Bahrain

Culture deeply influences every aspect of society and life. It is about behaviour learned or acquired from human responses to environmental conditions and stimuli (McGee, 2008). Hofstede (1984, p. 82) defined culture as "the collective programming of the mind which distinguishes the members of one group or society from those of another". Culture is transferable from parents to their children, leaders to their followers, and teachers to students, and between friends. It is reflected in many aspects of people's lives, including the way they observe the world and collective and personal beliefs.

Bahrain and other GCC countries' cultures are based on Arab-Islamic and Bedouin (tribal) traditions and values. Islam itself, as the common religion within the GCC countries, was the animating principle of numerous great civilisations in Asia, Africa and Europe, and it consequently has well developed religious, legal, political and financial systems (Lewis and Churchill, 2008). Consequently, Islam profoundly affects Bahrain sociocultural dimensions and indeed infrastructure (Collins, 2013). All Islamic states profess to base their constitutions and legal systems on Islamic law (Sharia), deriving legitimacy from conformity with Islamic texts. One cannot understand the business environment in Bahrain and other GCC countries without understanding that Islam is a vibrant force throughout commercial, political and personal life. However, this influence is more often experienced as latent and reflexive behaviour rather than concerted action, and is largely conditioned by the Bedouin tribal values that Islam generally reaffirmed, including generosity, justice, loyalty and status, which are important parameters of individual and group worth in Arab society (Rice, 2003).

Arabs generally have collectivist identities and priorities, which eases their interactions and the creation of large groups. Largely because of their collectivist nature (low individualism) and uncertainty avoidance, Bahrain and other GCC countries are considered as more feminine in the Hofstede (1980) paradigm, whereby people value taking care of others and the quality of life within society as a whole, emphasising cooperation and caring for others as opposed to individual achievement. People in Bahrain are known for their strong relationships and their loyalty to their society and close family ties. By implementing Hofstede's culture dimensions, At-Twaijri and Al-Muhaiza (1996) concluded the following about GCC countries, including Bahrain, with regard to their cultural dimensions:

- Power Distance: GCC countries are known to be ruled by families; therefore, they are politically centralised and consequently their power distance score is high. However, now they are moving towards decentralising by involving people outside the ruling families in top decisions.
- Uncertainty Avoidance: Oil is the main source of revenue for GCC countries. Changing oil prices make them fearful of losing their wealth. This makes GCC citizens risk avoiders.
- Individualism vs. Collectivism: GCC countries are collectivists, as associations to a tribe are valued, as are other forms of association. Moreover, Islam, as the dominant religion, emphasises unity, as people are rewarded and urged to help and care for each other.
- Masculinity vs. Femininity: GCC countries are feminine as they are affected by their religion and tribal system that emphasises cooperation and caring.

2.4 Economy and capital market

Before the 1930s, pearl fishing was the mainstay of Bahrain’s economy. In 1932, the Bahrain Petroleum Company discovered oil. The discovery brought gradual changes to social and economic life. Bahrain’s economy is now primarily based on petroleum processing and refining (Joshi & Wakil, 2004). The boom in oil prices in the 1970s was an enormous boost to the country's economy (Joshi & Wakil, 2004) but fluctuations in oil prices can impact the Bahraini economy significantly. For example, the decline in oil price from the second half of 2014 onwards has resulted in some challenges for the Bahraini economy. At the moment Bahrain is experiencing low growth and has a high fiscal deficit (EY, 2016).

Figure 2.2 shows the oil and gas contribution to the Bahraini government's revenues for the years from 2009 to 2018. It can be noted that oil and gas contribute more than 75% of the total revenues; this peaked at 86% to 88% from 2011 to 2014 because of the increase in oil prices on the global market.

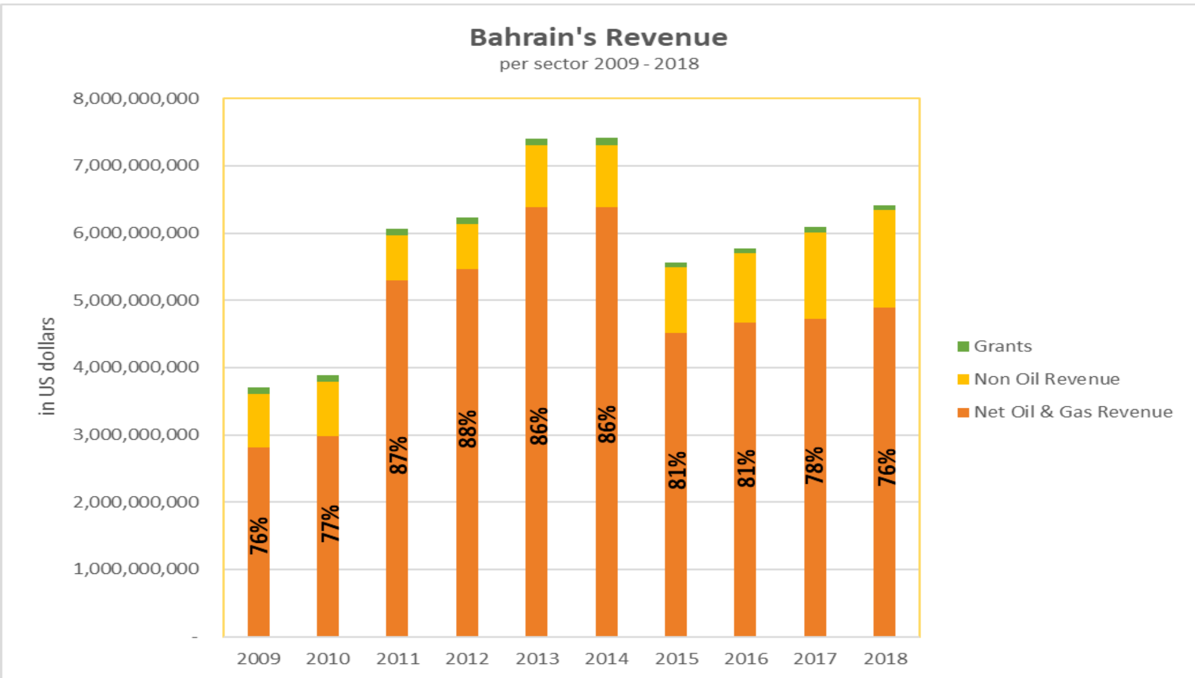


Figure 2.2. Bahrain's revenue, by sector, 2009–2018

Source: Bahrain Ministry of Finance

To characterise the Bahraini economy further, Table 2.2 presents some economic indicators for the period 2005–2016, namely gross domestic product (GDP), GDP growth, GDP per capita, gross national income (GNI), the time required to start a business and net foreign direct investment inflows.

Table 2. 2: Economic Indicators

Year	GDP (current US$)	GDP growth (annual %)	GDP per capita (current US$)	GNI (current US$)	Time required to start a business (days)	Foreign direct investment, net inflows (current US$)
2005	15,968,726,862	6.77	17959.18	15,555,428,989	–	1,048,601,306
2006	18,505,053,191	6.47	19308	18,119,148,936	–	2,914,659,868
2007	21,730,000,000	8.29	20977.11	21,431,329,787	9.4	1,756,312,515
2008	25,710,877,660	6.25	23067.57	24,787,207,447	9.4	1,793,998,355
2009	22,938,218,085	2.54	19356.67	20,538,484,043	9.3	257,149,561
2010	25,713,271,277	4.33	20722.1	23,340,132,979	9.3	155,771,009
2011	29,157,446,809	1.98	22810.1	25,392,819,149	9.3	780,851,064
2012	30,749,308,511	3.73	23649.37	26,912,308,511	9.3	154,468,0851
2013	32,898,670,213	5.42	25010.18	28,613,829,787	9.3	3,727,712,766
2014	33,387,712,766	4.35	24983.38	27,723,712,766	9.3	1,518,617,021
2015	31,125,851,064	2.86	22688.88	29,389,851,064	9.4	64,893,617.02
2016	32,250,132,979	3.47	22354.17	30,063,031,915	8.3	243,351,063.8
2017	35,432,686,170	3.8	23716	33,443,324,468	8.3	518,882,978.7
2018	37,746,196,809	1.8	24050	35,670,132,979	8.3	…

The World Bank: World Development Indicators (as of July 2019)

Bahrain is considered a financial hub in the Middle East and North Africa (MENA) region (Joshi et al., 2008). It was one of the earliest GCC countries to open its markets to foreigners; non-GCC nationals have been allowed to own up to 49% of some businesses (MENA-OECD, 2011). Bahrain has recently witnessed many reforms, including in its business sector. Fluctuations in oil prices (the main source of income), coupled with the uncertainty-avoidance culture of Bahrain, have led to reforms that aim to diversify the sources of national income by attracting foreign and local investors (Fakhro, 2010). One of these reforms is the establishment of the Economic Development Board (EDB), which formulates and oversees the economic development strategy of Bahrain, and aims to create the right climate to attract foreign direct investments into the country (www.bahrainedb.com). Currently, five main sectors are targeted by the EDB: financial services, information and communications technology, logistics, manufacturing, and tourism.

The EDB supports Bahrain in moving towards building a free market economy in order to enhance the private sector activities (Shoult,Terterov & Wallace , 2008). The EDB was the initiator of the 2002 privatisation law, designed to establish a knowledge-based services economy (Shoult et al., 2008) with the private sector as the engine of economic growth. The privatisation programme covers the service and production sectors, particular communications, electricity and water, tourism, transport, ports and airports, oil and gas services, and postal services (Shoult et al., 2008). Some state-owned industries have already been privatised, such as transportation and telecommunications.

The existence of a capital market can influence the investment environment, as it will determine the nature, type and availability of information required by investors, as well as financial reporting practices (Doupnik and Salter, 1995). The Bahrain Stock Exchange (BSE), established in 1987, is one of the oldest in the region. In 2010, Bahrain Bourse (BHB) replaced the BSE as a self-regulated multi-asset marketplace. Bahrain Bourse aims to offer issuers, investors and intermediaries a suit of exchange-related facilities, including trading, listing, deposit and settlement services for various financial instruments (www.bahrainbourse.com). Table 2.3 presents the number of companies listed in the Bahrain capital market and the total market capitalisation for the period 2005–2014.

Table 2.3: Number of listed companies and total market capitalisation

Year	No. of listed companies	Market CAP ($million)
2005	40	17,366
2006	43	21,122
2007	44	27,016
2008	45	19,947
2009	44	16,263
2010	44	20,061
2011	44	16,589
2012	43	15,533
2013	43	18,469
2014	44	22,068
2015	44	19251
2016	43	19394
2017	42	21706
2018	43	21863

The World Bank: World Development Indicators

2.5 Legal system

A country's legal system plays an important role in effecting its regulations and practices. From the 18th century, Bahrain's legal system was based on that of the UK, the colonial power. British extra-territorial jurisdiction was introduced in parallel to the local jurisdiction (Islamic law – Shariah) in order to govern non-Muslim residents of the British entrepôt in the Arabian Peninsula. The local authorities extensively adopted legislation from the colonial government of India and final appeal decisions of the Privy Council in England. This situation persisted until independence in 1971, but even thereafter Bahrain has still continued to develop its codified legal systems within the parameters of the British system (Al-Suwaidi, 1993).

Since December 1973, the Constitution of Bahrain has been the legal and political foundation of the state. The Constitution has parts covering the state and government system, society, public rights and duties, powers, and general provisions. The Bahraini legal system is based on a hybrid of: Islamic law; Egyptian civil, criminal and commercial codes; principles drawn from British common law; and local traditional customs (Bassiouni et al., 2011).

In 1992, the Consultative Council (Shura Council) was established by an order of the King. It aims to improve the functions and performance of the Council of Ministers with regard to the drafting of legislation. It initially consisted of 30 members appointed by the King. In 2002, a new Constitution was drafted on the request of the new King. A Ministerial Committee and some Egyptian constitutional experts were appointed to make amendments to the 1973 Constitution. The changes were related to a change in the country's name from State to Kingdom and to change the Legislative Chamber. The new Legislative Chamber (National Council) consists of two chambers, one representing the citizens, known as the Council of Representatives, and the other appointed by the King, known as Consultative Council (Shura Council). Through a referendum held on 14 and 15 February 2001, the people of Bahrain approved the amendments. On 14 February 2002, the new Constitution was introduced to the Amir who immediately issued and published it on the same day. Article 2 of the new Constitution provides that the Islamic Shariah is the main source of legislation; general matters and private transactions are governed by laws derived from modern legislation (Radhi, 2015).

However, there were some problems in the National Council in relation to new legislation proposed by the Council of Representatives, as its powers were equal to those of the Consultative Council. As a result, constitutional amendments were made in 2014 and more power was given to the Council of Representatives. Now, any decisions on legislation by the National Council need to be approved by a majority of the Council of Representatives, and it has more power than the appointed Consultative Council.

According to the new Constitution, the court system in Bahrain comprises Civil Courts, Islamic Courts and Military Courts. The Civil Courts are divided into four tiers: the Lower Courts, the Higher Civil Courts, Supreme Civil Courts of Appeals and finally the Court of Cassation (Bassiouni et al., 2011). These courts settle all civil, criminal and administrative cases, including personal cases involving non-Muslims. The Islamic Courts are divided into two jurisdictions: Sunni and Shia Jaafari jurisprudence. The Military Courts rule on crimes committed by members of the Bahrain Defence Force, the National Guard and public security officials (Bassiouni et al., 2011). The Public Prosecution is an integral branch of the judiciary charged with initiating criminal proceedings, besides overseeing the work of law enforcement officials and administering prison and detention facilities (Bassiouni et al., 2011).

With regard to the laws and regulations governing the business sector, the importance of Bahrain as a centre for the international banks and companies has forced the government to make strides in the legislation governing commercial companies (Al Baharna, 1994). The 1975 Law of Commercial Companies was replaced by a new law in 2001, the Law of Commerce was promulgated in 1987, and the Commercial Agency Law was promulgated in 1992 (amended in 1998). In 1973 the Central Bank of Bahrain (formerly Bahrain Monetary Agency) was established to monitor the banking sector as well as the operation of all other financial institutions. Furthermore, in 1987 the new Bahrain Stock Exchange Law stated that a Stock Exchange should be established as a separate legal entity and carry out its activities in accordance with the provisions of this law. The Bahrain Centre for International Commercial Arbitration was constituted in 1993 in order to render all services related to arbitration in commercial disputes at an international level (Fouchard et al., 1999). Later, in 1994 the Law on International Commercial Arbitration (UNCITRAL Model Law) was adopted; it applies to international arbitration unless the parties opt out. In 2009, the Bahrain Chamber for Dispute Resolution (BCDR-AAA) was established as an independent dispute-settlement institution. The BCDR-AAA, in partnership with the American Arbitration Association (AAA), provides commercial and governmental users contracting in the Gulf and beyond with solutions to economic, financial and investment disputes (www.bcdr-aaa.org).

2.6 Financial regulatory authorities

2.6.1 The Ministry of Industry, Commerce and Tourism

The Ministry of Industry, Commerce and Tourism handles the registration of all companies and branches of foreign companies as well as commercial agencies. Through its Directorate of Companies Control, it encourages new investment and provides existing businesses with the support needed for growth. The Directorate's main objectives are: to ensure that companies are in compliance with the Commercial and Companies Law and maintain good corporate governance; to maintain accurate records on companies, their operational characteristics and financial results; to monitor sectoral performance; to produce statistics, trend analysis and policy indicators; to link with other regulatory bodies inside and outside Bahrain; and to encourage and support companies and keep them informed about new developments (www.moic.gov.bh).

The Ministry regulates and supervises companies in accordance with the Commercial Companies Law and the provisions of companies' articles of association. The Commercial Companies Law provides the Ministry with the administrative and judicial authority to take any necessary measure against any violations. Article (351) of the Commercial Companies Law states: "The duties of supervision, attendance of the general assemblies and drafting reports on violations of the provisions of this law shall be undertaken by whomever the Minister of Commerce and Industry designates for this purpose, who shall have the powers of judicial enforcement. The reports shall be submitted to the general prosecutor upon a decision by the Minister of Commerce and Industry or by whomever the Minister designates".

2.6.2 The Central Bank

The Central Bank of Bahrain (CBB) is a public body established in accordance with the Financial Institutions Law 2006. The CBB succeeded the Bahrain Monetary Agency, which was established in 1973. It is responsible for maintaining monetary and financial stability in Bahrain and acts as the single integrated regulator for the financial services sector. Article 4 of the Law specifies the CBB's duties and powers, which include: the issuance of the national currency; the licensing, regulation and supervision of persons undertaking regulated financial services, including those governed by Islamic Shariah principles; management of the government's reserves of gold and foreign currency; and safeguarding the interests of licensees' customers.

The CBB is the single regulator of the entire financial system in Bahrain. Therefore, its scope of responsibilities is not limited to financial services institutions (i.e. banks, investment firms, insurance firms, brokers, money changers, ancillary service providers, etc.) but it also regulates Bahrain's licensed exchanges and clearing houses and acts as Listing Authority for companies and financial instruments listed on the exchanges, as well as as conduct in Bahrain's capital market (Arvai & Prasad, 2014). Through its Capital Markets Supervision Directorate (CMSD), the CBB supervises and regulates the capital markets in Bahrain. The CMSD attempts to comply with international standards, especially those of the International Organisation of Securities Commissions (IOSCO), in regulating the capital market. In 2008, Bahrain became a signatory to the IOSCO Multilateral Memorandum of Understanding (MMOU) after the MMOU was reviewed by the IMF (www.cbb.gov.bh).

As a regulatory and supervisory authority, the CBB issues regulatory instruments which make the licensees and other specified persons legally obliged to comply. These instruments are contained in the CBB Rulebook. The CBB Rulebook is comprises seven volumes, covering different financial service activities, including activities undertaken by: conventional bank licensees and Islamic bank licensees, insurance licensees, investment businesses, specialised licensees, capital markets, and collective investment undertakings.

Breach of the CBB Rulebook can lead to sanctions. These can range from a formal warning to cancellation or amendment of a licence. In extreme cases, it can result in criminal proceedings. Article 114 of the CBB Law provides the Governor of the Bank with the right to assign CBB officials or others to inspect a licensee or listed company, to ensure compliance with the law and regulations. Article 115 of the CBB Law provides the CBB's officers with the capacity of "Jurisdiction Investigation Officers" with respect to criminal offences.

2.6.3 Bahrain Bourse

In 1987, the Bahrain government established the Bahrain Stock Exchange, which is the predecessor of Bahrain Bourse. In 2010, Bahrain Bourse was established as a shareholding company to replace the BSE (www.bahrainbourse.com). Bahrain Bourse is a self-regulated multi-asset marketplace. It is required to follow the Central Bank and Financial Institutions Law, as the Central Bank is the official regulator for any licensed exchanges and clearing houses in Bahrain. Bahrain Bourse reports to the Capital Market Supervision Directorate within the Central Bank.

Bahrain Bourse aims to provide comprehensive exchange-related facilities, including listing, trading, settlement and deposit services for various financial instruments and different investors, issuers and intermediaries (www.bahrainbourse.com). It is responsible for the implementation of the trading, clearing and settlement rules, and for monitoring the prices of securities. Bahrain Bourse has joined several international organisations such as the Federation of Euro-Asian Stock Exchanges, the World Federation of Exchanges, the Union of Arab Stock Exchanges, the Africa and Middle East Depositories Association and the Association of National Numbering Agencies, which enables Bahrain Bourse to strengthen its position within the global markets (www.bahrainbourse.com).

2.6.4 Bahrain Accountants Association

The Bahrain Accountants Association was established in 1971 and it is considered to be one of the oldest of such associations in Bahrain and in the region (www.bahrainaccountants.com.bh). The main objectives of the Association are (www.moic.gov.bh):

- to provide professional supervision and control over its members to improve their professional standards in accordance with the accounting standards and safeguard their rights;
- to serve the economy by developing the concepts of the accounting profession in Bahrain;
- to cooperate with relevant associations and institutes within and outside Bahrain;
- to update its members on the accounting standards and any further information, as well as in the area of auditing;
- to oversee accounting and auditing research;
- to arrange seminars and workshops that can assist in achieving the Association's objectives.

The Association provide comments and recommendations to regulatory bodies in Bahrain, but it does not have any power or authority to enforce any requirements related to the accounting and auditing profession (Al-Ajmi, 2009).

2.7 Financial reporting law and enforcement mechanisms

2.7.1 Legislation

Financial reporting in Bahrain is governed by the Company Law and the Central Bank of Bahrain Law. These pieces of legislation contain provisions that cover corporate activities relating to the formation, operation, dissolution and liquidation. With regard to financial reporting requirements, the emphasis is on protecting the users of financial reports by requiring firms to maintain proper books and prepare audited annual financial statements. The legislation does not specify the content or format of the financial statements but it requires at least the annual balance sheet and profit and loss statement to be submitted to the firm's shareholders, and that these reflect a "true and fair view" of the firm's position. The annual audited financial statements and quarterly financial reports must be submitted to the regulatory bodies. Table 2.4 provides some information on the reporting requirements.

Table 2.4: Financial Reporting Rules and Regulations

Company law	Securities and exchange law	Company registrar	Financial statements to be prepared	To whom should financial statements be submitted	Submission deadline	Guidelines for preparing financial statements
Company Law No. 28 of 1975, replaced by Law No. 21 of 2001	Central Bank of Bahrain and Financial Institutions Law 2006	Ministry of Industry, Commerce and Tourism	Balance sheet and profit and loss statement	All Shareholders, Registrar of companies, Bahrain Bourse, Capital Market Directorate (Central Bank), and Central Bank (for financial institutions)	Annual reports should be submitted within three months from year-end and quarterly reviewed financial statements within two months from the quarter-end	Must provide a true and fair view

Source: Al-shammari, B. (2005) and Ministry of Industry, Commerce and Tourism (http://www.moic.gov.bh)

Bahrain Bourse listing regulations, on the other hand, govern the listed firms, monitor the issuing process, specify the rights and responsibilities of directors, and support and develop the capital market. Bahrain Bourse requires listed firms to comply with the Company Law and Central Bank of Bahrain Law, in addition to meeting the disclosure requirements contained in the securities regulations. These include that each listed firm must submit annual audited financial statements and quarterly financial reports to the Bourse.

2.7.2 Accounting and auditing standards

The government in Bahrain regulates the financial reporting and control the accounting and auditing profession. The Bahrain Accountants Association has no regulatory power to license accountants and auditors or to formulate accounting and auditing standards (Al-Shammari et al., 2008). The Ministry of Industry, Commerce and Tourism is the body that issues these licenses. The rapid growth and opening up of the capital market in Bahrain, the presence of multinational corporations and the ambition to attract such more companies led Bahrain to adopt the International Accounting Standards (IASs). This meets the interests of shareholders, as international investors demand detailed information and greater comparability in financial reporting (Al-Basteki, 2000). The adoption of IASs has been required since 1996, with the passing of the External Auditing Law No. 26 of 1996.

The External Auditing Law regulates the auditing profession. Audits can be conducted only by government-certified and licensed auditors. Auditors are not required to take any exams or do minimum training, but they have to have working experience. External auditors are responsible to the regulators and any other related parties; therefore, penalties may apply where the auditors breach a regulation (Al-Shammari et al., 2008). External auditors may be subject to disciplinary proceedings by the Ministry of Commerce if they violate regulations related to financial reporting or professional norms, or if they commit an act of negligence or a dishonourable act (Al-Shammari, 2005).

2.7.3 Enforcement

In Bahrain, the Directorate of Companies Control of the Ministry of Commerce, the Capital Market Directorate of the Central Bank and Bahrain Bourse primarily rely on the external auditor’s report in monitoring companies’ compliance with the international accounting standards in preparing their financial statements. These regulatory bodies check the companies' compliance with the laws and regulations and communicate with the external auditor if they have any concerns or if the auditor issued only a qualified audit report. If there is an issue with the company's financial statements, the regulators advise the company's management to take certain actions to correct the situation. If the company's management refuses to take the correct steps, then the regulators will raise the issue with the company's shareholders at the annual general meeting.

During their monitoring process, regulators have the capacity (by law) to request detailed information about the company, including its disclosed information and news. They have the power to submit enquires to the regulated companies and receive their response in a timely manner. In addition, the three regulatory parties prepare a set of financial statistics for all regulated companies on a regular basis; therefore, the companies should collaborate by providing any required information.

2.7.4 The development of corporate governance

Bahrain is a financial capital in the Middle East, enjoying its geographical location between Asian and European markets. It has launched a wide range of economic plans aimed at diversifying the economy and stimulating growth and stability (Mousa & Desoky, 2012). In order to create a healthy business climate that attracts foreign investment, protects investors and other stakeholders, and enhances companies' value, Bahrain promotes corporate governance principles. Before the code get established, Bahraini Companies law have in place some features of international corporate governance best practices which are implemented by the listed companies (Hussain and Mallin, 2002). For instance, listed companies' boards are dominated by non-executive directors, majority of companies have an audit committee, some companies have a remuneration committee but none has a nominations committee, the boards are meeting 4.4 times a year on average, and a succession plans are in place for some companies (Hussain and Mallin, 2003).

The Bahraini code of corporate governance was established by the Ministry of Industry, Commerce and Tourism, the Central Bank of Bahrain and the National Corporate Governance Committee through a consultative process in 2011. It has been in operation since January 2011, and by the end of 2011 all companies to which the code applies should be in full compliance.

The principles underpinning the Bahraini code of corporate governance is in line with the principles of the Organisation for Economic Co-operation and Development (OECD). These principles are embedded in the laws and regulations. For instance, Article (4) of the Commercial Companies Law states that “Any commercial company of whatever type incorporated or based in Bahrain shall be subject to the provisions of this Law’’. The corporate governance provisions can be found in the Commercial Companies Law, the Central Bank of Bahrain Law, the Central Bank of Bahrain Rulebook and the Law to establish and organise the Bahrain Bourse.

The code is based on principles that adhere to international best practice. The code has a “comply or explain” framework, which means companies should comply with the recommendations or provide an explanation for why they are not doing so. The code comprises the following nine core principles of corporate governance: the company shall be headed by an effective, collegial and informed board; the directors and officers shall have full loyalty to the company; the board shall have rigorous controls for financial audit, internal control and compliance with law; the company shall have rigorous procedures for the appointment, training and evaluation of the board; the company shall remunerate directors and officers fairly and responsibly; the board shall establish a clear and efficient management structure; the board shall communicate with shareholders and encourage their participation; company shall disclose its corporate governance; and companies which refer to themselves as "Islamic" must follow the principles of Islamic Sharia (Bahrain Corporate Governance Code, 2010). Table 2.5 presents the main corporate governance issues addressed by the Bahraini code of corporate governance.

Table 2.5: Main Issues Addressed by Bahrain code of corporate governance

	Issue	
Board composition	Non-executive directors	At least 50 percent of the board should be non-executive
	Board independence	At least three independent directors. One-third should be independent in companies with a controlling shareholder
	Roles of the Chairman and CEO	Must be separate
	Board size	Not more than 15 members
	Meeting frequency per year	At least four times
	Nomination procedure	In nominating board members, the nomination committee should consider any criteria approved by the board such as judgement, specific skills, experience with other comparable businesses, and the relation of a candidate's experience to that of other board members
	Succession planning	At least annually, the board should review and concur on a succession plan, addressing the policies and procedures for selecting a successor to the CEO. The succession plan should include an assessment of the experience, performance, skills, and planned career paths for possible successors to the CEO
Independence of board members	Being former employees or senior executives	Employee or senior executive within the preceding one year
	Material business relationship directly or as a partner, shareholder, director, or senior employee of a body that has such a relationship	A financial relationship amounting to 31,000 BD within the preceding one year
	Has received or receives additional remuneration from the company, apart from a director's fee	A financial relationship amounting to 31,000 BD (not counting director's remuneration) within the preceding one year
	Has close family ties with any of the company's advisers, directors, or senior employees	A family connection with 5 per cent ownership within the preceding one year
	Represents a significant shareholder	Connected to a shareholder holding more than 10 percent of voting shares within the preceding one year
	Holds cross-directorships or has significant links with other directors through involvement in other	Not stipulated

	companies or bodies	
	Long board tenure	Serving more than six years is considered relevant to the determination of independence
Board training and development	Induction	The chairman of the board shall ensure that each new director receives a formal and tailored induction, which should include meetings with senior management, visits to company facilities, presentations regarding strategic plans, significant financial, accounting and risk-management issues, compliance programmes, its internal and independent auditors, and legal counsel
	On-going development	All directors shall continually educate themselves as to the company's business and corporate governance
	Board evaluation	The board should conduct an evaluation of its own performance, as well as the performance of its committees and its individual directors
Board committees	Audit	Yes
	Nomination	Yes
	Remuneration	Yes
	Corporate governance	Yes
	Risk management	Yes
	Executive	Yes
	Investments	Not stipulated
Audit Committee	Composition	At least three members
	Independence	Majority independent
	Committee Chair	Independent non-executive director
	Financial experts	Majority should be financial experts
	Other	Non-board members (experts) can be appointed
	Meeting frequency per year	At least four times
	Terms of reference	Not stipulated
Audit committee duties	Monitor the integrity of the financial statements	Yes
	Monitor the effectiveness of the internal audit function	Yes
	Recommend the appointment of the external auditor	Yes
	Non-audit work carried out by the auditor	The audit committee should determine whether the auditor's independence was compromised by non-audit work. The committee may establish a formal policy specifying the types of non-audit services that are permissible
	Auditor rotation	Not stipulated
	Whistle-blowing	The board should adopt a "whistle-blower" programme, under which employees can confidentially raise concerns about possible improprieties in financial or legal matters
Risk management	Accountability	The audit committee should review risk management systems
	Other	Directors' induction should include presentations regarding risk management issues
	Internal audit risk management	The internal auditor's duties include a review of the adequacy and effectiveness of the company's risk management process
	Disclosure	The management discussion and analysis report, included in the annual report, should identify and comment on the management of principal risks and uncertainties faced by the business
Remuneration	Remuneration committee	The remuneration committee should make recommendations on remuneration policies
	Remuneration guidelines	All performance-based incentives should be awarded under written, objective performance standards that have been approved by the board and are designed to enhance shareholder and company value, and under which shares should not be vested and options should not be exercisable within the first two years of the date of award of the incentive
	Disclosure	The company should disclose the remuneration paid to each board member, divided into sitting fees and other remuneration (split between performance- and non-performance-based). Remuneration paid to each person in the executive management divided in each case into salaries, perquisites, bonuses, gratuities, pensions, and any other components. Details of stock options and performance linked incentives available to senior executives. The remuneration policy
	Shareholder approval	Shareholders should approve the remuneration policies and all performance-based incentive plans
Corporate social responsibility	Code of ethics/conduct	The company should disclose whether the board has adopted a written code of ethical business conduct, and if so the text of that code and a statement of how the board monitors compliance
	Corporate social responsibility	Not stipulated
	Charitable giving	Not stipulated

Source: Bahrain Code of Corporate Governance (2010) and Shehata (2015)

2.8 Conclusion

The Kingdom of Bahrain is an independent Islamic Arab state. The culture of Bahrain is based on Arab-Islamic and Bedouin (tribal) traditions and values. Islam, as a framework, plays a key role in its social life and business environment. Bahrain's society and economy developed from pearl fishing to become stronger after the discovery of its petroleum reserves. The legal system in Bahrain is managed by Islamic Sharia, but it has adopted many regulations and rules that derived from the UK's regulations.

This chapter has highlighted the main monitoring devices which play an important role in regulating and developing the Bahraini business environment. Moreover, important laws and regulations, such as Companies Law, the Central Bank Law, and accounting and auditing laws are discussed.

Overall, this chapter provided a concise view of Bahrain's culture, the legal system, economic situation, and regulations and monitoring devices related to the business environment. The following chapter will discuss the literature in relation to earnings quality and corporate governance.

Chapter 3: Review of the Literature on Earnings Quality

3.1 Introduction

The previous chapter presented a brief background on Bahrain, including: the economic system and capital market, the legal system, the financial reporting environment, and the code of corporate governance. This chapter reviews the literature related to earnings quality, while the next chapter will focus on the role of corporate governance in improving earnings quality. This chapter is organised as follows: section 3.2 describes the use and quality of financial reports generally, and section 3.3 discusses earnings quality specifically, including its definition and measures. Section 3.4 discusses the incentives for earnings management. Section 3.5 describes the techniques ("red flags") used to manage earnings. The concluding remarks, including a discussion of the gaps in the literature, are made in section 3.6.

3.2 Financial reporting

Financial reporting is a useful mechanism through which managers communicate with outside parties such as creditors, investors and regulators. Financial reports should present useful information to assist different parties in making economic decisions. This is in line with the objectives of financial reports proposed by International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) in their statements on financial accounting.

To make the financial reports useful for decision making, managers (as preparers of financial reports) should communicate the information and ensure its reliability and relevance. Reliable and relevant information supplied by financial reporting provides confidence in capital markets (Armstrong et al., 2010). However, the ability of financial reports to provide sufficient and appropriate information for different users is questionable.

Distortions in financial reports have been created because of the conflicts of interests between managers and outside parties. Managers can manipulate financial reports to achieve and maximise their own interest. This can occur when their objectives are different from those of other stakeholders. Some studies provide evidence supporting this argument (Collins & DeAngelo, 1990; Healy, 1985). Therefore, financial reporting has been criticised in recent years.

Large accounting scandals and bankruptcy in developed and developing markets have been witnessed. These cases provide evidence that companies have failed to supply different stakeholders with accurate information. Information provided by financial reports can be misleading. Therefore, users of financial reports are questioning their quality and usefulness in making economic decisions. In addition, these scandals have undermined confidence in the quality of financial reports and the effectiveness of corporate governance. A number of studies find that financial reports are not used as a source for making economic decisions (e.g. Bartlett & Chandler, 1997), while other studies investigate ways to enhance the quality of financial reports (Cohen, Krishnamoorthy, & Wright, 2004) and the ways financial reports affect market efficiency and individual behaviour (Healy & Wahlen, 1999; Lev & Zarowin, 1999).

Financial reporting studies have proceeded in several directions, such as behavioural research, the decision usefulness approach and market-based accounting research. In addition, these studies have been dominated by a positive accounting research paradigm, which aims to explain and predict how individuals behave when they face particular economic issues (Watts & Zimmerman, 1986). Moreover, financial reporting studies raised concerns about the roles of corporate governance mechanisms, regulators, and auditors in monitoring managers' behaviour (Cohen et al., 2004; Jensen & Meckling, 1976).

However, empirical studies have not provided convincing and conclusive evidence to support the usefulness of financial reports. For instance, studies which cover the association between corporate governance mechanisms and the quality of financial reports have produced contradicting findings (Beasley, 1996; Chen & Jaggi, 2000; Goodwin & Seow, 2002). The reasons for the mixed evidence might include: the use of different instruments to measure variables affecting financial reports; the use of different sample sizes and functional models (Watts & Zimmerman, 1986); and the differences in the time period and the cultural environment (country) of the studies (Chen & Jaggi, 2000; Perera, 1989).

However, the majority of these studies do not try to analyse the financial reporting practices from an institutional perspective, for example studying the factors, such as rules and regulations, which can influence these practices. Most of the research to date has ignored the institutional environment in which financial reporting takes place. This might be because of the claim that accounting is "a neutral device that merely documents and reports the facts of economic activity" (Miller, 1994). However, financial reporting practices are influenced not only by economic variables but also by institutional environments. Accounting and governance research has recognised that actors' behaviour is influenced by rules, procedures, incentives and other economic factors. Therefore, calls for financial reporting to be studied within its institutional environment have been emerged in accounting literature (Hopwood, 2000; Isidro, Nanda, & Wysocki, 2016; Leuz & Wysocki, 2016; Bonetti, Magnan, & Parbonetti, 2016; Power, 2009 Wysocki, 2011).

3.3 Earnings quality

3.3.1 Definition

According to the Statement of Financial Accounting Standards (SFAC) No. 1, the users of financial statements refer to the earnings figure to help them:

> *(a) evaluate management's performance, (b) estimate "earning power" or other amounts they perceive as "representative" of long-term earning ability of an enterprise, (c) predict future earnings, or (d) assess the risk of investing in or lending to an enterprise.* (SFAC 1, paragraph 47)

Earnings represent a measurement tool for the users of financial reports to evaluate the company's performance. The earnings figure is considered a summary of the financial performance of the company which can be used for things such as compensation plans, investors' and creditors' decisions and in debt covenants (Dechow, 1994). Therefore, the earnings figure is considered to be of high quality if it provides the precise information that supports decisions in the capital market (Francis, Olsson, & Schipper, 2008).

High-quality earnings provide support for those involved in decision-making in different areas, such as: investor protection; compensation arrangements; debt contracts; setting accounting standards; and economic development (Schipper & Vincent, 2003). However, low-quality earnings lead to: misallocation of capital; lenders being misinformed; standard setters being misled; and increased cost of equity (Bhattacharya, Daouk, & Welker, 2003; Schipper & Vincent, 2003).

Earnings quality is a multidimensional construct that has been variously defined in the literature. Schipper and Vincent (2003) defined earnings quality as the extent to which reported earnings faithfully represent Hicksian economics-based income (which is "the amount that can be consumed during a period, while leaving the firm equally well off at the beginning and the end of the period" (Hicks, 1939)). Dechow and Schrand (2004) have defined earnings quality from a financial analyst's perspective. They asserted that high earnings quality provides more accurate numbers that reflect the firm's current performance, indicating future performance, and that can be used as a measure for assessing the intrinsic value of a firm. Similarly, Dechow, Ge, and Schrand (2010, p.344) defined high quality earnings as earnings that "*provide more information about the features of a firm's financial performance that are relevant to a specific decision made by a* specific decision-maker".

Many studies have attempted to measure the quality of financial reports by analysing the properties of reported earnings, as earnings considered as a summary of the financial performance of the company and its management, and can be used in, for example, setting compensation plans; by investors and creditors; and in debt covenants (Dechow, 1994). The earning figure helps users make economic decisions.

Earnings quality is measured by a multitude of proxies in the empirical literature. However, there is no generally accepted measure for earnings quality. Schipper and Vincent (2003) refer to the decision usefulness of financial reports, which is based on the qualitative characteristics in the FASB's Conceptual Framework. The quality of earnings depends on the relevance, reliability and comparability of the information provided by the financial report. The literature that has been developed under the "decision usefulness" rubric has sought to measure earnings quality by accrual quality, smoothness, persistence, predictability, timeliness, value relevance, conservatism, restatements and abnormal accruals that reflect earnings management (Dechow et al., 2010; Ewert & Wagenhofer, 2015: Francis, LaFond, Olsson, & Schipper, 2004; Perotti & Wagenhofer, 2014; Schipper & Vincent, 2003).

3.3.2 Measures of earnings quality and the properties of earnings quality

As mentioned in the above section, earnings quality is a multidimensional concept; thus, its measures are multifaceted as well. In the empirical literature, several measures have been developed as proxies for earnings quality, each attempting to measure a specific property of earnings. Therefore, there is no single superior measure for earnings quality and the existing measures should not be seen as substitutes (Dechow et al., 2010; Ewert & Wagenhofer, 2015). This section follows Francis et al. (2004) in classifying the measures of earnings quality as accounting-based and market-based measures. Accounting-based measures (namely persistence, predictability, smoothness and abnormal accruals) are measured using accounting information, while market-based measures (namely value relevance, timeliness and conservatism) are measured using market and accounting data.

As many of the measures of earnings quality capture a specific feature of earnings, they can have contradictory implications. Therefore, a discussion is provided in Chapter 6, on methodology, to justify the earnings quality measures used in this study.

3.3.2.1 Accounting-based measures

3.3.2.1.1 Persistence

Persistence earnings are desirable as they predict themselves and are valuable for the user as an input to equity valuation models (Dechow et al., 2010). Therefore, persistence or sustainability has often been used as a measure of earnings quality, where sustainable earnings are considered to be of high quality (Francis et al., 2008). Schipper and Vincent (2003) noted that persistent earnings are associated with investors’ responses to earnings. This supports the hypothesis that persistent earnings are useful for valuation purposes (Dechow & Schrand, 2004).

Persistence as a quality attribute has been criticised because high-persistence earnings can indicate opportunistic income smoothing (Dechow et al., 2010). However, it has been argued that high-impersistence earnings can present the actual outcome of the business in a volatile economy (Schipper and Vincent, 2003). Likewise, a company’s performance may be impersistent even without any earnings management (Earnings management is discussed in detail and defined in section 3.4).

Prior research (e.g. Lev, 1983 and Francis, LaFond, Olsson, and Schipper, 2004) measured earnings persistence as the slop coefficient ($\beta_{1,j}$) in the following model:

$$X_{j,t} = \beta_{0,j} + \beta_{1,j}X_{j,t-1} + \varepsilon_{j,t} \quad (1)$$

Where $X_{j,t}$ measured as firm j's net income before extraordinary items in year t divided by the weighted average number of outstanding shares during year t (equal to adjusted earnings per share). For each firm-year, persistence is calculated over rolling five-year windows. This procedure yields firm- and year-specific estimates of $\beta_{1,j}$, which capture the persistence of earnings. Values of $\beta_{1,j}$ close to 1 imply highly persistent earnings, while values close to 0 imply highly transitory earnings.

3.3.2.1.2 Predictability

Earnings predictability is the ability of reported earnings to predict future earnings (Francis et al., 2004; Lipe, 1990; Penman & Zhang, 2002). High-quality earnings are a good predictor of future earnings and can be used in equity valuation (Dechow & Schrand, 2004; Dichev et al., 2013; Francis et al., 2004; Penman & Zhang, 2002). High-quality current earnings provide more useful data for the forecasting metric and result in more accurate valuations (Dechow & Schrand, 2004).

Predictability is closely connected to persistence; greater variability of earnings decreases its predictability (Schipper and Vincent, 2003). As a result, predictability as a quality attribute has been criticised, as it has not been clarified whether predictable earnings indicate high-quality earnings or earnings smoothing. Likewise, if the firm's underlying economics is hard to predict, unpredictable earnings are not an indication of low-quality earnings (earnings management).

Predictability measure is derived from the firm- and year-specific persistence model. Lipe (1990) and Francis et al. (2004) use the square root of the error variance from the persistence equation. Large values of predictability imply less predictable earnings.

$$\sqrt{\boldsymbol{\sigma}^2}(\boldsymbol{\varepsilon}_j) \qquad \textbf{(2)}$$

3.3.2.1.3 Smoothness

There are contradictory views in the literature on smoothness of earnings as a quality measure (Gao & Zhang, 2015; Khurana, Pereira, & Zhang, 2018). One stream of research reflects the idea that the relevant and informative fluctuations in cash flow are artificially smoothed out by managers in order to smooth the earnings number (Francis et al., 2008; Leuz, Nanda, & Wysocki, 2003), and smooth earnings are viewed as low-quality earnings. The other stream of research reflects the idea that managers are smoothing transitory fluctuations in cash flow in order to produce a more useful and persistent earnings number (Francis et al., 2008). This view holds that smooth earnings indicate high-quality earnings.

The first stream, which believes that smoothing reduces the quality of earnings, assumes that management responds to a negative (positive) cash flow by increasing (decreasing) accruals (Barth, Landsman, & Lang, 2008). Managers have several incentives to report smooth earnings (Leuz et al., 2003). For example, managers may wish to look less risky in order to reduce the cost of capital (Francis et al., 2004) and to increase the company's share price (Tucker & Zarowin, 2006). In contrast, the second stream, which believes that smoothing improves the quality of earnings, assumes that smoothing is not necessarily opportunistic, but it helps reflect the company’s true economic performance. Investors perceived smooth earnings to be less risky (Graham, Harvey, & Rajgopal, 2005) as they can contain private information about future earnings (Khurana et al., 2018). Consistent with that, Dichev and Tang (2009) find that smooth earnings are persistent and predictive of earnings for up to five years ahead.

Therefore, it is an open question whether smoothness is an indicator of high- or low-quality earnings. Following the conceptual framework, it can be a desirable feature of earnings; however, the widespread use of opportunistic income smoothing (Dechow et al., 2010) makes the researcher believe that it is an indicator of earnings management.

Leuz, Nanda, and Wysocki (2003) measure smoothness by examining the ratio of the standard deviation of net income before extraordinary items scaled by beginning total assets to the standard deviation of cash flow from operations scaled by beginning total assets:

$$\boldsymbol{\sigma\left(NIBE_{j,t}\right)/\ \sigma\left(CFO_{j,t}\right)} \qquad \textbf{(3)}$$

Standard deviations are calculated over rolling five-year windows. Larger values of smoothness indicate less earnings smoothness.

3.3.2.1.4 Abnormal accruals

Earnings consist of cash flows and accruals which are used to adjust the recognition of cash flows over time and provide a better measure of company performance (Dechow & Dichev, 2002). Prior research distinguishes between “normal” and “abnormal” accruals. Normal accruals capture the adjustment that reflects the fundamental performance of the company, while abnormal accruals capture distortions induced by earnings management or application of the accounting rules (Dechow et al., 2010). Therefore, a large body of literature assumes that the accruals component represents the managed part of earnings (Dechow et al., 2010), and the existence of accruals reduces the quality of earnings. However, prior research has shown that accruals produce more persistent earnings (Sloan, 1996) and more predictable earnings (Penman & Zhang, 2002). This suggests that accruals improve the decision usefulness of earnings.

Accruals are often divided into normal (those resulting from the firm's fundamental earnings process) and abnormal (those resulting from intentional or unintentional accounting errors). Jones (1991) developed the original abnormal accruals model that allowed her to identify the accruals that are determined by property, plant and equipment, and revenue. The remaining part of accruals (not explained by these fundamentals) can indicate earnings management and low-quality earnings. Jones's model has been modified by later researchers in the area, who have thereby developed new abnormal accruals models, such as the modified Jones model (Dechow, Sloan, & Sweeney, 1995), the performance matched model (Kothari, Leone, & Wasley, 2005), and the idiosyncratic shocks model (Owens, Wu, & Zimmerman, 2017).

Dechow and Dichev (2002) proposed a new model to measure the quality of accruals, based on the fact that "accruals shift or adjust the recognition of cash flows over time, so the adjusted numbers (earnings), better measure firm performance" (Dechow and Dichev, 2002). It assumes that incorrect estimates must be corrected in future accruals and earnings. Therefore, the estimated errors (from the model) represent noise, which reduces the usefulness and quality of the accruals. However, the Dechow and Dichev model has been criticised for focusing on short-term working capital and ignorings the long-term (e.g. PPE and impairments of goodwill), which likely reflect earnings management (Dechow et al., 2010). Moreover, this model has been criticised for not capturing the perceptions of investors and analysts because it focuses on current accruals instead of total accruals (Barth et al., 2008).

The modified Jones model is the one most commonly used to capture abnormal accruals (i.e. the distortion component of accruals). It is expressed as follows (Dechow et al., 1995):

$$\boldsymbol{TA_{j,t} = \beta_1 + \beta_2 \left(\Delta\, REV_{j,t} - \Delta\, REC_{j,t}\right) + \beta_3\, PPE_{j,t} + \varepsilon_{j,t}} \quad \textbf{(4)}$$

Where $TA_{j,t}$ are total accruals for firm j in year t, $\Delta\, REV_{j,t}$ is the change in net sales (net sales in year t less sales in year t-1), $\Delta\, REC_{j,t}$ is the change in net receivables (net receivables in year t less net receivables in year t-1) and $PPE_{j,t}$ is gross property, plant and equipment. All variables in the model are scaled by lagged total assets. The absolute error term (residual) from this model is the abnormal accruals.

3.3.2.2 Market-based measures

3.3.2.2.1 Value relevance

The concept of value relevance is based on the idea that accounting numbers should explain the variation in stock return (Holthausen & Watts, 2001). Earnings with high ability to explain variation in returns (greater explanatory power) are of high quality (Francis et al., 2008). Earnings are value relevant if the predict share price; therefore, value relevance is a measure that shows how earnings reflect a firm’s underlying economics (Barth, Beaver, & Landsman, 2001).

Based on the idea that investors respond to earnings that have value implications, value relevance is empirically measured as the explanatory power of a regression of stock returns on earnings. A high correlation between share price and earnings indicates that earnings better reflect the fundamental performance of the company and therefore the earnings figure is of high quality (Dechow et al., 2010). However, this measure has been criticised on the grounds that accounting numbers are not the sole driver of stock price (Dechow et al., 2010).

Value relevance has been measured in previous studies (e.g. Francis et al. (2004) and Jennifer Francis & Schipper (1999)) explained variability from the following regression of returns and change in earnings:

$$\boldsymbol{RET_{j,t} = \beta_1 + \beta_2 EARN_{j,t} + \beta_3 \Delta EARN_{j,t} + \varepsilon_{j,t}} \quad \textbf{(5)}$$

Where $RET_{j,t}$ is the firm's 15-month return ending three months after the end of fiscal year *t*; $EARN_{j,t}$ is the firm's income before extraordinary items in year *t* (NIBE) scaled by the firm's market value at the beginning of the year; and $\Delta\, EARN_{j,t}$ is the change in the firm's NIBE in year t and is also scaled by the market value of the firm at the beginning of the year. Then, relevance will be equal to the negative adjusted R^2 of this equation. So the large (small) value of relevance will mean less (more) value relevant earnings.

3.3.2.2.2 Timeliness

Timeliness has been defined by Ball et al. (2000, p. 2) as "the extent to which current-period accounting income incorporates current-period economic income, our proxy for which is change in market value of stockholders' equity". It is related to the length of time taken to reflect the news or information in earnings (Beekes, Pope, & Young, 2004). Therefore, timeliness means decision makers having the information in time for it to be able to influence their decisions (Ball, Robin, & Wu, 2003; Ball & Shivakumar, 2005). The equity market perceives earnings as of high quality if they reflect the information in a timely manner (Ball, Robin, & Sadka, 2008; Ball et al., 2003; Ball & Shivakumar, 2005). Timeliness has been criticised as an earnings quality measure on the grounds that it fails to prove that asymmetric timeliness improves decision making (Dechow et al., 2010).

In the literature (e.g. Basu, 1997; Francis et al., 2004), timeliness has been measured by using the following reverse regressions, where earnings are the dependent variable and returns the independent variables:

$$\boldsymbol{EARN_{j,t} = \alpha_0 + \alpha_1 NEG_{j,t} + \beta_1\, RET_{j,t} + \beta_2\, NEG_{j,t}.RET_{j,t} + \varepsilon_{j,t}} \quad \textbf{(6)}$$

Where $EARN_{j,t}$ is the firm's income before extraordinary items in year *t* (NIBE) scaled by the firm's market value at the beginning of the year; $RET_{j,t}$ is the firm's 15-month return ending three months after the end of fisical year *t*; and $NEG_{j,t}$ is equal to 1 if $RET_{j,t}$ < 0 and 0 otherwise. Then, timeliness will be equal to the negative adjusted R^2 of this equation. So the large (small) value of timeliness will means less (more) timely earnings.

3.3.2.2.3 Conservativism

Conservatism has been defined by Basu (1997) as “capturing accountants’ tendency to require a higher degree of verification for recognising good news than bad news in financial statements”. Conservatism has been found to be a desirable measure of earnings quality as it constrains managers’ incentives and ability to manipulate and decreases the information asymmetry between managers and users of financial reports (Hui, Matsunaga, & Morse, 2009; Watts, 2003) and also to reduce private information and increase stock price (LaFond & Watts, 2008). However, some researchers view conservatism as an undesirable measure because it reduce the predictability of earnings, as conservatism generates hidden reserves in the accounts (Penman & Zhang, 2002).

Conservatism as a measure of earnings quality has been criticised by many scholars. Some researchers, such as Bricker, Previts, Robinson, and Young (1995), find that there is limited or no relationship between earnings quality and conservative accounting. Moreover, it is difficult to rely on one measure to determine a firm’s conservatism as economic events and disclosure policy can influence the measurement of conservatism as well (Givoly, Hayn, & Natarajan, 2007).

Conservatism has been measured (e.g. Basu, 1997; Francis et al., 2004) as the negative of the ratio of the coefficient on bad news to the coefficient on good news, of the from the following equation:

$$\boldsymbol{EARN_{j,t} = \alpha_0 + \alpha_1 NEG_{j,t} + \beta_1 RET_{j,t} + \beta_2 NEG_{j,t}.RET_{j,t} + \varepsilon_{j,t}} \quad \textbf{(7)}$$

Where, $EARN_{j,t}$ is the firm's income before extraordinary items in year t (NIBE) scaled by the firm's market value at the beginning of the year; $RET_{j,t}$ is the firm's 15-month return ending three months after the end of fisical year *t*; and $NEG_{j,t}$ is equal to 1 if $RET_{j,t}$ < 0 and 0 otherwise. Then conservatism will be:

$$\boldsymbol{Conservatism} = -\ \frac{(\boldsymbol{\beta_{1,j}} + \boldsymbol{\beta_{2,j}})}{\boldsymbol{\beta_{1,j}}} \qquad \textbf{(8)}$$

The large (small) value of conservatism will mean less (more) conservative earnings.

3.3.3 Determinants of earnings quality

Prior studies have identified a number of factors that influence the quality of earnings. These factors are classified into three main categories: country-level factors; firm-level factors; and corporate governance factors.

3.3.3.1 Country-level factors

Prior research indicates that the environment in which the firm is operating varies across countries and the findings from one specific context cannot be generalised to another because of the differences in the institutional context (Ball et al., 2000). The quality of earnings is affected by many factors, such as the country's legal environment and the strength of the law enforcement regime. The literature examines the relationship between institutional variables like the legal institutions, capital-market features, enforcement systems, culture, political institutions and societal trust and the cross-country differences in financial reporting (Leuz & Wysocki, 2016).

Differences in the legal environment and law enforcement regime (particularly its strength) across countries have a significant impact on financial reporting (Holthausen, 2009). Investor protection is an institutional factor affecting corporate choices and can determine cross-country differences in the quality of financial reporting (La Porta et al. , 1997, 2000). Strong investor protection can mitigate the agency conflict between controlling shareholders and their appointed managers and minority shareholders (Chen et al., 2013). It limits the managers' ability to conceal accounting information from outsiders (Leuz et al., 2003). A country's legal provisions (its laws and regulations) protect shareholders and creditors by mitigating the managers' ability to manipulate financial reports. Investor protection is also determined by the extent to which firms follow these rules and regulations. Protecting investors from expropriation by managers has economic effects on firms and countries. Therefore, countries try to improve their investor protection systems in order to provide a business environment that protects investors' rights and attracts new investors.

The legal environment affects the usefulness of financial accounting information in two ways. First, it determines the extent to which laws provide investors with protection from expropriation by the firm's insiders. This protection is greater with strong legal rights and better financial accounting information about the firm's outcomes and managerial decisions. Second, it determines the enforcement of rules and regulations related to the property and contractual rights of individuals and firms (Bushman & Smith, 2001).

Most of the studies that examine the relationship between the strength of investor protection and the quality of financial reports find that strong investor protection can limit managers' ability to manage earnings (Burgstahler et al., 2006; Haw et al., 2004; Houqe et al., 2012; Leuz et al., 2003). Investor protection assists in maintaining high-quality financial reporting, as bad news reflects on reported earnings in a timely manner (Bushman & Piotroski, 2006), share price is more informative (Haw et al., 2012; Wang & Yu, 2015) and CEO compensation can easily be assessed (Hu & Kim, 2019).

In addition, political institutions influence the behaviour of corporate investors, managers and regulators, and other stakeholders, by creating incentives which shape reported accounting information. Bushman and Piotroski (2006) examine the impact of political economy on incentives for financial reporting. They find that firms in countries with high political involvement speed the recognition of good news and slow the recognition of bad news in earnings. Moreover, Leuz and Oberholzer-Gee (2006) argue that firms with political ties are less likely to have publicly traded debt or equity securities abroad, because these firms dislike the transparency and scrutiny that come with publicly traded securities. Firms with political connections can acquire support more easily from the market than non-connected peer firms can (Faccio, 2006). This suggests that politically connected firm's management might care less about the quality of its financial reports. Therefore, political connections have a negative impact on corporate transparency. In addition, Bushman, Piotroski, and Smith (2004) document that firms with few political connections have more transparent financial reports than politically connected firms, as they provide valuable information in a timely manner.

Although culture is recognised in individuals' thoughts and actions, it becomes "crystallised in the institutions and tangible products of a society" (Hofstede, 1984, p.82). Therefore, culture affects whole societies due to the combined contribution of constituent individuals. Furthermore, culture is central factor that affects the quality of financial reporting. The relationship between accounting and culture has been described as follows: ‘‘accounting is a socio-technical activity involving both human and non-human resources and techniques as well as the interaction between the two ... although the technical aspect of accounting is less culture dependent than the human aspect, because the two interact, accounting cannot be culture free” (Perera 1989, p. 43, as cited in Chand, Cummings, & Patel, 2012). Gray (1988) argues that national culture, as a key informal institutional factor (North, 1990), influences accounting practices, thus impacting the quality of financial reporting differentially across countries. Nobes (1998) adds that culture is one of the background factors that cause the differences in international financial reporting practices.

Hofstede (1980) provided the basis for some of the most extensive research on cross-country cultural differences over recent decades, in the identification of four fundamental dimensions of societal values to differentiate the cultural features in various countries: individualism versus collectivism; large versus small power distance; strong versus weak uncertainty avoidance; masculinity versus femininity; and long-term versus short-term orientation. Gray (1988) further extended Hofstede’s work in order to develop his theoretical model linking the societal values to four accounting subculture dimensions: professionalism versus statutory control; uniformity versus conformity; secrecy versus transparency and conservatism versus optimism. Gray (1988) assumes that accountants’ values are related to their country’s societal values, and as accounting values affect accounting systems, he concluded that cultural factors must influence the development of financial reporting systems directly at a country level (Doupnik & Tsakumis, 2004). Based on Gray’s framework, at the country level, accounting subculture has dimensions of professionalism and uniformity related to the authority and enforcement of accounting practice, and dimensions of conservatism and secrecy related to the measurement and disclosure of accounting information (Doupnik & Tsakumis, 2004).

Empirical studies have identified the relationship between financial reporting and national culture. Researchers provide some evidence for the influence of culture on the existence of earnings management (Doupnik, 2008; Gray et al., 2015; Guan, Pourjalali, Sengupta, & Teruya, 2005; Han et al., 2010; Nabar & Boonlert, 2007), auditor choice (Hope, Kang, Thomas, & Yoo, 2008), accountants' application of rules (Tsakumis, 2007), interpretation of verbal expressions of uncertainty over accounting standards (Doupnik & Richter, 2003), accountants' judgements (Chand et al., 2012), auditor-detected accounting errors (Chan, Lin, Lai, & Mo, 2003) and auditors' expectation and assessment of the risk of material misstatement (Hughes, Sander, Higgs, & Cullinan, 2009). Consequently, culture is considered an important factor in explaining why countries' financial reporting practices and quality differ.

3.3.3.2 Firm-level factors

Firm-level characteristics are important determinants of earnings quality worldwide. Empirical literature shows that firm characteristics such as performance, debt, growth and size are associated with earnings quality. In some situations, firm-level factors can have significantly more explanatory power than country-level factors (Gaio, 2010).

Prior research provides mixed evidence about the relationship between firm size and earnings quality. Some scholars have shown that firm size is positively related to earnings quality. For instance, Francis et al. (2004) find that firm size is positively related to different measures of earnings quality, namely smoothness, persistence, predictability, value relevance, timeliness and conservatism. In addition, Gaio (2010) finds that the size of the firm is also positively related to an aggregate measure of earnings quality which consists of seven earnings attributes (smoothness, persistence, predictability, value relevance, timeliness, accruals quality and conservatism). Small firms are expected to have deficiencies in their internal control system, which will negatively affect the quality of reported earnings (Ashbaugh-Skaife, Collins, & Kinney, 2007; Doyle, Ge, & McVay, 2007; Ge & McVay, 2005). Nonetheless, some scholars have shown that firm size is negatively associated with earnings quality. In response to political/ regulatory scrutiny, large firms are likely to choose accounting methods that increase the firm's reported income (Dechow et al., 2010; Jensen & Meckling, 1976b; Watts & Zimmerman, 1986).

A large number of scholars have found that a firm's debt leverage is negatively associated with earnings quality. Firms that are close to a debt covenant restriction could take action to boost income or manipulate earnings to avoid violating the contract (Watts & Zimmerman, 1986). This can reduce the quality of reported earnings and influence the usefulness of earnings numbers. Studies provide evidence that debt leverage is related to different measures of earnings quality, such as choice of accounting method in order to increase reported income (Othman & Zeghal, 2006; Rodríguez-Pérez & van Hemmen, 2010), accounting and auditing enforcement releases (Dechow, Sloan, & Sweeney, 1996) and restatements (Efendi, Srivastava, & Swanson, 2007).

Researchers have investigated the role of firm performance and earnings quality. They found that firms with poor performance engage in accounting tactics to improve the reported earnings and lower the quality of earnings. Therefore, weak performance provides incentives to manage earnings (Burgstahler et al., 2006;

Dechow, 1994; Doyle et al., 2007). However, DeAngelo, DeAngelo, and Skinner (1994) do not find a relationship between earnings quality and weak performance. They argue that weak performance may limit the opportunities to manage earnings. They found that the managers of 76 troubled firms recognised their firms' financial difficulties rather than inflating earnings.

When firms need financing to meet the investment opportunities, managers may try to enhance the quality of earnings to reduce the cost of capital (Francis et al., 2004). However, researchers investigating the relationship between firm growth and earnings quality find that high-growth firms rate lower on measures of all the following: earnings persistence (Penman & Zhang, 2002), target beating (McVay, 2006), measurement errors (Richardson, Sloan, Soliman, & Tuna, 2005), internal control weaknesses (Ashbaugh-Skaife et al., 2007) and aggressive reporting accruals (Kothari et al., 2005).

3.4 Incentives for earnings management

The quality of reported earnings is associated with the existence of earnings management in the preparation of earnings information: low earnings management produces higher earnings quality (Barth et al., 2008; Dechow and Schrand, 2004; Dechow et al., 2010; Healy and Wahlen, 1999; Penman and Zhang, 2002; Schipper and Vincent, 2003). Healy and Wahlen (1999) have defined earnings management as the use of the managers' judgements in preparing the financial reports and structuring transactions in a way that misleads stakeholders or influences contractual outcomes by affecting the company's apparent economic performance. Similarly, Schipper (1989) has defined earnings management as "disclosure management in the sense of a purposeful intervention in the external financial reporting process with the intent of obtaining some private gain”. Accounting standards permit management to exercise some judgement in determining some of the reported information. Hence, the flexibility of the accounting standards allows earnings management to occur. Earnings management is therefore exercised within the grey area between legitimacy and fraud (Levitt, 1998).

However, Dechow and Skinner (2000) observe that fraudulent accounting practices can be distinguished from the judgements and estimations that are permitted under the accounting standards. However, it is difficult to identify the management’s intent. Discretionary factors are important in determining the quality of reported earnings. Therefore, it is important to identify the motives behind earnings management and the techniques used, and these are discussed below.

Earnings figure can be used for valuation or performance evaluation, contracting and stewardship purposes. The earnings figure reflects the firm’s current performance, indicates future performance and is used as a measure for assessing the intrinsic value of the firm. Higher-quality earnings figures provide more useful data for the forecasting metric and result in more accurate valuations (Dechow & Schrand, 2004). Therefore, the earnings figure is important for valuation and investment as it affects investment efficiency (Biddle et al., 2009) and the cost of both equity capital (Francis et al., 2004) and debt capital (Jiang, 2008).

In addition, earnings are used to determine executive compensation (Baber et al., 1998; Nwaeze, Yang & Yin, 2006). A compensation contract based on the firm’s performance is linked to the quality of earnings, as earnings represent a summary of the period performance. The firm’s performance affects the movement of management as well. For instance, earnings restatements can increase management turnover (Desai et al., 2006) and executives may lose their jobs (Karpoff et al., 2008).

Furthermore, the earnings figure is of interest to standard setters, as they use it to evaluate the effectiveness of their standards (Schipper & Vincent, 2003). The quality of reported earnings guides the standards setter to any adjustment needed to increase the quality of financial reports. Furthermore, earnings are also used to monitor the firm’s compliance with debt contracts (Li, 2016). Debt contracts are monitored by linking them to accounting measures (Christensen et al., 2016). These measures are therefore used in the formulation of debt contracts (Leftwich, 1983; Ball et al., 2008).

By way of summary, Healy and Wahlen (1999) have proposed a fourfold categorisation of managers’ incentives to manage earnings:

- Capital market motivations: As investors and financial analysts depend on accounting information to evaluate the stock value, managers have an incentive to manipulate earnings in order to influence stock price. Many studies have investigated this practice, in different contexts. For example, Burgstahler and Dichev (1997) find that managers engage in earnings management to avoid a decrease in earnings, Daniel et al. (2008) indicate managers manage earnings to meet expected dividend levels, and Graham et al. (2005) find that managers engage in earnings management to increase or maintain share prices and meet earnings benchmarks in order to improve the firm’s credibility in the market.

- Management contracts: Management compensation contracts can produce incentives to manage earnings, as the better the company's performance, the higher the management compensation. Involving the firm's performance in compensation contracts is one of most important incentives to manage earnings (Watts and Zimmerman, 1986). Bergstresser and Philippon (2006) found that managers manage earnings more when they have stock-based incentives. In addition, managers with high equity incentives usually manage earnings to meet analysts' forecasts (Cheng & Warfield, 2005).
- Lending contracts: Many studies have found that companies that meet their dividend covenants have little evidence of practising earnings management. However, companies facing financial difficulties may try to manage cash flows by reducing dividend distributions and restructuring their operations. Chamberlain et al. (2014) provide an understanding of the relationship between earnings management and debt covenant. They provide evidence that managers manage reported earnings to avoid violation of debt covenant. Moreover, Franz et al. (2014) argue that earnings management is more likely to be observed where there are poor credit ratings, where the firm does not meet analyst forecasts and where there are implications for debt covenant violation.
- Regulatory motivations: There is an incentive to manage earnings where there is a need to meet minimum regulatory requirements. Haw et al. (2005) discuss the pressure for managers to manage earnings in order to show their compliance with regulations. They show that management follows an income-increasing strategy to meet regulatory ROE targets in relation share offers or bond issuance. Management also has an incentivise to manage earnings

downward to mitigate political costs and avoid large tax bills by obtaining tax-exempt status (Monem, 2003).

3.5 Techniques used to manage earnings (red flags)

Earnings can be managed into two ways: real actions and choice of accounting policy. Real earnings management is the departure from normal operational practices to mislead some stakeholders to make them believe that certain goals have been achieved in normal operations (Roychowdhury, 2006). Real earnings management does not violate laws or regulations as long as management discloses these operations in the financial reports (Chi, Lisic, & Pevzner, 2011). Managers are more likely to engage in real earnings management when legislation and the regulatory regime are stringent (Cohen, Dey, & Lys, 2008). It increases when there are tighter accounting standards which reduce accounting policy choice (accruals) for earnings management (Ewert & Wagenhofer, 2005). Skinner and Dechow (2000) and Healy and Wahlen (1999) point out some of the real earnings management actions which assist in improving/increasing reported earnings. These actions include the acceleration of sales, delaying research and development (R&D) and maintenance expenditures and alterations in shipment schedules.

Accounting policy is divided into two categories. One is the choice of accounting policies, such as the depreciation policy and revenue recognition while the other is discretionary accruals, such as inventory values, credit losses and extraordinary items (Scott, 2009).

Ortega and Grant (2003) have classified the earnings management techniques into four categories, as follows:

- Revenue recognition: This is recognising the revenue before it is due, in order to increase earnings in the current period. However, on an accruals basis it should be recorded as revenue when earned.
- Timing of operating expenses: This technique is built up on shifting the operating expenses from one period to another in order to manage earnings (net profit). This is usually used when the company is facing lower than expected earnings for a period and so expenses are transferred to the next period.
- Unrealistic assumptions in the estimation of liabilities: In order to manage earnings, management may estimate liabilities aggressively. This technique can be used to manage earnings by reducing earnings in the current period if they are higher than expected. This will provide the management with a reserve that can be converted during periods of low earnings.
- Real operation actions: These are the actions that manage the business and increase the shareholders' value. These actions try to provide the company with financial stability through acceptable business decisions, like reducing prices to increase sales volume to reach the earnings target.

There are some popular earnings management techniques that do not fit into one of the aforementioned categories. Examples are: managers manipulate earnings before extraordinary items to avoid reporting losses (Burgstahler & Dichev, 1997); earnings are manipulated by taking real actions which delay advertising expenditures (Graham et al., 2005); price discount is used to improve sales, overproduction is used to reduce costs, and decrease expenditures are used to increase margins (Roychowdhury, 2006); revenue, fixed assets, investments, business combinations, intangibles and leases are manipulated (Nelson et al., 2003); investment and accounting decisions are made with a view to managing earning (Monem, 2003); and sales discounts, reduced expenses and longer credit terms are used to manage earnings (Franz et al., 2014). Indeed, earnings management techniques have been categorised in many different ways, such as cookie jar reserve, big bath, big bet on the future, flushing the investment portfolio, throw out a problem child, change GAAP, sale or leaseback and asset exchange, early retirement of debt, shrink the ship, depreciation, sale, asset exchange, use of derivatives, and operating versus non-operating income (McKee, 2005).

3.6 Summary and research gaps in the literature

The review of the literature shows that there is no agreed definition or measure for earnings quality. In addition, the empirical literature measures earnings quality and identifies its determinant and consequences using archival data. This raises questions about the ability of such research to distinguish between earnings results from business fundamentals (e.g. business model and operating environments) and those that stem, rather, from the financial reporting process itself (e.g. management decisions, auditing, governance structures, regulation and standards, and information systems). Examples of these questions include: How can earnings quality be defined? What are the characteristics of high-quality earnings? What factors can influence the quality of reported earnings? What policies or regulations promote high-quality earnings? What are the indications for low-quality earnings?

Dichev et al. (2013) used a questionnaire survey and interviews to address these issues. They provide novel insights compared with the traditional empirical archival research (Nelson & Skinner, 2013). However, their results are based only on 169 managers of US public firms. Their findings provide a strong understanding for aspects of managers' decision making; however, they missed the perception of other parties that are involved in financial reporting practices (Nelson & Skinner, 2013). In addition, the financial reporting practices, which are linked to the quality of earnings, are influenced by the environment in which firms are operating (Arnold, 2009; Hopwood, 2000; Power, 2009; Wysocki, 2011; Hopper et al., 2017). Therefore, Dichev et al.'s (2013) findings cannot be generalised to other contexts.

Therefore, this study aims to fill this gap by providing a better understanding of earnings quality and its determinants and consequences by obtaining the perception of different stakeholders involved in financial reporting practices using semi-structured interviews and a questionnaire survey. Moreover, this study increases the understanding of earnings quality by eliciting the perceptions of different stakeholders in Bahrain, which has its own unique culture, regulations, political system and ownership structure.

Chapter 4: Role of Corporate Governance in Improving Earnings Quality

4.1 Introduction

Chapter 3 discussed the previous studies of earnings quality. It provided a definition of earnings quality and gave an overview of the measures and determinants of earnings quality, as well as of the incentives and techniques to manage earnings. This chapter will review the findings of previous studies to identify how monitoring mechanisms, corporate governance mechanisms and external auditing constrain earnings management and improve the quality of reported earnings. This chapter is structured as follows: section 4.2 defines corporate governance; section 4.3 discusses the relationship between corporate governance and financial reporting, and the governance mechanisms that have a direct impact on the processes of financial reporting; and finally, section 4.4 presents the summary and the gaps in the literature.

4.2 Corporate governance

Systems of corporate governance have been established in response to failures and crises. The South Sea Bubble in the 1700s is documented as the first failure of governance in England, while the stock market crash of 1929 is considered as the first failure in the United States. These failures established the business laws and practices in England and the securities laws in the United States. Moreover, the failures of well-known companies such as Enron, WorldCom and Waste Management have also contributed to improvements in corporate governance.

There is no agreed definition of corporate governance in the literature, and indeed it has been the subject of debate over the last few decades. The concept of corporate governance has been defined from different viewpoints. Tricker (2015) classifies the definitions based on five different perspectives: operational, relationship, stakeholders, financial economics and societal.

A lot of work on corporate governance has been done from the operational perspective, where the focus is on the shareholders, the board and the management. Definitions of corporate governance based on an operational perspective focus on governance structures, processes and practices (Tricker, 2015). A good example is Sir Adrian Cadbury's definition of corporate governance as "the system by which companies are directed and controlled". In addition, the Cadbury report identifies the board of directors' responsibility to govern the company while the shareholders are responsible for appointing the auditors and directors and making sure that an appropriate governance system is in place. The same perspective was adopted by the Organisation for Economic Co-operation and Development (OECD) in its code of corporate governance: "Corporate governance is about the procedures and processes according to which an organisation is directed and controlled". In the OECD report, the operational perspective is strengthened by the inclusion of the relationships between various participants: "The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization – such as the board, managers, shareholders, and other stakeholders – and lays down the rules and procedures for decision-making". California Public Employees Retirement System, as an institutional investor, has reinforced the relationship perspective by including corporate governance participants in its definition of corporate governance:

“shareholders, company management, and the board of directors”. Other researchers, such as Monks and Minow (1995), have added further participants to the corporate governance system, such as the employees.

The OECD’s definition of corporate governance takes a wider view of the parties involved in and affected by the corporate governance system. It includes “other stakeholders”, as well as the management, board and shareholders. A stakeholder has been defined by Freeman and Reed (1983) as “any group or individual who can affect or be affected by the achievement of the organisation’s objectives”. This definition is universal and broad, and presents the reciprocal impact of relationships, transactions or contracts with the organisation. Tricker (2015) adopts the stakeholder perspective in the following definition: “corporate governance is about the activities of the board and its relationships with the shareholders or members, and with those managing the enterprise, as well as with the external auditors, regulators, and other legitimate stakeholders”.

Corporate governance has been defined by financial economists through a different lens from that of the management and lawyer experts. Shleifer and Vishny (1997) find that “corporate governance deals with the ways suppliers of finance to corporations assure themselves of getting a return on their investment”. The financial economist's main concerns regarding corporate governance relate to ownership concentration and the legal protection provided to investors. Financial economists’ main contribution to corporate governance research is related to the application of agency theory to board-level activities (Tricker, 2015).

Blair (as cited by Tricker, 2015) sets corporate governance as a high-level concept. She defines corporate governance as “The whole set of legal, cultural, and institutional arrangements that determine what public corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated". In addition, Sir Adrian Cadbury (Cadbury: Global Corporate Governance Forum, World Bank, 2000): "Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals…. The aim is to align as nearly as possible the interests of individuals, corporations and society." These definitions include all of the stakeholders, including the contractual stakeholders (like employees, managers, shareholders, suppliers, consumers, customers, bankers) and those outside the company whose interests can nonetheless be affected by the company's behaviour (like societal local, national and international interests). This societal perspective raises some philosophical issues about the relationship between the individual, the company and the country (context).

It is observed that there is no universally accepted definition of corporate governance. However, it is clear that corporate governance has moved from its narrow (shareholder-oriented) perspective towards a broader (stakeholder-oriented) perspective because of the important role the stakeholders play in the existence and prosperity of firms (Wu & Patel, 2015). The increase in firms' power and impact on various stakeholders and society have extended their responsibilities to other stakeholders (Wu & Patel, 2015). Therefore, the firm should align the interests of shareholders and stakeholders. The OECD has addressed this alignment by determining the long-term benefits the firm can obtain by recognising the interest of various stakeholders. The OECD (2004, p. 11) has defined corporate governance as:

> “a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring.”

4.3 Corporate governance and financial reporting

Agency theory is considered the cornerstone for corporate governance research. The role of governance is to mitigate the agency conflicts between managers and owners that arise because of the separation between ownership and control (Jensen & Meckling, 1976). However, the use of agency theory to explain the demand for corporate governance is questionable in emerging markets because the conflict shifts from principal-agent to principal-principal conflict (Young, Peng, Ahlstrom, Bruton, & Jiang, 2008a). Corporate governance research focuses on the incentives and control mechanisms that aim to protect outsiders (principally shareholders) from opportunistic managers (Shleifer & Vishny, 1997). One of the governance control and monitoring mechanisms is the production of external financial reports that allow shareholders to evaluate managers’ performance (Habib & Jiang, 2015). Financial reports should provide high-quality information and there should be commitment to transparency of information to reduce the information asymmetry which arises between managers and other stakeholders (Kothari, 2001).

The existence of a relationship between corporate governance and financial reporting has been supported by theoretical and empirical studies (Gaio & Raposo, 2014). Researchers find that financial reporting plays an important role in corporate governance (Armstrong et al., 2010; Bushman & Smith, 2001; Sloan, 2001). Conversely, corporate governance arrangements have a direct influence on financial reporting quality (Ball et al., 2000; Sloan, 2001). These studies found that the quality of financial reporting is affected by the firm's governance structures. Efficient governance mechanisms increase the quality of financial reporting by reducing the managers' incentives and ability to manage earnings and manipulate financial statements (Cohen et al., 2004; Sloan, 2001).

The failure of the corporate governance system is a failure of the financial reporting system (Norwani et al., 2011). Hence, Rezaee (2004) indicates that corporate governance is responsible for improving the quality of financial reports. He suggests that well-balanced corporate governance mechanisms should be used to manage and monitor the firms. The sections below discuss the effect of some of the corporate governance mechanisms on the quality of financial reports.

4.3.1 Board characteristics

Company boards are responsible for monitoring the actions of management (Vafeas, 2005). Prior studies have examined the relationship between board characteristics and financial reporting by using earnings management, accounting fraud, and qualified audit reports as measures for earnings quality. The sections below discuss studies of the relationship between the effectiveness of the board and the quality of earnings.

4.3.1.1 Board independence

Independence of the board of directors is linked to the presence of outside directors (non-management members). Independence of the board is assumed to be related to the strength of the board (Beasley, 1996; Kang, Cheng, & Gray, 2007). An independent board is considered to be a strong mechanism for monitoring managers and preventing opportunistic actions (Uribe-Bohorquez, Martínez-Ferrero, & García-Sánchez, 2018). An independent board assists in reducing agency costs and increasing financial transparency (Chen, Cheng, & Wang, 2015). Prior studies have found that the extent of earnings management is negatively associated with board independence.

Xie, Davidson, Dadalt, Davidson Iii, & Dadalt (2003) use a sample of US firms for the period from 1992 to 1996 to investigate the relationship between earnings management and the independence of the board of directors. They find that firms with a large percentage of independent directors are associated with low earnings management. However, this study control for size and year only, not for variables such as ownership and leverage. On the other hand, Klein (2002a) conducts a study of 687 US firms for the period from 1991 to 1993 and control for a number of variables, such as performance, leverage, growth and ownership. She finds that earnings management is negatively related to the percentage of independent directors on the board.

Based on a sample of UK firms, Peasnell, Pope, and Young (2000) investigate the relationship between corporate governance mechanisms and earnings management for the per- and post-Cadbury periods. They find that low earnings management (income-increasing accruals) associated with a high percentage of non-executive directors in the post-Cadbury period, but they do not find evidence of an association in the pre-Cadbury period.

Chen et al. (2015) investigate the effectiveness of board independence in reducing earnings management. They study a panel of 1587 US firms for the period from 2000 to 2005, where only 722 of the firms did not have a majority independent board in 2000. They find that the reform requiring independent board members reduced earnings management and improved the firms’ performance. In addition, they found independent directors with easier access to information are more effective in reducing earnings management.

Park and Shin (2004) investigate the effect of board composition on earnings management in Canadian firms for the period from 1991 to 1997. They document that there is no evidence of an association between outside board members and earnings management. However, they find that the presence of officers of financial intermediaries and institutional shareholders on the board reduces earnings management. They believe that the reasons for this weak relationship are: outside directors lack financial sophistication and access to information to detect earnings management; lack of ownership interest; the presence of dominant shareholders (concentrated ownership); and a not well developed labour market. On the other hand, Niu (2006) investigates Canadian firms for the period from 2001to 2004, and finds that the number of independent directors on the board is negatively related to earnings management. The study by Niu (2006) is more reliable than that by Park and Shin (2004) since it covers a more recent period and the effect of corporate governance practices becomes clearer.

Osma and Noguer (2007) examine the association between board composition and the existence of board committees and earnings management. This study covers 155 Spanish firms for the period from 1999 to 2001. They find that the presence of institutional directors is negatively related to earnings management; however, the presence of independent directors is positively correlated with earnings management. However, Dimitropoulos and Asteriou (2010) find that the presence of independent directors was negatively related to earnings management for 97 non-financial firms listed on the Athens Stock Exchange.

Abdul Rahman and Ali (2006) investigate the effectiveness of the board of directors, audit committee and concentrated ownership in reducing earnings quality among Malaysian firms. The study covers 97 Malaysian firms for the period from 2002 to 2003. They find an insignificant relationship between board independence and earnings management. They believe that corporate governance mechanisms are ineffective in relation to oversight. The board of directors lacks knowledge of the company's affairs and the management has dominance over the board.

Similarly, Siregar and Utama (2008) examine the effect of corporate governance, ownership structure and firm size on earnings management using all firms listed on the Jakarta Stock Exchange. They find that firms with a high proportion of independent directors on the board are less likely to engage in earnings management. In addition, Jaggi, Leung, and Gul (2009) examine this relationship for 770 Hong Kong firms over the period from 1998 to 2000. They find that independent board members are effective in the monitoring of earnings management and in improving the quality of earnings. However, they find that independent directors are not effective in family-controlled firms.

Thus, the majority of prior studies have concluded that a high percentage of independent directors on the board reduces earnings management and improves the quality of reported earnings. However, some studies conducted in Eastern countries provide contradictory results. They find that the independence of the board of directors may not mitigate earnings management. These findings may be due to the influence of the institutional setting in which the firms are operating. Contextual factors have both direct and indirect influence over financial reporting and corporate governance practices.

4.3.1.2 Board size

Board size is another important board characteristic that affects earnings quality. Jensen (1993) argues that the board's capacity as a monitoring mechanism is related to its size. A large board can reduce the ability of its members to communicate, monitor and coordinate, and this can negatively affect the quality of financial reporting. However, previous studies indicate that large boards with members with different areas of expertise are capable of monitoring management and mitigating earnings management, while small boards are expected to be dominated by blockholders or executives (Xie et al., 2003).

Xie et al. (2003) used a sample of US firms for the period from 1992 to 1996 to investigate the relationship between earnings management and the board size. They find that firms with large boards are associated with lower earnings management. Similarly, Ghosh, Marra, & Moon (2010) investigate the association between board size and earnings management for US firms for the period from 1999 to 2006. They also find that a large board is associated with low earnings management.

Abdul Rahman and Ali (2006) investigate the influence of board size on earnings management among Malaysian firms. The study covers 97 Malaysian firms for the period from 2002 to 2003. They find that board size is positively related to earnings management, which suggests that smaller boards are more focused on monitoring management and reducing earnings management. Likewise, Kao and Chen (2004) find that a large board is positively related to earnings management when they investigate this relationship using all non-financial listed firms on the Taiwan Stock Exchange. On the other hand, Sun, Salama, Hussainey, and Habbash (2010) find that board size is not associated with earnings management.

There is thus no agreement on the direction of the relationship between board size and earnings management. Some studies argue that small boards are more effective, while others argue that large boards have a diversity of experience and more independent members and so are more effective. However, these contradictory findings arise from different markets and so the differences between them may well relate to differences between the contexts under investigation.

4.3.1.3 Board meetings

Studies have measured the board's monitoring quality in terms of the board's frequency of meeting, as an indication of the board's diligence (Vafeas, 1999). The frequency of board meetings can be considered a proxy for the time board directors have to perform their duties (Greco, 2010; Vafeas, 1999). A high frequency of meeting is related to: an enhanced oversight of financial reporting (Carcello, Hermanson, Neal, & Riley, 2000); more frequent earnings forecasts (Greco, 2010); and greater transparency (Laksmana, 2008). In addition, a high number of meetings indicates a greater involvement of the directors in monitoring activities and that they are taking a more active position to maintain the quality of financial information and, hence, to reduce earnings management (Sáenz González & García-Meca, 2014).

Vafeas (1999) find that there is a positive association between performance and the number of board meetings. In addition, Xie et al. (2003) used a sample of US firms for the period from 1992 to 1996 to investigate the relationship between earnings management and the meeting frequency of the board. They find that firms with high meeting frequency are associated with lower earnings management as the board members are able to be effective monitors. Furthermore, Sáenz González & García-Meca (2014) find that board activity (measured as the number of board meetings) is negatively associated with earnings management in Latin American non-financial firms. This means that the board is an active monitor of financial reporting.

However, some studies find that there is an insignificant or positive relationship between earnings management and the number of board meetings. For instance, Ebrahim (2007) finds that the number of board meetings is positively related to earnings management. This might be an indication that the board reacts to urgent business or circumstances rather than conducting these meetings as part of the function of monitoring financial reporting.

These studies on the influence of board meetings on earnings management have produced mixed results. Therefore, their claims cannot be generalised, which means that further investigation is needed to understand the extent to which, in different contexts, board meetings can lower managers' ability to act opportunistically to increase their wealth.

4.3.1.4 Politically connected firms

Previous studies focus mainly on specific corporate governance mechanisms, such as board composition and the properties of earnings. However, a few studies consider the role of particular types of directors, such as venture capitalist, bankers or politically connected directors. Studies that cover the effect of politically connected firms on earnings are scarce (Bona-Sánchez, Pérez-Alemán, & Santana-Martín, 2014). In addition, the few studies there are focus on the classic agency conflict between shareholders and managers, adopt an international perspective (e.g. Chaney, Faccio, and Parsley, 2011), and analyse the findings from countries with important institutional differences and dissimilar types of political connections, which might confound interpretation of the results (Bona-Sánchez, Pérez-Alemán, & Santana-Martín, 2014).

Chaney et al. (2011) investigate whether earnings quality differs with political connections in different countries and politically connected firms. Their sample consists of 209 politically connected firms from 19 countries. They find that the presence of political connections is associated with low-quality earnings figures. In addition, Bona-Sánchez, Pérez-Alemán, & Santana-Martín (2014) investigative the earnings informativeness of politically connected non-financial firms in Spain over the period from 2003 to 2011. They find that politically connected firms affect the credibility of reported earnings negatively and hence the informativeness of earnings.

Furthermore, Fan, Wong, & Zhang (2007) examine the role of government intervention (political connections) in China's newly partially privatised firms. Their sample consists of 790 firms, 27% of which were politically connected. These companies have boards populated by current or former government bureaucrats. These boards show low professionalism, as only a small number of the directors have relevant professional background. These firms' accounting and stock return performance is poor relative to their unconnected counterparts.

Moreover, Leuz and Oberholzer-Gee (2006) examine the role of political connections in financing strategies and the long-run performance of companies. They cover 130 Indonesian listed firms. They find that well-connected firms are less likely to have publicly traded debt or equity abroad. This can be explained in terms of these firms having access to preferential financing at home and firms with political ties dislike transparency.

Therefore, the existing literature shows that there is an influence of the presence of politically connected board members on the quality of earnings. However, there is not much evidence on this relationship, and it cannot be generalised, as the setting is likely to influence this relationship. Hence, investigating this association in Bahrain can provide interesting new evidence.

4.3.1.5 Nomination and remuneration committee

There is not much prior research on nomination and remuneration committees in relation to earnings quality, as and it seems to have been assumed that they do not affect the quality of financial reports. However, the main incentive for managers to manipulate earnings is their compensation, which is evaluated and recommended by the nomination and remuneration committee. Xie et al. (2003) argue that managers' incentives are based on the company's performance, so it is in their self-interest to give the company the appearance of good performance through managing the earnings. This leads to the agency problem. Serious difficulties may arise if insiders have been appointed to serve on this committee.

Anderson & Bizjak (2003) examine whether independence promotes shareholders' interest and whether the presence of the CEO on the compensation committee leads to opportunistic pay structures. They use 110 US listed firms for the period from 1985 to 1998. They find little evidence that the independence of the committee affects executive pay, or the presence of insiders, or whether the CEO reduces the total incentives.

On the other hand, other researchers find that the existence and composition of the nomination and remuneration committee influence the board's independent role in constraining earnings management. Prior studies find that there is a negative relationship between board independence and the presence of the CEO on the nomination committee. Klein (2002b) finds that the presence of the CEO on the nomination committee is related to the more earnings management in the firm. One explanation is that the presence of the CEO reduces the independence of the committee and its ability to mitigate earnings management. In addition, Osma and Noguer (2007) investigate whether the composition of the nomination committee affects the independent directors' role in constraining earnings management. Their sample comprises 155 Spanish firms. They find that an independent nomination committee is positively associated with earnings management. They indicate that adopting specific corporate governance practices worldwide might not have the same impact on the quality of financial reports.

Thus, little research has been done into the role of the remuneration and nomination committee in improving earnings quality. More evidence covering this relationship, especially from different contexts, is required.

4.3.1.6 Ownership structure

The ownership structure has a critical influence on the governance mechanisms and the ability to constrain manipulation. Corporate ownership influences the corporate governance practices and the quality of financial reports accordingly. Many studies, such as Leuz et al. (2003), have attributed the differences in the quality of financial reports to the ownership structures. Studies have found that concentrated ownership allows large shareholders to monitor and influence management behaviour (Armstrong et al., 2010). Wang (2006) finds that the presence of concentrated ownership is associated with the incidence of fraud and accordingly the quality of financial reports. Moreover, Liu and Lu (2007) find a significant relationship between the level of ownership concentration and earnings management. Therefore, the quality of financial reports seems to be affected by concentrated ownership.

There are two predominant views: the first argues that concentration of ownership may strengthen monitoring mechanisms and restrict opportunistic behaviour, while the other suggests that majority shareholders may collaborate with management against the minority shareholders and other stakeholders in order to increase their wealth (Shleifer & Vishny, 1997). Therefore, specific governance practices are required to solve both the vertical agency problem (between owners and managers) and the horizontal agency problem (between majority and minority owners).

Therefore, ownership structure is considered as a mechanism that can mitigate agency problems and reduce agency costs. Hence examining the relationship between ownership structure and earnings quality can provide a complete view of the role of corporate governance. Thus, this section will discuss the types of ownership which could affect the governance practices.

4.3.1.6.1 State ownership

With regard to the effect of state-ownership on the quality of earnings, studies have provided mixed evidence. For example, Ding, Zhang, and Zhang (2007) examine the role of ownership structure in earnings management in Chinese listed firms in 2002. They show that there is a significant non-linear relationship between earnings management and ownership concentration. They find that the agency cost is high when the ownership concentration level is low. Moreover, they find that privately owned firms favour earnings-boosting methods more than state-owned firms because they are under pressure to report good financial performance to compete with state-owned firms.

Wang and Yung (2011) examine the impact of state ownership on earnings management for Chinese listed firms for the period from 1998 to 2006. They find that state-owned firms have higher earnings quality than privately owned firms. They believe that this result can be explained by the government serving as a powerful external monitor guarding against managerial opportunism or by state protection reducing the pressure on managers to manage earnings.

However, the quality of information provided in the financial reports from firms with high state ownership can be lower than that of similar non-state-owned firms, as these firms have less need to respond to market pressures (Chaney et al., 2011). Liu et al. (2014) examine the influence of state ownership on earnings quality for Chinese listed firms for the period from 1998 to 2005. They find that state-owned firms have lower earnings quality than non-state-owned firms. State-owned firms in China have high discretionary accruals, more earnings smoothing, less frequent timely recognition of losses, more frequently managed earnings towards the target and less value relevance. They note that government can direct its controlling ownership power to self-serving purposes, which negatively influences firms' financial reporting.

Ben-Nasr, Boubakri, & Cosset (2015) examine the impact of residual state ownership on earnings quality for 350 newly privatised firms from 45 countries. They find that state ownership is associated with low-quality earnings. State ownership is associated with transitory earnings, high abnormal accruals and low earnings informativeness. They think that the potential tunnelling of corporate resources for political purposes influences state-owned firms to report low-quality earnings.

4.3.1.6.2 Family ownership

Family ownership has a significant impact on accounting and reporting practices (Prencipe, Bar-Yosef, & Dekker, 2014). Family ownership can affect the quality of financial reports in two ways: the alignment effect and the entrenchment effect. The alignment effect is where families, as controlling owners, increase monitoring (Shleifer & Vishny, 1997). Demsetz and Lehn (1985) state that families might monitor firms more effectively as they have long experience and presence in the firms and they try to build future strength. The findings of some studies are consistent with the alignment effect. For instance, Ali, Chen, and Radhakrishnan (2007) investigate the influence of family ownership on the quality of reported earnings. They cover US firms for the period from 1998 to 2002, which is before the introduction of the Sarbanes Oxley Act 2002. They find that family firms have higher-quality earnings than non-family firms, although they disclose less information. Wang (2006) investigates the impact of founding-family ownership on earnings quality for the period from 1994 to 2002. He documents that founding-family ownership is associated with higher earnings quality (lower abnormal accruals, less persistence of transitory loss components in earnings and more informative earnings) than is the case for non-family firms.

On the other hand, the entrenchment effect argues that family firms are less efficient because the concentrated ownership incentivises managers to expropriate wealth from external shareholders (Shleifer & Vishny, 1997). This agency problem is serious in countries where family ownership is widespread, financial reporting less transparent and legal protection of minority shareholders weak (Ball et al., 2003; Fan & Wong, 2002). Prior studies document that earnings quality is low in countries with low investor protection (Leuz et al., 2003). Jaggi et al. (2009) investigate the effect on earnings management of the presence of independent directors in family-controlled firms listed on the Hong Kong Stock Exchange. They find the effectiveness of the board in its monitoring duties is only moderate in family-controlled firms; therefore, these firms have low-quality earnings. Furthermore, in a study of Italian listed firms with family ownership, Prencipe, Bar-Yosef, Mazzola, and Pozza (2011) examine the influence of family ownership on earnings quality. They find that family-controlled firms are less likely to smooth earnings.

4.3.1.6.3 Managerial ownership

There are two agency problems between shareholders and managers which the level of managerial ownership influences (Lennox, 2005; Morck, Shleifer, & Vishny, 1988; Shuto & Takada, 2010). These two agency problems are: the incentive alignment effect and the management entrenchment effect. First, the incentive effect is where managers with large shareholdings have an incentive to act in line with outside shareholders. Second, the entrenchment effect is where managers with large shareholdings act in their own private interests (Holderness & Sheehan, 1991).

Warfield et al. (1995) use a sample of US firms for the period from 1988 to 1990 to investigative the effect of managerial ownership on the informativeness of earnings and the magnitude of discretionary accrual adjustments. They find that earnings informativeness is more than doubled with managerial ownership. However, the magnitude of discretionary accrual adjustments is negatively related to managerial ownership. However, this study can be criticised for not controlling for other kinds of ownership structure.

Based on UK-listed firms for the period between 1993 and 1996, Peasnell, Pope, and Young (2005) examine whether the incidence of earnings management depends on the role of outside board members and the presence of an audit committee. They consider the case of managerial ownership, as it can influence the board's monitoring of earnings management. They also find that managerial ownership is associated with a lower incidence of earnings management.

In addition, Sánchez-Ballesta & García-Meca (2007) examine the relationship between managerial ownership and earnings quality for a sample of Spanish non-financial listed firms for the period between 1999 and 2002. They find that the informativeness of earnings increases as managerial ownership increases. However, this relationship reverses when the managerial ownership becomes too high.

Shuto and Takada (2010) examine the influence of managerial ownership on accounting conservatism (asymmetric timelines of earnings) for non-financial Japanese firms for the period from 1990 to 2005. They find that both low and high degrees of managerial ownership are significantly negatively related to the timeliness of earnings. This result is consistent with the incentive alignment effect, where managers act in line with outside shareholders' interests.

Gabrielsen, Gramlich, and Plenborg (2002) investigate the relationship between managerial ownership and usefulness of accounting earnings. Their study covers 76 Danish firms for the period from 1991 to 1995. In contrast to the findings of Warfield et al. (1995), they find that managerial ownership is negatively related to the usefulness of earnings. Their explanation for this contradictory findings is that the institutional setting in the US and Denmark are different. Capital market pressure, the convergence of manager and shareholder interests, taxes, manager entrenchment and ownership structures are important factors that might relate to the differences between the two contexts.

4.3.1.6.4 Institutional ownership

The existence of institutional ownership leads to three hypotheses regarding its influence on the monitoring of the firm. These three hypotheses are: the strategic alignment hypothesis, the efficient monitoring hypothesis, and the conflict of interest hypothesis (Pound, 1988). According to the strategic alignment hypothesis, institutional owners exacerbate earnings management. The interests of the institutional owners will be aligned strategically with the those of management, at the expense of the minority shareholders. In contrast, the efficient monitoring hypothesis postulates that institutional owners mitigate earnings management because they can monitor management at low cost and they have greater expertise. The conflict of interest hypothesis assumes that disagreement between institutional investors and groups of investors will favour management actions that promote investors' interests (Sakaki, Jackson, & Jory, 2017).

Studies have looked for the impact of institutional ownership on firm performance. For instance, Cornett, Marcus, Saunders, and Tehranian (2007) find that institutional ownership and the number of institutional stockholders are significantly related to firm performance. Institutional investors have been divided into two groups: transient investors and long-term investors. Koh (2007) examines the relationship between different types of institutional investor and earnings management. He finds that long-term institutional investors constrain earnings management practices, while the transient institutional investors are not associated with earnings management. Therefore, the type of institutional investor and the setting under investigation are important to the association between institutional ownership and earnings management. In addition, Jiang and Anandarajan (2009) find that institutional ownership is positively related to earnings quality. However, this relationship is weak when institutional investors are predominantly transient (i.e. are short-term investors). Transient institutional investors might use their ability to affect the managers' decisions to increase the value of their shares.

On the other hand, Velury and Jenkins (2006) examine whether institutional ownership affects the quality of reported earnings using US listed firms for the period from 1992 to 1999. They find a significant positive relationship between institutional ownership and earnings quality; however, they find that concentrated institutional ownership affects earnings quality negatively. In addition, Hadani, Goranova, and Khan (2011) find that large institutional owners are in a good position to constrain earnings management through their ability to gauge firm performance against the firm's long-term fundamentals.

Chung, Firth, and Kim (2002) investigate the role of institutional ownership in monitoring managers and its influence in mitigating earnings management. They examine this relationship using US firms during the period from 1988 to 1996. They find that institutional investors put pressure on managers to limit earnings management. They believe that institutional investors might apply direct or indirect pressure. Institutional investors can use direct pressure by explicitly telling managers of their preferences for no earnings management. Indirect pressure occurs when managers believe that the institutional investors will be unhappy if the company is involved in earnings management or when managers believe that the institutional investors will unravel the earnings management.

Mitra and Cready (2005) examine the relationship between institutional ownership and management's accounting discretion exercised to manage accruals. They examine the relationship using 373 firms non-regulated, non-financial and non-services in nature firms listed on the New York Stock Exchange for the eight years 1991 to 1998. They provide evidence of an inverse relationship between the total percentage shareholding of institutional owners and accounting discretion exercised to manage abnormal accruals. However, they find that this relationship is influenced by the size of a firm and the information environment in which it operates. They find that this inverse relationship is restricted to smaller firms in their sample which have an impoverished information environment. But they find no significant relationship between institutional ownership percentage shareholding and accounting discretion exercised to manage abnormal accruals in larger firms.

The role of institutional investors in improving the quality of reported earnings is influenced by factors such as the percentage of their ownership, the type of institutional ownership (short term or long term), firm characteristics, and the environment or setting in which the firm is operating.

4.3.1.6.5 Blockholder ownership

Blockholding is an ownership structure where the shareholder owns a large number of shares in a company. Blockholders can be individual investors, banks, corporations, fund managers, pension funds, private equity firms or governments (Claessens, Djankov, & Lang, 2000). Two views are put forward in the literature: one argues that concentration of ownership may strengthen the monitoring mechanisms and restrict opportunistic behaviour, while the other suggests that majority shareholders may collaborate with management against the minority shareholders and other stakeholders in order to increase their wealth (Shleifer & Vishny, 1997). Therefore, blockholders might manage earnings in their own interest and reduce other shareholders' residual claims (Claessens et al., 2000).

Yeo, Tan, Ho, and Chen (2002) examine the effect of managerial ownership and blockholdings on the informativeness of earnings for all firms listed on the Singapore Stock Exchange for the years 1990 through to 1992. They use discretionary accruals to measure earnings management and its effects on earnings informativeness. They find that blockholdings have a strong positive relationship with the informativeness of earnings. This result is consistent with the role of the large shareholder as a monitor of management practice.

Based on 1500 US firms listed in the period from 2002 to 2009, Dou, Hope, Thomas, & Zou (2016) investigate the relation between earnings management and blockholders using accrual-based earnings management, real earnings management, and restatements as earnings management measures. They find that blockholders are influencing financial reporting practices rather than selecting them.

However, Zhong, Gribbin, and Zheng (2007) examine the relationship between blockholders and earnings management using non-financial US firms listed on the New York Stock Exchange for the period from 1994 to 2003. They find that blockholders produce pressure on managers to manage earnings upward when the firm’s performance is declining. These results suggest the blockholders are not effective monitors. They believe that this relationship might be influenced by the regulatory changes introduced by the Sarbanes-Oxley Act.

On the other hand, Agrawal and Chadha (2005) examine the relationship between corporate governance mechanisms, including blockholding, and the incidence of earnings restatements. They use 159 US firms that restated earnings in 2000 or 2001. They find that blockholdings are not related to the probability of a company restating earnings. In addition, Peasnell, Pope, and Young, 2001 and Xie et al. (2003) find that blockholders are not related to the incidence of firms publishing defective financial statements and earnings management, respectively.

Therefore, the evidence related to the relationship between blockholding and earnings quality cannot be generalised. This relationship is affected by different factors, such as the nature of the blockholders (they are not uniform), the strength of the regulatory system, governance practices, investor protection and the financial reporting requirements.

4.3.2 Audit committee

The audit committee is responsible for overseeing and monitoring the financial reporting process to make sure that managers are reporting the firm's performance ethically (Kusnadi, Leong, Suwardy, & Wang, 2016). By manipulating the financial reports, shareholders will get false information and this will result in higher information asymmetry and a higher cost of capital (Kusnadi et al., 2016). The audit committee is responsible for monitoring and reviewing the integrity of financial reports, the internal audit function, internal financial control and the independence of external auditors (Financial Reporting Council, 2016). The effectiveness of the audit committee in monitoring and overseeing the financial reporting process depends on the independence of its members (Klein, 2002b), its size (Lin, Li, & Yang, 2006) and the frequency of its meetings (Xie et al., 2003).

Prior studies have examined the relationship between audit committees and earnings quality by using earnings management, accounting fraud and qualified audit reports as measures for earnings quality. A few studies have focused on the audit committee process in order to understand its activities (Wu & Patel, 2015). Beasley, Carcello, Hermanson, and Neal (2009) provide insights into the audit committee process through in-depth interviews with 42 individuals serving on US public company audit committees. They find that committee members avoid serving on "ceremonial" audit committees and strive to provide effective monitoring of financial reporting. In addition, they find that the interviewees' responses vary with personal and company characteristics, with notable differences in the audit committee members' accounting expertise and time of appointment to the committee (before or after the SOX). The research results indicate that audit committee operations are dynamic and socially constructed; therefore, contextual factors should be taken into consideration in understanding the function of the audit committee.

Through a case study of a major UK public company, Turley and Zaman (2007) investigate the processes and conditions influencing the operation and effectiveness of audit committees by focusing on the interaction between the audit committee's members, individuals from financial reporting and the internal audit function, and external auditors. They find that the informal networks (outside the formal processes and structure) between audit committee participants influence the effects of the committee on governance outcomes.

Gendron and Bédard (2006) investigate the process by which the meaning of "effectiveness" of the audit committee is socially constructed, through interviews with a small group of people who attend audit committee meetings in three large Canadian public companies. They find that attendees' reflective acts in processes and activities surrounding the committee's meetings play an important role in configuring the meaning of "effectiveness". In addition, the attendees' confidence in the effectiveness of the audit committee in achieving its main duties varies.

Lin, Xiao, and Tang (2008) use a questionnaire survey to investigate the perceptions of the roles of the audit committee, its responsibilities and basic characteristics, in China, from the perspectives of independent directors, investors, creditors, managers and auditors. They find that various stakeholders have generally accepted the audit committee's "ceremonial" roles and responsibilities that improve the structure of corporate governance. However, the committee’s roles and responsibilities related to improving internal controls, financial reporting, auditing and rules compliance have not been fully recognised at present. In addition, their study reveals that the audit committee’s operations in practice, in a large portion of listed companies in China, are ineffective. The reasons for this include the poor qualifications of committee members and their insufficient commitment, deficiencies in the governance structure of the listed companies, the lack of clear and stringent legal requirements relating to the committee’s responsibilities and obligations, and constraints of the two-tier board system.

Most of the above-mentioned quantitative studies have relied on secondary data to identify the relationship between audit committee characteristics and the quality of financial reporting. Their contribution is therefore limited, as they provide little insights into the functioning of audit committees. Although some studies have used qualitative approaches to understand this process, their contribution is also limited, as they focus on specific factors affecting the operation of audit committees and lack a comprehensive examination that covers the contextual environment.

The sections below discuss empirical studies that have examined audit committee characteristics in relation to earnings quality.

4.3.2.1 Audit committee independence

Most of the previous studies focus on the independence of audit committee members. These studies assume that independent audit committee members will provide better financial reports and this has been confirmed in empirical studies (Lin et al., 2006). Klein (2002a) examines the impact of independent directors in the audit committee on the existence of earnings management. By using a sample of 692 US firms, she shows a negative association between the proportion of independent directors and earnings management. Moreover, Bédard et al. (2004) investigate the relationship between audit committee characteristics (independence and activity) and earnings management for 300 US firms for the year 1996. They find a negative association between earnings management and fully independent audit committees. But their results may have been biased because they employed only one measure of earnings management (signed earnings management) using the modified Jones model.

Lin et al. (2006) study the association between the audit committee's characteristics (size, independence, financial expertise, activity and stock ownership) and earnings restatements (as a measure of earnings management) by selecting 212 US firms. They fail to find support for the theory that earnings management can be reduced by the presence of independent audit committees. However, their findings can be criticised as they did not use discretionary accruals as a measure for earnings quality and their sample covers only one year, which can affect the reliability of the results. Similarly, Xie et al. (2003) find that audit committee independence is not significantly associated with earnings management. They use 282 US firms for the years 1992, 1994 and 1996, and adopt Jones's (1991) model to measure earnings management (by estimating the current discretionary accruals).

Results are also mixed in other contexts. Piot and Janin (2007) examine the relationship between the independence of audit committee and the level of earnings management. Their study includes 120 French firms for the period from 1999 to 2001. They find that there is no significant relationship and they expect that the collective board responsibility for the quality of financial reports may hamper the monitoring incentive of independent directors. Likewise, Abdul Rahman and Ali

(2006) find that the relationship between the independence of audit committees and earnings management is insignificant in Malaysia. However, in samples of Australian firms it was found that the independence of audit can reduce earnings management (Kent, Routledge, & Stewart, 2010; Koh, Laplante, & Tong, 2007).

In addition to earnings management, audit opinion and accounting fraud are used as measures for the quality of financial reports in relation to audit committee independence. In the US market, it has been found that fraud decreases with the presence of an independent audit committee (Crutchley, Jensen, & Marshall, 2007). Audit committees' independence is also related to the probability of receiving going-concern audit reports (Carcello & Neal, 2000).

4.3.2.2 Audit committee size

Audit committee size can be an indication of the effectiveness of monitoring practices, as does board size. Some researchers argue that small audit committees can be more efficient in monitoring financial practices and in mitigating opportunities for earnings management, while others claim that big audit committee can monitor financial reporting practices better (Ghosh et al., 2010). The latter consider that a big committee will be more likely to include outside directors, who will enhance the effectiveness of the committee.

Few studies have investigated the effect of audit committee size on earnings quality and they find inconsistent conclusions. For instance, Lin, Li, and Yang (2006) examine the characteristics of audit committee (size, independence, activity, financial expertise and stock ownership) in preventing earnings management. The study focuses on 106 US firms for the year 2000. They find that there is a negative relationship between audit committee size and earnings management. In addition, Ghosh et al. (2010) examine the effect on earnings management of board and audit committee characteristics for the period before and after the Sarbanes-Oxley Act (SOX). The study covers US firms for the years from 1998 to 2005. They find that audit committee size has a marginal negative effect on discretionary accruals for the post-SOX years relative to the pre-SOX years. They find that this mechanism become less influential in affecting discretionary accruals for the post-SOX years.

However, using a sample of 300 US firms for the year 1996, Bédard, Chtourou, and Lucie Courteau (2004) find no significant relationship between audit committee size and earnings management. Likewise, Xie, Davidson, Dadalt, Davidson Iii, and Dadalt (2003) find no relationship between audit committee size and earnings management. Moreover, Abbott, Parker, and Peters (2004) examine the characteristics of the audit committee and the likelihood of financial restatement for 88 restatements of annual reports in the period 1991-1999. They find no association between audit committee size and restatement.

4.3.2.3 Audit committee meetings

Independent and competent audit committees play an effective and efficient monitoring role (Abdul Rahman & Ali, 2006). The number of audit committee meetings represents the diligence and scrutiny level exercised by its members (Ghosh et al., 2010). Committees that meet frequently are more likely to demand high-quality financial reports from the management and the external auditors (Ghosh et al., 2010). Therefore, regulators recommend that audit committees hold at least three or four meetings a year. The committee is expected to meet a minimum of once each quarter (Yang & Krishnan, 2005).

Xie et al. (2003) used a sample of US firms for the period from 1992 to 1996 to investigate the relationship between earnings management and the frequency of audit committee meetings. They find that firms with high meeting frequency are associated with lower earnings management, as the committee members able to serve as effective monitors. However, Lin et al. (2006) examine the characteristics of the audit committee in preventing earnings management for 106 US firms for the year 2000 and they find that there is a positive but not significant (at 10% significant level) relationship between audit committee meetings and earnings management. Ghosh et al. (2010) also examine the effect of board and audit committee characteristics for the period before and after the SOX on earnings management for US firms for the years from 1998 to 2005. They find that the frequency of audit committee meetings is positively related to earnings management. They suggest that audit committees should react to an escalating problem rather than taking a proactive position to mitigate managerial discretion (Vafeas, 1999). In addition, Sun et al. (2010) examine the audit committee meeting effect on earnings management for UK firms for the year 2007 and they find that it has an association.

On the other hand, a number of studies did not detect any relationship between the frequency of audit committee meetings and earnings quality. For example, Abbott et al. (2004) examine the characteristics of audit committees and the likelihood of financial restatement for 88 restatements of annual reports in the period from 1991 to 1999. They find no relationship between the frequency of audit committee meetings and restatement. In addition, Bédard et al. (2004), using a sample of 300 US firms for the year 1996, find no significant relationship between the frequency of audit committee meetings and earnings management. Likewise, Abdul Rahman and Ali (2006) investigate whether more frequent audit committee meetings reduce earnings management among Malaysian firms. The study covers 97 Malaysian firms for the period from 2002 to 2003. They find an insignificant relationship between frequency of audit committee meetings and earnings management.

4.3.2.4 Audit committee expertise

The main responsibilities of the audit committee are to oversee the financial reporting and audit process and to maintain the quality of financial reports. Therefore, the appointment of members with expertise in accounting, finance and governance is an important attribute of the committee. Most the studies find that audit committees with expert members can improve the quality of financial reports. For instance, previous studies find that audit committees with at least one financial expert have greater interaction with the external and internal auditors (Raghunandan, Read, & Rama, 2001) and are associated with a lower incidence of financial restatement (Abbott et al., 2004). In addition, Xie et al. (2003) find that audit committees with financially sophisticated members can reduce the level of discretionary current accruals and improve the quality of financial reports accordingly, and Bédard et al. (2004) find that the inclusion of audit committee members with financial and governance expertise is associated with low earnings management.

In contrast, Abdul Rahman and Ali (2006) find insufficient evidence to support the theory that the presence of financial experts on the audit committee can reduce earnings management. The reason for the failure might be the weak role played by the audit committees in Malaysia and the small sample covered in their study compared with the samples covered in other studies. Similarly, Lin et al. (2006) find no significant relationship between audit committee expertise and earnings management/earnings quality. But their results might be unreliable, since their sample is small and they cover only one year before the passage of the SOX, which enhanced the role of audit committees.

4.3.2.5 External auditing

Auditing is considered a monitoring device that is required as a result of the potential conflicts of interest between managers and owners (Jensen & Meckling, 1976; Watts & Zimmerman, 1986). The quality of the audit can be defined as the probability of the auditor discovering a breach in the accounting system and reporting that breach (DeAngelo, 1981b). Audit quality is also described as the probability that material misstatements will be detected and reported by the auditor (DeAngelo, 1981b). DeFond and Zhang (2014, p.280) define audit quality as a “greater assurance that the financial statements faithfully reflect the firm's underlying economics, conditioned on its financial reporting system and innate characteristics”. Therefore, high-quality auditors are expected to consider the faithfulness of the client’s financial statements in reflecting the underlying economics of the firm, in addition to its compliance with the accounting principles. High audit quality leads to high-quality financial reporting because of the increase in the credibility of the financial reports (DeFond & Zhang, 2014). The section below will provide an overview of the literature that explains how external auditing can affect the quality of financial reports.

4.3.2.5.1 Auditor competencies

Auditor competence is the auditor’s ability to deliver a high-quality audit; it includes skills, training and expertise (DeFond & Zhang, 2014). Researchers examine whether characteristics of the auditor office can capture the competencies of auditors which influence audit quality (DeFond & Zhang, 2014). A growing body of research supports the use of auditor size as a proxy for the quality of audit. Recent evidence has suggested that “Big N” offices offer higher-quality audit because of the expertise available in-house. For instance, Lin and Hwang (2010) use various measures for the quality of audit (industry specialisation, audit fees, auditor size, auditor tenure) and find that Big4 auditors have a significant negative relationship with earnings management. Moreover, Eshleman and Guo (2014) indicate that the Big4 auditors provide higher-quality audits. They find that firms appointing Big4 auditors are less likely to subsequently issue an accounting restatement.

Chen et al. (2005) investigate the relationship between the auditor size (Big5) and earnings management in Taiwan IPO companies for the period from 1996 to 1998. They find that Big5 auditors are related to lower earnings management in the IPO year in Taiwan companies. This means that higher-audit quality can constrain earnings management. Chen et al. (2005) test the agency theory in their study and so did not consider ownership structure in the Taiwan IPO companies under investigation.

Becker et al. (1998) use the Jones model to measure earnings management and use Big 6 auditors as a measure for audit quality. Their study covers 10,379 US companies audited by Big 6 auditors and 2,179 companies audited by non-Big 6 auditors. They find that companies audited by non-Big 6 audit firms have higher discretionary accruals than companies audited by the Big 6 firms. In addition, Behn et al. (2008) investigate the relationship between audit quality (auditor size and speciality) and the predictability of accounting earnings by focusing on analyst earnings forecast properties for US companies from 1996 to 2001. They suggest that companies audited by Big 5 audit firms are associated with better forecasting performance by analysts.

However, auditors' competencies are also affected by the audit environment, such as market conditions, auditing standards, regulatory intervention and the institutional environment (DeFond & Zhang, 2014). Therefore, some studies focusing on the auditor size have produced different findings. For instance, Maijoor and Vanstraelen (2006) examine the influence of audit firm quality (Big 4) on the level of earnings management using data for the period 1992-2000 from three EU countries (Germany, France and the UK). They find that there is no evidence that a Big 4 audit firm reduces the magnitude of earnings management. They indicate that differences in the audit environment regimes across European countries can result in variation in the quality of audit provided by the international Big 4 audit firms.

4.3.2.5.2 Independence of the auditor

Independence of the auditor is one of the fundamental principles emphasised by regulatory bodies and professional accounting organisations (e.g. IFAC, 2013; IOSC, 2002). According to the Code of Ethical for Professional Accountants issued by the International Federation of Accountants (IFAC), auditors should maintain both independence of mind and independence in appearance. These two types of independence are defined as follows:

> ***Independence of Mind:*** *" The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism" (IFAC, 2013).*
>
> ***Independence in Appearance:*** *"The avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, or a member of the audit team's, integrity, objectivity or professional skepticism has been compromised" (IFAC, 2013).*

Auditor independence is considered the cornerstone supporting the value of audits. Therefore, there is a common recommendation from regulatory and advisory bodies to appoint independent, competent and qualified auditors to add to the credibility of financial reports (e.g. OECD, 2015b). In order to enhance the independence of the auditor, it has been suggested that the board audit committee be responsible for appointing the external auditors and overseeing their independence and making sure that the external auditors are accountable to shareholders (IOSC, 2002; OECD, 2015b).

Although the importance of auditor independence has been widely recognised, there is a debate over the factors that affect it. Most studies focus on the non-audit services and auditor tenure as issues affecting auditor independence. Supporters argue that restrictions can reduce potential threats to auditor independence from the close relationship between the auditor and the client (Basioudis, Papakonstantinou, & Geiger, 2008; Dee, Lulseged, & Nowlin, 2006). On the other hand, opponents claim that providing non-audit services and a longer tenure allows the auditors to gain deep knowledge about their client and improve the quality of audit provided (Chen, Lin, & Lin, 2008; Jenkins & Velury, 2008). Researchers in this area have employed archival, survey and experimental approaches to investigate these issues using samples of public companies listed in the US.

Some studies have discussed the construction of auditor independence in a local context where the concept of “auditor independence” has been imported from Western countries. These studies find that local context influences the construction of auditor independence. For instance, in the Czech Republic, in the context of market instability and an immature legal framework, auditor independence is perceived as an economic concept (Sucher & Kosmala-MacLullich, 2004). In Poland, auditor independence is perceived to be a concept imported from Western countries and therefore it is seen as alien to local tradition (MacLullich & Sucher, 2005). The socio-economic and political situation and regulatory changes have narrowed the perceived concept to its economic dimension. Hudaib and Haniffa (2009) provide insights and interpretations of auditor independence in Saudi Arabia, where they find that the concept is influenced by various cultural dimensions. These studies provide insights into auditor independence within contexts different from Western countries. They find that it is not possible to achieve auditor independence without taking into consideration the local culture and accounting traditions of each country.

Some studies do not investigate the local context deeply to gain a full understanding of the contextual influences in the concept. They adopt a narrow view to investigate the auditor independence by using a quantitative methodology to determine the relationships between different factors. As the meanings and operation of auditor independence cannot be captured statistically, these studies provide limited insight. However, studies that investigate the local construction of auditor independence show how the concept is interpreted and practised from a cultural and historical perspective (Hudaib & Haniffa, 2009; MacLullich & Sucher, 2005; Sucher & Kosmala-MacLullich, 2004).

4.3.3 Earnings quality and corporate governance in Bahrain

Few studies examine the effectiveness of corporate governance mechanisms in Bahrain. For instance, Alareeni (2018) investigates the influence of corporate governance mechanisms on earnings management in companies listed in Bahrain Bourse. The study cover 20 Bahraini listed companies during the period 2011-2015. It examines the impacts of board size, board independence, CEO duality, and internal ownership. Earnings management measured using the absolute value of discretionary accruals computed using the Modified Jones (1995) model. The findings show that board size is negatively related to earnings management while board independence and internal ownership are negatively related to earnings management. Moreover, the CEO duality does not have an effect on earnings management in Bahrain.

In addition, Ahmed and Hamdan (2015) examine the impact of corporate governance mechanisms on firm performance for 42 companies listed in Bahrain Bourse during the period from 2007 to 2011. They find that corporate governance mechanisms are significantly related to two performance measures, namely return on assets and return on equity, but not significant with earnings per share performance measure. Overall, they find a positive influence of corporate governance mechanisms on performance for the firms listed in Bahrain Bourse.

Furthermore, Mousa and Desoky (2012) examine the impact of corporate governance mechanisms on firm performance for 43 companies listed in Bahrain Bourse during the period from 2008 to 2010. They employ three different corporate value measures (Tobin's Q, ROA, and EPS). They find that board size has a significant effect on corporate value while board independence, duality of CEO, and ownership concentration variables have insignificant effect on corporate value. ROA model report that CEO duality only has a significant relationship with ROA. Regarding the EPS model, all board characteristics are significantly influence corporate value, while ownership concentration variables are insignificant to corporate value using EPS measure.

However, these studies do not cover all companies listed on Bahrain Bourse and they only investigate small number of corporate governance mechanisms for short periods. In addition, these studies do not provide enough explanations for their findings. Therefore, this study will fill this gap by covering all Bahraini non-financial listed firm for the period from 2005 to 2016. The study will investigate a lot of corporate governance mechanisms that are related to the board characteristics, nomination and remuneration committee, ownership structures, and audit committee. Moreover, it will provide a deep explanation for the findings by providing supports from the interviews findings.

4.3.4 Hypotheses development

The previous subsections discussed existing empirical results and theory concerning the relationship between earnings quality and corporate governance mechanisms. It forms the basis for the study hypotheses which will be discussed below.

Agency theory predicts that the board of directors can enhance the quality of financial reports by monitoring managers (Peasnell et al., 2005). Prior research has investigated the relationship between earnings management and board characteristics. Xie et al. (2003) found that companies with large boards are associated with low earnings management. On the other hand, prior studies support the concept that independent directors on the board enhance the ability to monitor management (Lee, 2008). Greater participation by independent directors on the board reduce the earnings management (Persons, 2006). Interestingly, the board of directors and top management for Bahraini companies include politically connected members. A politically connected director is: a member of parliament, minister or the head of state, is or closely related to a top official (Faccio, 2006); a current or former officer of the government bureaucracy (Fan et al., 2007); or is closely related to a politician (Chaney, Faccio, & Parsley, 2011). Close relationships include friendship, past political, and well-known relationships with political parties (Chaney et al., 2011). These individuals with a political connection can influence the management to manage earnings to pursue another objective, such as benefiting the managers, gaining promotion, or pursuing a political agenda (Liu & Lu, 2007). Following from these discussions, the following hypotheses are proposed:

Hypothesis 1: there is a positive relationship between board size and earnings quality.

Hypothesis 2: there is a positive relationship between the frequency of board meetings and earnings quality.

Hypothesis 3: there is a positive relationship between the number of outsiders (non-executive) among board members (percentage) and earnings quality.

Hypothesis 4: there is a positive relationship between the number of independent outsiders among board members (percentage) and earnings quality.

Hypothesis 5: there is a negative relationship between the existence of politically connected board members and/or managers and earnings quality.

In addition, managers may manipulate the companies' financial reports because they are seeking to increase their compensation and benefit in other ways that are linked to the reported earnings (performance). Prior research has found that the presence of a compensation committee can influence a company's financial reporting process as it handles agency issues (Xie et al., 2003). Concerns arise when the CEOs or executives serve on the remuneration and nomination committee, as this will increase the agency problems between the shareholders and management

(Anderson & Bizjak, 2003). It has been suggested that this committee can generate strong monitoring tools that prevent management from managing earnings. Independent directors on this committee are able to accomplish this objective (Petra & Dorata, 2008). Following from these discussions, the following hypotheses are proposed:

Hypothesis 6: there is a positive relationship between the existence of a nomination and remuneration committee and earnings quality.

Hypothesis 7: there is a positive relationship between the independence of the nomination and remuneration committee and earnings quality.

Moreover, the audit committee is the delegated body of the board which is responsible for overseeing and monitoring financial reporting. Much emphasis has been placed on the role of the audit committee in preventing fraudulent accounting (Klein, 2002a). Inconsistent with prior studies, Klein (2002a) selects some characteristics of audit committees that can prevent earnings management. Many researchers, like Lin, Li, and Yang (2006) and Yang and Krishnan (2005), have found that the size of the audit committee is negatively associated with the occurrence of earnings restatements. In addition, Lin et al. (2006) found that the audit committee's activity level is negatively associated with the occurrence of restatements. Furthermore, the independence of the members of the audit committee is an important factor in effective monitoring (Chen & Zhang, 2014). Many studies have emphasised that an independent audit committee can reduce the occurrence of earnings management (Abbott, Parker, and Peters, 2004; Bédard, Chtourou, and Lucie Courteau, 2004; Xie et al., 2003). Following from these discussions, the following hypotheses are proposed:

> *Hypothesis 8: there is a positive relationship between the size of the audit committee and earnings quality.*
>
> *Hypothesis 9: there is a positive relationship between the frequency of audit committee meetings and earnings quality.*
>
> *Hypothesis 10: there is a positive relationship between the percentage of outsiders on the audit committee and earnings quality.*
>
> *Hypothesis 11: there is a positive relationship between the percentage of independent outsiders on the audit committee and earnings quality.*

Auditing is a monitoring device that is required because of the potential conflicts of interest between managers and owners (Jensen & Meckling, 1976; Watts & Zimmerman, 1986). The function of audit is to discover breaches in the accounting system and to report that breach (DeAngelo, 1981a). It is also described as the probability that material misstatements will be detected and reported by the auditor (DeAngelo, 1981b). Therefore, high-audit quality increases both the quality and the credibility of financial reports (DeFond & Zhang, 2014). The reputation of international big audit firms should deter poor auditing (Peasnell et al., 2001). Therefore, it is expected that appointing one of the international big four audit firms will constrain earnings management. If a company's accounts are found to be defective in an audit, the company might well change auditor thereafter, either because of disagreements between managers and auditors, or because the auditor fails to defend that (Peasnell et al., 2001). Following from these discussions, the following hypotheses are proposed:

Hypothesis 12: there is a positive relationship between the use of one of the international big four auditors and earnings quality.

Hypothesis 13: there is a relationship between change of auditor and earnings quality.

Unlike the dispersed shareholder base in the US and the UK, Bahraini listed companies are characterised as having concentrated ownership structures. Their shares are often owned by groups of “insiders” who have long-term relationships with the company. They can be members of the founding families, a small group of shareholders, other companies (cross-shareholdings) or government. Agency theory suggests that high levels of insider ownership provide better corporate governance, leading to higher-quality financial reports (Sánchez & García-Meca, 2005). Agency theory predicts that ownership concentration might mitigate the agency problem and reduce agency costs by aligning the interests of the company with those of the owners (Jensen and Meckling, 1976). Shleifer and Vishny (1986) state that controlling shareholders have an incentive to monitor and influence the management in order to protect their investments. However, the complexity of the principal-agent problem increases when there are minority as well as major shareholders. Major shareholders (controllers) can exercise their control to meet their own interests and expropriate minority shareholders’ rights, as large shareholders can impose their preferences even if they are contrary to the minority shareholders’ preferences (Shleifer & Vishny, 1997). Therefore, controller shareholders can influence managers’ decisions and encourage them to engage in earnings management to maximise their benefits (Guthrie & Sokolowsky, 2010).

For developing countries, where state and family ownership is generally highly concentrated, ownership structure theory helps to explain the firm's agency cost (Claessens et al., 2000). This theory explains that the proportion of equity held by different shareholders is associated with the direction and extent of earnings management (Dempsey, Hunt, & Schroeder, 1993). Prior studies have found a negative relationship between insider ownership and earnings quality (Leuz, Nanda, & Wysocki, 2003; Fan & Wong, 2002). Following from these discussions, the following hypotheses are proposed:

Hypothesis 14: there is a negative relationship between state ownership and earnings quality.

Hypothesis 15: there is a negative relationship between family ownership and earnings quality.

Hypothesis 16: there is a negative relationship between institutional ownership and earnings quality.

Hypothesis 17: there is a negative relationship between individual ownership and earnings quality.

Hypothesis 18: there is a negative relationship between managerial ownership and earnings quality.

Hypothesis 19: there is a negative relationship between blockholder ownership and earnings quality.

4.4 Summary and research gaps in the literature

This chapter has presented a brief discussion of the prior research on corporate governance mechanisms in relation to earnings quality and the hypothesis development. It can be noted that agency theory is the basis for these governance mechanisms, which try to reduce agency costs by protecting shareholders' interests and align the managers' (agents') interests with those of the shareholders (principal).

Although previous studies have examined those characteristics of the board and the audit committee that might have an effect on earnings quality, few studies have tried to investigate the effect of remuneration and nomination committees on earnings quality. In addition, the examination of the corporate governance mechanisms has been conducted using quantitative methods (regression analysis), which can show the type of relationship (positive or negative) but which do not provide a rich explanation for such relationships. Moreover, earnings quality is a multidimensional concept which has been measured differently in the literature; thus, there is no agreed single measure for earnings quality. Furthermore, ownership structure has a significant influence on earnings quality, both directly and indirectly. However, little attention has been given to the unique ownership structures common beyond the Western contexts generally studied.

Therefore, this study contributes to the literature by investigating the effects of governance mechanisms, including remuneration and nomination committees, on earnings quality, using mixed research methods. This study uses semi-structured interviews and a questionnaire survey to gain a deep understanding of the effect of the governance mechanisms in order to develop the hypotheses and then uses these insights to explain the results of the regression analysis. In addition, it uses measures of earnings quality that have been found to be important in the interviews and survey findings. Moreover, this study increases the understanding of these relationships by eliciting perceptions of different stakeholders in Bahrain, which is characterised by its unique ownership structure, culture, regulations and political system.

Chapter 5: Theoretical Framework

5.1 Introduction

This chapter presents the theoretical framework for this study. The framework assists in linking the research findings with the research questions and hypotheses. It explains the researcher's expectations. This chapter sets out the relevant theories on financial reporting and corporate governance practices, in particular, agency theory (section 5.2) and neo-institutional theory (section 5.3). Section 5.4 presents the concluding remarks.

5.2 Agency theory

The 'agency' relationship has been defined by Jensen and Meckling (1976) as a contract between one or more persons (the principal or principals) and another person (agent) to perform a service on his/her or their behalf, where the agent is provided with some decision-making authority. That is, agency theory describes and models the relationship between the principal, who delegates the work, and the agent, who performs the work (Eisenhardt, 1989). The separation of ownership and management sets up conflicts of interest between the two parties (Jensen & Meckling, 1976).

The principal requires information to assess the firm's performance; however, the agency relationship can impose the problem of information asymmetry. This problem indicates that principals and agents have access to different levels of information and, furthermore, agents will have more information (Healy & Palepu, 2001). This leads to other agency problems, which can be classified into the following four main categories:

- Moral hazard. This derives from the fact that managers' act in their won best interest, to maximise their wealth. The moral-hazard explanation of the agency conflict was first presented by (Jensen & Meckling, 1976). They built a model which assumes that a single manager owns the firm and they found that the manager's motivation to consume private perquisites increases as his/her ownership in the company declines. Jensen (1993) argues that the moral-hazard problem increases as the company becomes larger, because of the complexity of the company's contracting nexus and the difficulty of monitoring. Moreover, Jensen (1993) claims that the free cash flow at large companies will increase the moral hazard. The management at these companies has funds to hand without strong restrictions on spending. Therefore, the moral-hazard problem is linked to the manager's ownership of the company; as their stakes in the company increase, their incentive to work for the good of the company may increase.
- Earnings retention. Jensen and Murphy (1990) and Conyon & Murphy (2000) find that directors' remuneration is a function more of company size than of growth in shareholder returns. Jensen (1986) argues that managers prefer to retain earnings, while shareholders prefer higher cash distributions. Moreover, greater retained earnings benefits managers through more power and prestige, in addition to awarding themselves with higher remuneration (Jensen, 1986). Earnings retention also provides managers with greater job security, by reducing firm-specific risk. On the other hand, this route provides

the company with the needed funds to expand or invest without the need for external financing.

- Time horizon. This is another form of conflict between shareholders and managers. It concerns cash flow timing. Managers prefer short-term investment, as it has a direct impact on their employment contract (compensation). For instance, managers may use accounting tactics to record earnings in a period before their retirement, in order to maximise pensions linked to the company's reported earnings (Healy, 1985). Shareholders, in contrast, will be interested more in long-term investments, as they will determine the sustainability and profitability of the company in the future.
- Risk aversion. Managers try to minimise the risks their company faces, but high-risk investments generally provide a high return for shareholders. Managers avoid high-risk opportunities as they increase the chances of bankruptcy, which would affect their reputation (McColgan, 2001). Therefore, managers prefer equity financing to debt, in order to reduce the risk of default and bankruptcy (Brennan, 1995).

However, the principal can limit the conflict between the two parties and protect their interests by establishing incentives and incurring monitoring costs to control the agent's actions. The principal attempts to guarantee that managers' actions do not harm the principal's interest; however, the divergence between the principal's interest and the agent's actions might remain and be viewed as a residual loss (Hill & Jones, 1992). Principals can use devices such as corporate governance mechanisms and auditing to oversee and supervise managers and to reduce the agency cost (Lin & Hwang, 2010). These devices can mitigate the opportunistic behaviours of management, improve the company's reporting quality and increase its value (Denis & McConnell, 2003; Lo, Wong, & Firth, 2010).

However, agency problems can differ from one context to another. Moreover, agency costs can be incurred from conflicts between principals rather than conflict between principal and agent. In developed economies, because of the separation between ownership and control, conflicts between principals (owners) and agents (managers) receive the lion's share of attention (Young, Peng, Ahlstrom, Bruton, & Jiang, 2008). However, in emerging economies, the characteristics of the institutional setting change the nature of the agency problem, and ownership concentration results in more conflicts between principals (e.g. controlling shareholders and minority shareholders) (Morck, Wolfenzon, & Yeung, 2005; Young et al., 2008).

In order to mitigate agency problems, actions should be taken to monitor managers' behaviour. These actions are considered agency costs. Hill and Jones (1992) have defined the agency cost as the sum of monitoring expenditures, the agent's bonding expenditures and any remaining residual loss. The categories of agency cost are set out below.

- Monitoring costs. These are expenditures paid to control the agents' behaviours. They include the costs of auditing, training and hiring managers, and corporate governance costs. Fama and Jensen (1983) suggest that these expenditures are covered by agents, through adjustments to their compensation.
- Bonding costs. These are expenses incurred in aligning the agent's interest with the principal's interest (Jensen & Meckling, 1976). Lippert and Moore

(1995) argue that the bonding contract should guide agents (managers) to make decisions in the best interests of the shareholders.

- Residual loss. Even after incurring the monitoring and bonding costs, the shareholders' and managers' interests are not fully aligned. The remaining agency losses from the conflicts of interest are known as a residual loss (Jensen & Meckling, 1976).

Managers can influence the quality of reported earnings through the flexibility of accounting standards, which can misallocate the company's resources (Healy & Wahlen, 1999). Earnings manipulation or management can be a type of agency cost, as managers can, for example, release financial reports that do not accurately present the financial position of the firm and this will influence shareholders' decisions (Davidson et al., 2004).

Companies can develop monitoring mechanisms to reduce agency costs. Corporate governance mechanisms are an example. McKnight and Weir (2009) argue that governance mechanisms can reduce agency costs by realigning the interests of agents and principals. In addition, Jensen and Meckling (1976) argue that the employment of external auditors can reduce the agency problem. An external auditor is an independent monitor who reduces the incentive of managers to act in their best interest. Audit is an important tool that can reduce opportunistic behaviour costs (agency costs) related to managers (Watts & Zimmerman, 1983). Therefore, good corporate governance mechanisms and high-quality audit can reduce the opportunities for managers to pursue their own best interests at the expense of owners (shareholders).

In summary, agency theory has been used for a long time as a framework for studies of financial reporting and corporate governance. It assists in understanding the conflict of interest between agent and principal. Prior studies use agency theory as a framework to explain financial reporting and corporate governance practices and how governance practices and auditing improve earnings quality. Therefore, this study applied agency theory to understand and interpret financial reporting (earnings quality) and corporate governance and auditing practices. However, some previous studies find that agency theory does not explain all of these practices. It is therefore also necessary to apply another theory, to explain the results that cannot be explained by agency theory.

5.3 Institutional theory

Institutional theory provides a broad, rich and complex view of organisations. It refers to the power of underlying rules, values, norms and beliefs. Institutional theory explains how organisational structures and individual behaviour are influenced by the social, cultural and political forces surrounding the organisation (Fogarty, 1996). It suggests that organisations are affected by normative pressures arising from the organisation itself and external sources (Zucker, 1987).

Within the framework of institutional theory, there are two principles which should be taken into consideration. First, there is an assumption that the institutional environment is socially constructed, which means that it can both shape individual behaviour and be shaped by individuals within the environment. Essentially, the institutional environment is a human fabrication (Meyer & Rowan, 1977; DiMaggio &

Powell, 1983). Second, institutional theory assumes that organisations are open systems. This suggests that the external environment and its actors play an important role in shaping organizational structures and activities (Scott, 1998). Scott (1998) explain this view by saying that "Every organisation exists in a specific physical, technological, cultural and social environment to which it must adapt. No organisation is self-sufficient; all depend for survival on types of relations they establish with larger systems of which they are a part".

Based on these assumptions, organisations should not neglect the institutional environment in which they operate but should act in accordance with this environment's beliefs, norms and values. Institutionalists believe that organisations should follow the institutional rules and procedures in order to sustain appearances and to generate legitimacy rather than prioritising efficient results for the organisation (Meyer and Rowan, 1977). Therefore, organisations must conform to rules and requirements to receive support and legitimacy (Meyer & Scott, 1983).

Scott (1995) defines institutions as "cognitive, normative, and regulative, structures and activities that provide stability and meaning to social behaviour". North (1990) argues that institutions are "the rules of the game" which state the incentives for society members to become involved in economic activities. Institutions may be either formal (such as laws and regulations) or informal (such as conventions and norms). Both types influence social behaviour.

Old institutional theory focuses on the issues of influence, coalitions and competing values which are central within power and informal structures (Clark, 1960). However, new institutional theory emphasises legitimacy and the embeddedness of organisational fields (DiMaggio & Powell, 1983; Meyer and Rowan, 1977). New institutional theory assumes that organisational internal structures and procedures are shaped by external factors. It predicts that organisations operating within the same environment will present similar features, including internal structures and activities, which are those accepted by society (DiMaggio & Powell, 1983; Meyer and Rowan, 1977). Therefore, new institutionalists argue that organisations try to legitimise their operations by conforming to societal pressures, rather than prioritising internal efficiency.

Some researchers call for a complete theory to understand the abandonment, emergence and persistence of institutions and the interactions within these processes (Moll, Burns, & Major, 2006). Selznick (1996) questions the wisdom of drawing a sharp line between the old and new institutionalism because this inhibits the contribution of institutional theory to major issues of social policy and bureaucracy. Therefore, a number of scholars have tried to reconcile the old and the new institutional theory by integrating intra-organisational dynamics, institutional explanations, and interests and power of actors to provide a framework with more integrative and explanatory power (Greenwood & Hinings, 1996; Selznick, 1996). Greenwood and Hinings (1996) converge multiple themes of old and new institutionalism and label this convergence neo-institutionalism. Neo-institutional theory provides a broader view. It helps gain insights into the institutional environment and contextual pressures. In particular, it explains intra-organisational responses to contextual pressures.

5.3.1 Institutional analysis

From the sociological perspective, institutional scholars examine how macro social institutions influence and shape lower-level social activities and behaviour. They treat organisations less as a means to provide services and to produce goods, and more as symbolic cultural and social entities (Meyer & Rowan, 1977). The sociological approach argues that organisations and organisational actors are seeking legitimacy and social acceptance besides competing for resources. Based on this perspective, it is important to understand the institutional environment in order to understand the social system, because these forces guide or constrain legitimacy seeking (Aguilera & Jackson, 2003). Although "institutional" has been conceptualised in various ways (Scott, 1987), it refers to enduring systems of socially-organised practices and social beliefs related to various functional areas of society (e.g. law, regulations, politics and religion).

Scott (2001) provides a useful framework to analyse the effect of the higher-level environment on lower-level institutions. His institutional theory framework utilises three levels of analysis. At the highest level, there are societal institutions in which models and menus are formally proposed and informally enacted. This level provides the institutional context with acceptance and legitimacy. These institutions shape, facilitate and constrain actions and structures at lower levels. At the next level, there are governance structures comprising the organisational field and the organisations themselves. The organisational field is the sum of organisations operating in the same domain, such as audit firms; along with other organisations, these influence the performance of, for example, creditors and partners. The organisations are the lowest level, and these can vary by size, function, culture, structure and so on, and they influence and are influenced by the institutional environments and their organisational field. Finally, the institutional actors might be individuals or groups.

While inventing new ways of operating and negotiating institutional norms, the forces of diffusion and imposition of these institutional norms influence each of these levels (Judge, Li, & Pinsker, 2010). Therefore, the key assumption of institutional theory is that “all social actors are seeking legitimacy, and/or reinventing legitimacy norms, within the institutional environment” (Judge et al., 2010). These forces converge to create similarity or isomorphism of thought, structure and actions within the institutional setting.

Within neo-institutional theory, Dimaggio and Powell (1991) have identified three types of isomorphism. The first type is “coercive” isomorphism, which comes from legitimacy concerns and resource dependence. Based on this logic, the presence of institutions can force, or at least influence, economic actors to follow, for example, international accounting (and governance) standards and practices. Like organisations, nations might be forced to follow international standards because of coercive institutions outside its economy. Especially when an economy is small or poor and looking to gain support, it is more dependent on international standards and norms than large and wealthy economies. International non-governmental organisations are used to coercively making changes within an economy by guaranteeing some foreign support. For instance, the International Monetary Fund and the World Bank provide some support to countries in financial trouble, as well as developing countries. Usually, the international organisations require these countries to adopt international accounting and governance standards and practices as a condition to gain the needed support. Prior studies support the impact of coercive institutions on the adoption and implementation of international accounting and governance standards and practices. For example, Irvine (2008) argues that external coercive isomorphism contributed to adoption and implementation of the International Financial Reporting Standards (IFRS). The World Bank pushed the UAE to adopt the IFRS in order to establish an international capital market and attract foreign direct investment. Furthermore, Siddiqui (2010) found that external coercive pressures, from international financial agencies such as the World Bank, were influential in moving Bangladesh toward the adoption of Anglo-American models of corporate governance.

The second form of isomorphism identified by Dimaggio and Powell (1991) is “mimetic” isomorphism. This form refers to the tendency of individuals, organisations and nations to imitate the institutional practices of others which are viewed as successful and legitimate. Usually, successful multinational organisations follow the IFRS and international corporate governance best practice. Therefore, domestic organisations try to adopt what these successful foreign organisations are implementing in order to gain the opportunity to engage in foreign competition. Previous studies have documented that regional openness to foreign competition guides nations to adopt international standards and practices. Foreign direct investments have been found positively associated with the adoption of international standards and practices, and this adoption is often considered the price of membership of the global market (Irvine, 2008).

The third form of isomorphism within institutional theory is “normative” isomorphism. This form emphasises “the stabilising influence of social beliefs and norms that are both internalised and imposed by others” (Scott, 1995). It refers to the pressure used by professional groups and associations to adopt notable institutional practices that considered a proper or moral duty. Normative isomorphism is associated with professions because similar training and education instil similar professional values (Thornton & Ocasio, 2005). These values are carried into organisations by professionals, who prefer to adopt similar practices and structures. Professional accountants play a significant role in the adoption and implementation of international accounting standards and corporate governance practices. They were influential in the adoption of international accounting standards in Bangladesh (Zaman Mir & Shiraz Rahaman, 2005) and in the UAE (Irvine, 2008).

5.3.2 Reason for using institutional theory

The institutional perspective has been used by theorists to examine international alliances (Parkhe, 1998), mode of foreign entry (Meyer & Nguyen, 2005), strategic renewal of contracts with incumbent firms (Flier, Van Den Bosch, & Volberda, 2003) and general accounting research (Tuttle & Dillard, 2007). The usefulness and integrity of the institutional perspective have been acknowledged in explaining and interpreting accounting activity (Carpenter & Feroz, 2001; Mezias & Scarselletts, 1994).

Institutional theory is relevant in understanding the dynamics of financial reporting as these practices are related to accounting, which is an institution that is socially constructed (Miller, 1994; Hopwood, 2000; Aguilera & Jackson, 2003; Potter, 2005). Hopwood and Miller (1994, p. 228) argue that "accounting is intimately implicated in the construction and facilitation of the contexts in which it operates. It cannot be extracted from its environment". Therefore, accounting is no longer considered just a device to document and report the facts of economic activity (Miller, 1994).

In addition, institutional theory plays an important role in accounting research, as accounting operates in a complex institutional setting where social interactions are important. This argument is also supported by Carpenter & Feroz (2001, p. 566), who said that "The assumption that, in accounting, economic self-interest motives drive choice is not necessarily inconsistent with the notion that self-interest motive may be determined by organisational, political, and institutional factors. Institutional theory is important in explaining accounting choice in organisations where self-interest maximizing actors cannot exert effective influence over the choices of accounting practices because of their relative power positions in their organisations".

Covaleski, Dirsmith, and Samuel (1996) argue that accounting, as an institution, shows "ceremonial mean for symbolically demonstrating an organisation's commitment to rational course of action". Therefore, companies that meet society's expectations, norms and beliefs are more able to gain support from the community and obtain legitimacy (Scapens, 1994). Companies can achieve legitimacy by operating in accordance with the rules, norms and values of their institutional environment (DiMaggio & Powell, 1983; Meyer & Rowan, 1977; Scott, 1995). Meyer and Scott (1983) claim that organisations should conform to their environment's rules and requirements to receive support and legitimacy.

Financial reports, as a product of accounting practices, can be used as a tool to legitimise a company's activities. Financial reporting practices play an important role in constructing the company's rhetorical story which shows that its activities are in compliance with societal beliefs (Allen & Caillouet, 1994; Dowling & Pfeffer, 1975) and meet external expectations (Stanton, Stanton, & Pires, 2004). It thereby increases its legitimacy and resources. Hence, financial reports are used to enhance the company's legitimacy by showing that the company is committed to external values, such as the need for accountability and transparency (Coy & Pratt, 1998; Hooks, Coy, & Davey, 2002).

Therefore, it is more fruitful to understand the dynamics of financial reporting practices in the institutional setting. This can show how players within the company interact with each other and deal with norms, rules and beliefs to shape the company. Neu (1992, p. 234) argues that the "social construction perspective provides us with a better understanding of the factors mediating a manager's choices. This approach recognises that individual, institutional and societal relations influence, constrain and even define one's choice, both at a point in time and over time. Furthermore, a social construction perspective suggests that some practices are not consciously chosen; rather, they are so highly institutionalised that they are taken-for-granted". In addition, Mezias (1990) claims that institutional theory is useful in understanding financial reporting practices, and provides the following interesting argument:

> *"…financial reporting practice represents a relatively routine, albeit important type of behaviour at large, bureaucratic organisations: Designated accounting units gather information for presentation in the financial statements according to professionalised standard operating procedures and programs. The introduction of a new financial statement item, while relatively infrequent, represents more of a mundane than an extraordinary occurrence. The result is an important behaviour, comparable across organisations, dominated by a constellation of forces: regulatory pressures, norms of good practice and professionalisation… Second, the range of important players includes the accounting profession, individual organisations, and regulatory agencies, covering phenomena at both the organisational and inter organizational levels. The mix of phenomena at different levels allows for an emphasis that shifts from the individual organisation to its context in the institutional environment. Thus, the study of financial reporting practices allows for an exploration of isomorphic pressures produced by actions at both the organisational and inter-organisational levels."*

Institutional theory is used in this study as it allows an examination of the context in which accounting practices operate. Its emphasis is on the social context in which economic events occur, whereas agency theory, which is used extensively in accounting research, focuses on the conflict-of-interest problem and might not capture the complexity of the institutional context. Rahman, Yammeesri, & Perera (2010) argue that agency theory is used to explain accounting practices in country-specific studies. It helps to explain accounting practices in settings with strong agency orientation because it is based on the notion of separation between management, ownership and debt. Agency theory focuses mainly on exogenous factors related to financing. However, institutional theory explains accounting practices in international settings with or without a strong agency orientation, and it allows an examination of all exogenous and endogenous factors that influence corporate practice (Rahman et al., 2010).

Moreover, the importance of the wider social and economic setting of accounting is often emphasised, and calls are often made for the study of accounting practices in the context in which they occur. The accounting literature calls for the study of the financial reporting within its broader social and institutional setting (Arnold, 2009; Hopwood, 2000; Power, 2009; Wysocki, 2011; Miller, 1994; Potter, 2005).

In summary, institutional theory is sufficient to explain how and why a company commits to high-quality financial reporting practices. It can explain why the company adjusts its structures and practices in response to institutional pressures and how these institutional pressures in turn influence financial reporting and governance practices.

5.4 Conclusion

This chapter has presented the theories that are relevant to financial reporting and corporate governance practices and that have been applied in this study. Agency theory is the most relevant to this study's research question. However, there are some situations where agency theory does not fit (e.g. Abdul Rahman & Ali, 2006). The literature shows that the findings of some studies do not necessarily apply to some other contexts. Due to some factors, such as culture and religion, the relationship between agents and principals can differ from one country to another.

Therefore, the findings of studies conducted in, for example, the US and UK might not be applicable in Bahrain.

Since agency theory is not able to interpret all of the study's findings, institutional theory is used as a complementary framework to interpret the findings where necessary. Institutional theory is helpful in understanding financial reporting and corporate governance practices in relation to the environmental setting where they are implemented. It links these practices with the contextual factors that can influence them.

Chapter 6: Research Methodology

6.1 Introduction

This chapter explains the research methodology, data collection methods and data analysis procedures. The research methodology is determined by the researcher's beliefs about reality and knowledge and the nature of the study. As mentioned previously, this study aims to explore and identify different aspects of earnings quality and to determine the extent to which corporate governance mechanisms can improve the quality of earnings in Bahrain. Because of the complexity of the issue under investigation and the need for rich insights, a mixed-methods approach has been employed.

Financial reporting and corporate governance are viewed as social practices. Therefore, in order to gain a better understanding of the processes and outcomes of adopting and implementing these practices a mixed research methodology is required. Qualitative research is needed to explore the relevant issues within the institutional setting, which can provide a rich explanation for the issues under investigation. Therefore, semi-structured interviews were conducted to gain insights into issues related to the quality of reported earnings in Bahrain. Following the interviews, a questionnaire survey was used to gather perceptions of these issues, to supplement the information gathered from the interviews and to gain further insights. Finally, the primary data were used to develop hypotheses regarding the relationship between corporate governance and earnings quality in Bahrain, and these were tested using secondary data.

This chapter is organised as follows: section 6.2 describes the philosophical assumptions and section 6.3 presents the research design for this study. The research approach is presented in section 6.4, followed by the research phases and their detailed processes in section 6.5. The conclusion is presented in section 6.6.

6.2 Philosophical assumptions

Research methodology is “the overall approach to the research process from the theoretical underpinning to the collection and analysis of the data” (Collis & Hussey, 2013) and makes explicit the researcher’s general approach to investigating the topic. The researcher’s methodological choice is determined by his philosophical assumptions, which are involved every stage of the research (Burrell & Morgan, 1979). These include assumptions about reality (ontology), human knowledge (epistemology) and the extent to which and the ways in which the researcher’s own values influence the research process (axiological) (Saunders et al., 2016). Those notions shape the researcher understanding of his/her research question, the methods used and the way he/she interpret the research findings (Crotty, 1998).

Hence, any research begins by making the researcher’s philosophical ideas explicit in order to justify the chosen research approach (Creswell, 2014, p.6). These philosophical ideas are “a basic set of beliefs that guide action” (Guba, cited in Creswell, 2014, p. 6). These philosophical ideas have been termed “paradigms”, “worldviews”, “epistemologies and ontologies”, or “broadly conceived research methodologies” (Creswell, 2014, p. 6)., which, according to Creswell (2014), are often shaped by the researcher’s discipline and research experience, as well as the inclinations of the researcher’s supervisors. Four main research paradigms have been discussed widely in the literature: postpositivism, constructivism, transformativism and pragmatism (Burrell & Morgan, 1979; Crotty, 1998; Creswell, 2014; Mertens, 2010). Below is a brief discussion of the four paradigms.

6.2.1 Positivism and postpositivism

Positivism was the dominant paradigm in social science from the 1930s to the 1960s (Gray, 2013). This philosophy is considered the traditional form of research and is known as the “scientific method” or “empirical science”, primarily associated with quantitative than qualitative research designs (Creswell, 2014). Positivists hold a realist ontology, where they believe that social reality is external to individuals. Matters exist independently, without any dependence on the knower (Cohen et al., 2003, p. 6). Guba and Lincoln (1994, P. 109) state that “an apprehendable reality is assumed to exist, driven by immutable natural laws and mechanisms”. Hence, positivists seek to explain and predict what happens in the social world by searching for regularities and causal relationships (Burrell & Morgan, 1979).

Postpositivism is a development of positivism which challenges the “absolute truth of knowledge” (Philips & Burbules, 2000) and recognises that in studying the human behaviour and actions we cannot be positive about the “claims of knowledge” (Creswell, 2014). Therefore, postpositivists do not subscribe to strict cause and effect, even though they recognise that all cause-and-effect relations carry certain probabilities with which they may occur. Postpositivists provide knowledge through a “postpositivist lens” by observing and measuring the objective reality which exists “out there” (Creswell, 2014). Their main aims are the development of numeric measures of observations and the study of individuals’ behaviour (Creswell, 2014).

The general propositions of postpositivism have been summarised by Philips and Burbules (2000), who stipulated four key assumptions: knowledge is conjectural and absolute truth can never be found; research is the process of making claims and then refining or abandoning some of these claims for more strongly warranted claims; knowledge is shaped by data, evidence and rational considerations; research aims to develop relevant and true statements that can explain a specific situation or describe a causal relationship; and objectivity is an essential aspect of competent research, and methods used and conclusions reached must be examined for potential bias.

6.2.2 Constructivism/interpretivism

Constructivism or social constructivism is often combined with the interpretivism, and is typically seen as an approach to qualitative research (Creswell, 2014). Interpretivists see reality as multiple and complex and hence socially constructed (Crotty, 1998; Cohen et al., 2003). They believe that the "social world can only be understood from the standpoint of the individuals who are part of the ongoing action being investigated" (Cohen et al., 2003). Social constructivists explore and understand the phenomenon inductively by starting with the individual in order to understand their interpretations of the world in which they live and work (Creswell, 2014). Individuals develop subjective meanings based on their experiences, which may be varied and multiple (Creswell, 2014). The subjective meanings are negotiated historically and socially and they are formed through interaction with others. Therefore, constructivist researchers focus on the contexts in which people live and work in order to understand participants' cultural and historical settings (Creswell, 2014). They try to make sense of the meanings that others have about the world. Researchers notice that their interpretations of meanings are shaped by their personal, historical and cultural experiences; therefore, they position themselves in the research and acknowledge the influence these factors will have on their interpretations and the research process (Creswell, 2014).

Creswell (2014) discusses the key assumptions of the constructivist position that were identified by Crotty (1998). These key assumptions are: meanings are constructed by human beings as they participate in the world they are interpreting; humans engage in the world and make sense of this world based on their historical, cultural and social perspectives; social perspective is always the basic generation of meaning that arises in and out of interactions within a human community. Constructivism or interpretivist epistemology is associated with qualitative research that is largely inductive, where the researcher generates meanings from the data collected in the field (Creswell, 2014).

6.2.3 Transformativism

Transformativism is an approach that was proposed during the 1980s and 1990s by individuals who felt that postpositivist laws and theories were not appropriate to "marginalised individuals" or an issue of social justice and power, oppression and discrimination (Creswell, 2014). Transformative research enquiry needs to be linked with politics and political change that addresses social oppression (Mertens, 2010). Participants in transformativist research are provided with a "voice" to raise their consciousness or to advance an agenda for change to improve their lives (Creswell, 2014). This philosophical worldview focuses on the needs of groups and individuals in society that are marginalised or disenfranchised; therefore, it integrates the theoretical perspectives with the philosophical assumptions that construct a picture of the issues examined (Mertens, 2010).

Creswell (2014) discusses the key features of the transformative position that were identified by Mertens (2010). These key features are: the importance of the study in relation to the lives and experiences of diverse marginalised groups; the focus of the research on the inequalities based on race, gender, ethnicity, sexual orientation, disability and socioeconomic class; the study's links to political and social action on these inequalities; and beliefs about how the case works and why the problem exists.

6.2.4 Pragmatism

Pragmatism was founded by the philosophers Charles Pierce, William James and John Dewey at the beginning of the twentieth century and it has seen a recent revival (Gray, 2013). Pragmatists attempt to conduct innovative and dynamic research that is flexible. Pragmatism, unlike postpositivism, arises out of actions, situations and consequences rather than the antecedent conditions (Creswell, 2014). Researchers following pragmatism focus on the research problem rather than methods and use all approaches available to understand the problem (Johnson & Onwuegbuzie, 2004; Tashakkori & Teddlie, 2003).

As discussed by Cherryholmes (1992), Morgan (2007) and Creswell (2014), pragmatism has the following key elements:

- It is not committed to any one system of reality and philosophy.

- Pragmatists have freedom of choice between methods, techniques and procedures of research that assist them in meeting their purposes and needs.
- Pragmatists do not look to the world as an absolute unity.
- Pragmatists believe that the truth is what is relevant at the time and works for the aim of the research. Therefore, mixed-methods researchers who follow a pragmatism philosophy tend to use both qualitative and quantitative data as they work to provide the best understanding of the problem.
- Based on the pragmatist researchers' intended consequences (where they want to go with it), they look to the "what and how" of research.
- Pragmatists agree that research occurs in historical, social, political and other contexts.
- Pragmatists believe that external world is independent of the mind as well as that loaded in the mind and hence one should stop asking questions about reality and the laws of nature.
- Pragmatism opens the door for mixed-methods researchers to use multiple methods, different worldviews and assumptions, and different forms of data collection and analysis.

6.3 Research design for this study

Pragmatism argues that the most important determinant of the research philosophy adopted is the research question. If the research question does not suggest the adoption of either a positivist (quantitate) or an interpretive (qualitative) position, then the pragmatist's view is confirmed that it is perfectly possible to integrate different positions that are highly appropriate for the study (Saunders et al., 2009). Pragmatism is particularly suitable for mixed-methods research (Creswell & Plano Clark, 2011).

Existing studies have afforded limited insight into the quality of reported earnings and the role of corporate governance in improving its quality. Therefore, based on the objectives of this study, this study adopts a mixed-methods research design.

Financial reporting and corporate governance are viewed as social practices. To understand the process and outcome of these practices along with the interactions with institutional factors, this study uses a mixed-methods design. The qualitative first part of the study (semi-structured interviews) allows an understanding of the quality of reported earnings within the institutional context and provides a richer explanation for this issue under investigation. This qualitative part supports the development of the following two quantitative parts (the questionnaire survey and the analysis of secondary data).

In the second part, a quantitative research method (questionnaire survey) has been used to obtain the perceptions of a bigger sample to supplement the information gathered from the interviews and to gain further insights. In the third and final part of the study, a quantitative research method (secondary data analysis) has again been employed to test the relationship between the quality of reported earnings and the corporate governance mechanisms implemented.

6.4 Research approach

6.4.1 Mixed-methods research

Mixed-methods research is defined by Johnson and Onwuegbuzie (2004) as "the class of research where the researcher mixes or combines quantitative and qualitative research techniques, methods, approaches, concepts or language into a single study". At one point, mixed-methods research even became a separate research method, with its own worldview and techniques (Tashakkori & Teddlie, 2003). Mixed-methods research is an attempt to legitimise the use of qualitative and quantitative methods to offer the best chance to obtain useful answers to research questions (Johnson & Onwuegbuzie, 2004). Johnson et al. (2007) find that mixed-methods research is a third methodological approach, in addition to purely qualitative and quantitative research, and provides the most complete, informative, balanced and useful results. Complex research studies, like this study, combine qualitative and quantitative research approaches as this enhances insights into the issue under investigation.

This study employs qualitative and quantitative research approaches. Qualitative research is defined by Bryman (2016, p. 374) as "a research strategy that usually emphasises words rather than quantification in the collection and analysis of data. As a research strategy, it is inductivist, constructionist, and interpretive, but qualitative researchers do not always subscribe to all of these intellectual positions". Creswell (2014) agrees and defines qualitative research as "a means for exploring and understanding the meaning individuals or groups ascribe to a social or human problem; this process involves emerging questions and procedures, data typically collected in the participant's setting, data analysis inductively building from particulars to general themes, and the researcher making interpretations of the meaning of the data". In addition, Bryman (1988, p. 46) refers to the qualitative approach as "an approach to the study of the social world which seeks to describe and analyse the culture and behaviour of humans and their groups from the point of view of those being studied". Therefore, the qualitative phase of the present study assists in understanding the context in which financial reporting and corporate governance practices are adopted. This phase involves semi-structured interviews with relevant parties and explores the way these practices are influenced by institutional factors within the setting.

In quantitative research, on the other hand, the stress is on data in the form of numbers (Saunders et al., 2016). The quantitative approach is used to test theories by examining relationships between variables, where these variables can be measured, and the numbered data can be analysed statistically (Creswell, 2014). Surveys as a quantitative approach have been defined by Bryman (1988) as "one of the main methods of data collection which embodies the features of quantitative research to be explored below. The survey's capacity for generating quantifiable data on large numbers of people who are known to be representative of a wider population in order to test theories or hypotheses has been viewed by many practitioners as a means of capturing many of the ingredients of a science". Creswell (2014) added that the survey provides a quantitative description of population opinions by covering a sample of that population. The analysis of secondary data is also a useful quantitative method for providing a better understanding and explanation of research problems. The advantages of using secondary data are its availability and saving money and time.

6.4.2 Research strategy

There are many examples in the literature of studies that employ mixed-methods research (Tashakkori & Teddlie, 2003). Those studies though vary in their implementation of mixed-methods designs, and Creswell & Clark (2011) classify mixed-methods designs into six common types: convergent parallel design, explanatory sequential design, exploratory sequential design, embedded design, transformative design and multiphase design. Given the aim and objectives of this study, the exploratory sequential design is selected. This design consists of two separate phases: qualitative followed by quantitative (Cresswell et al., 2003). In this design, the researcher first collects and analyses the qualitative data. Then, the quantitative data are collected and analysed next in the sequence, and they help to generalise the qualitative results obtained in the first phase. The second, quantitative phase builds on the first, qualitative phase; the two phases are connected in the intermediate stage in the study. The rational for this approach is that the qualitative data and their subsequent analysis provide a general understanding of the research problem. The quantitative data and their analysis generalise the qualitative findings with a larger sample. Figure 6.1 illustrates the process followed in this study.

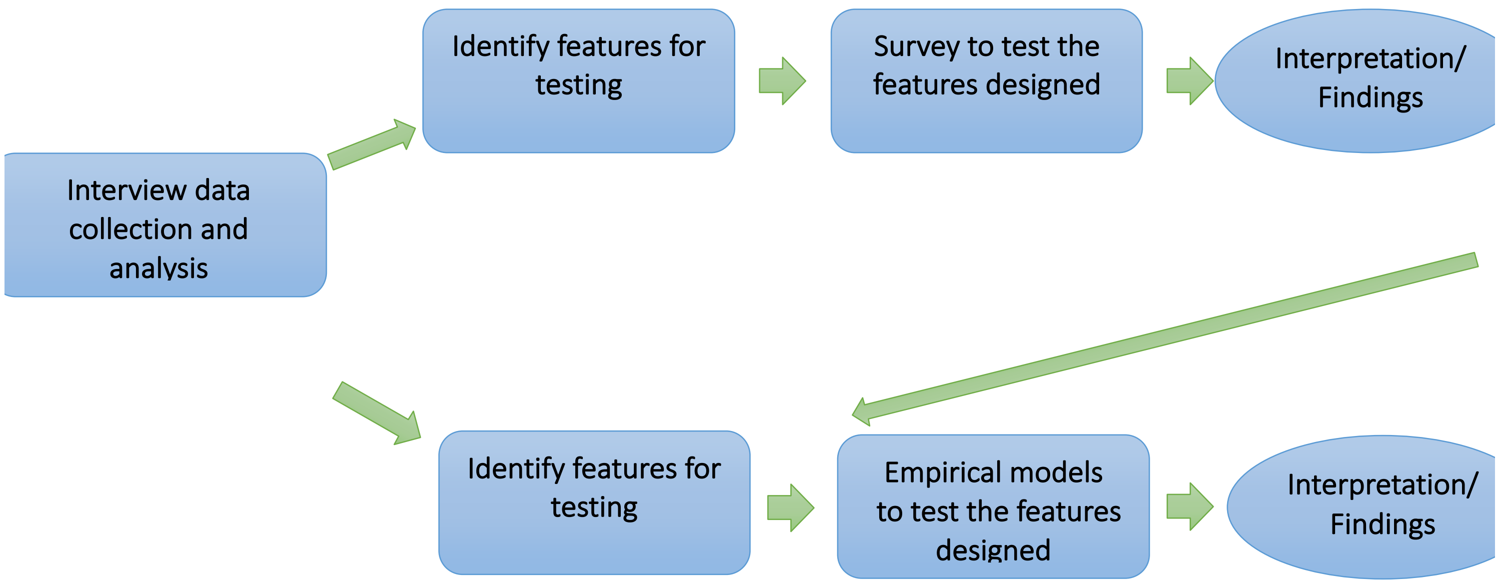


Figure 6.1 The process followed in this study.
Source: Based on Bryman and Bell (2015) and Creswell and Clark (2011)

In this study, priority is given to the qualitative approach. This decision is influenced by the research purpose of the study, which is to explore the environment where the international corporate governance and financial reporting practices are implemented. The quantitative approach, which is the questionnaire survey and analysis of secondary data, will be used to validate a generalisation of the qualitative findings to a larger sample.

6.5 Research phases

6.5.1 Data collection issues in Bahrain

The Bahraini religious, cultural, social and economic contexts affect the conduct of this kind of social study. During this study, the following problems arose:

- Access to data in Bahrain was difficult because of the social, political and cultural systems.
- Because of the structure of the study, most of the data collection was conducted during the year-end period, which is considered a busy time for the parties involved in financial reporting and corporate governance. This heavily affected the survey response rate.
- Access to survey participants was difficult; therefore, the researcher used email addresses provided by regulators.
- Secondary data on Bahraini companies are sparse, which drove the researcher to obtain information from the companies directly, and sometimes manually from annual reports, which was time-consuming.

- Secondary data were not available for all the companies for the whole of the study period, because some companies had not published annual reports for over ten years.

These issues were raised during the design of the data collection methods and in determining the sampling and groups of participants. The section below presents the research methods used in this study in more detail.

6.5.2 Qualitative phase

6.5.2.1 Data collection

Interviews are one of the most comprehensively applied approaches to data collection in the social sciences as they allow participants to express their own views (Bryman, 2016). According to Hussey and Hussey (1997), interviews are considered an appropriate technique if the interviewer is looking for complicated or confidential information. Interviews can be classified as structured, semi-structured or unstructured (Saunders et al., 2016). Semi-structured interviews are commonly used in exploratory studies as they provide important background and contextual material (Saunders et al., 2016). In semi-structured interviews, the researcher starts with an initial theme and key questions, although these questions might vary from one interview to another (Saunders et al., 2016). Semi-structured interviews are particularly flexible as they allow issues raised during the interview to be addressed, without a loss of focus on the key research themes.

Accordingly, this study employed semi-structured interviews in the first step, as they provide the opportunity to link the participants' personal histories, perspectives and experiences to the corporate governance and accounting environment. They assist in understanding the quality of reported earnings (including its concept, characteristics and determinants) within the institutional context and provide a richer explanation for this issue under investigation. In addition, they support the development of the two quantitative parts of the study that follow (questionnaire survey and analysis of secondary data).

A set of predetermined questions was designed, but the order and wording of the questions were modified based on the interviewer's judgement about the most appropriate way to gain insights into various issues under investigation.

6.5.2.2 Sample selection

The interview sample comprised people involved in corporate governance and financial reporting in Bahrain. Interviewees were selected based on their experience and knowledge in the relevant field. Majority of the interviewees held senior positions in their institutions. The researcher identified suitable interviewees based on his previous experience in the field and by searching the websites of Bahraini listed companies. As suggested in many research textbooks, interviews were continued until data saturation was reached: that is, when additional data provided little if any further information (Saunders et al., 2016). The sample comprised 25 participants (Table 6.1), who were interviewed during the fieldwork in Bahrain between December 2016 and January 2017. The sample brought a diversity of perceptions, as it drew on a variety of groups of individuals involved in the phenomenon, which generated a comprehensive set of data.

Table 6.1. Interview sample

Category (Number of Interviewees)	Company or Organisation / Position
Policy-makers (4)	Central Bank of Bahrain / Executive Director
	Ministry of Commerce and Industry / Assistant Undersecretary
	Bahrain Bourse / Internal Control and Board Secretary
	Central Bank of Bahrain / Head
Users of Financial Reports (7)	Bank/ Relationship Manager
	Bank / Credit Risk Manager
	Investment firm / Analyst
	Institutional Investor / Fund Manager
	Analyst following Bahraini market / Head of Research
	Individual Investor
	Institutional Investor (Chief Financial Officer of this Inst.)
Preparers & Professionals (10)	Financial Services Co. / Financial Controller
	Telecommunication Co. / Chief Financial Officer
	Real Estate Co. / Financial Controller
	International Accountancy Firm (Non Big 4) / Partner
	Big 4 Accountancy Firm/ Partner
	Tourist Co. / Chief Financial Officer and Board Secretary
	Big 4 Accountancy Firm/ Manager
	Industrial Co./ Investor Relation and Corporate Affairs
	Board Member (Audit Com. Chairman)
	Ex-Big 4 Accountancy Firm/ Manager and Head of Internal Audit
Academics (4)	A Public University
	A Private University
	A Public University
	A Public University
Total Number of Interviews	**25**

6.5.2.3 Design of the interview and administration

Interview questions were designed to elicit how the corporate governance and financial reporting practices are shaped by the institutional setting. The interview agenda and topics were informed by the financial reporting and corporate governance literature to ensure that the interview questions covered all the relevant issues. In addition, broad questions were incorporated in order to engage the interviewees in conversation and gain in-depth insights.

In terms of validity, a pilot study was conducted to ensure that the meaning of the questions would be understood by the interviewees. This assisted in improving the wording and sequence of the questions. Four pilot interviews were conducted with persons with expertise in corporate governance and financial reporting: an academic, an external auditor, a regulator, and a credit and risk officer. In addition, Nottingham University Business School Research Ethics Committee granted this research ethical approval.

Before the interviews, information about the corporate governance and financial reporting rules and regulations, companies' business, and interviewees' background were obtained from websites and official documents and reports. Interview appointments were arranged by telephone and email. As per their request, interview questions were provided for some interviewees in advance. All interviews were conducted face to face. The researcher started the interview by explaining the purpose of the study and the interviewees' contributions to the study. In addition, the researcher assured confidentiality and explained that data would be used only in this study and that all reasonable measures would be taken to protect their identities and responses. The interviews lasted between forty-five minutes and two hours. During the interviews, the researcher attempted to get answers to all of the scheduled questions. Sensitive questions were left until the end of the interview, to provide the interviewee with some time to gain trust and confidence in the researcher (Saunders et al., 2016).

The researcher tried to follow a set sequence but the contents of interviews were mostly governed by the flow of the interviewees' thoughts, followed by some prompts by the researcher to clarify meanings and keep the interview focused on the topics of interest. After obtaining the interviewees' permission, the interviews were recorded and the researcher also took notes (Saunders et al., 2016). The interviews were conducted in Arabic, as it is the official language in Bahrain. The researcher transcribed the interviews into English. Great care was taken to ensure that all original meanings were retained in the translated text; as expected, the transcription was a time-consuming task, as an hour of interview took six to ten hours to get transcribed (Saunders et al., 2016). Interview questions are included in the Appendix 4.

6.5.2.4 Data analysis

Various software packages for the analysis of qualitative data are available. Data analysis for this study has been conducted mainly manually. NVivo software has been used only to store and manage data in a way that allowed the researcher to access, retrieve and view the data conveniently. Although data analysis software is useful in managing the data, it never can replace the researcher's judgements in interpreting data (Harding, 2013). Yin (2011) also suggests that caution needs to be taken in using software in the data analysis stage. The issues under investigation are sensitive, as most of the interviewees are involved in the process. Therefore, their answers to the interview questions might be vague and indirect. In addition, corporate governance and financial reporting practices are shaped by the institutional setting; therefore, the interaction between the actors within the institutional context should be interpreted and understood. The nature of the study required the researcher's interpretation at the data analysis stage, especially as some data could be understood only with sufficient knowledge of the background and context.

Software allows the researcher to code text while working at the computer and to retrieve the coded text (Bryman & Bell, 2015). Coding involves categorising data with similar meanings (Saunders et al., 2016). It requires each unit of data within the transcript to be labelled with a code that summarises the extract's meaning, and the purpose of this process is to ensure that each piece of data accessible for the researcher for further analysis (Saunders et al., 2016). However, data were coded and sorted manually rather than relying on software. This provides the researcher with opportunities to think about the data and to generate ideas and insights. As noted above, NVivo software has been used only to store and manage data.

This study used a deductive coding method, in which the researcher started with a list of codes that was informed by the literature on financial reporting and corporate governance. However, during data collection, other codes emerged and were added to the list (inductive coding). Hence, the researcher was open to themes deriving from the data rather than forcing the data to fit into pre-existing codes (Miles, Huberman, & Saldana, 2014).

Nodes were used to manage evidence related to each code in NVivo. A node is "a collection of references about a specific theme, place, person or another area of interest” (Bryman & Bell, 2015). Hierarchically organised nodes were used to group related codes. To illustrate the process, the steps followed by the researcher are itemised below:

- The researcher read the transcript and stored it in the software.
- When evidence related to a particular code was identified, it was highlighted and added to the node allocated to that basic code.
- Evidence related to more than one code was highlighted and added to with those codes to the same node or another node.
- After finish coding all of the transcripts, the researcher could see how many references and how many sources (interview transcripts) there were under each code.

This system allowed the researcher to access the coded evidence along with the source data (interview). After finishing the coding, the researcher revisited the transcripts and made sure that all of the relevant data had been coded. Then all coded evidence was printed out, and the analysis was completed manually. The subsequent step was to examine all the coded evidence and notes within the interview transcripts to generate themes and develop concepts under each basic code.

During the analysis, the researcher wrote “theoretical memos” to organise coding at various levels and to record relationships observed between codes during the analysis. These memos helped to clarify, sort, and extend ideas and summaries all of the major findings of the study.

6.5.2.5 Reliability and validity

The quality of any study is assessed by two main criteria: reliability and validity. However, the meaning of these criteria differs considerably in qualitative and quantitative studies. There are two types of reliability: internal and external. Internal reliability can be achieved only if more than one member of the research team can agree on what they see and hear (Bryman & Bell, 2015). This criterion was achieved by involving a colleague in the translation of the interview transcripts. Moreover, interviews were audio-recorded, which allowed the interviewer to concentrate on what the interviewee said and organise follow-up questions.

External reliability is the ability to replicate the study. This is a difficult criterion to meet in qualitative research as it is impossible to “freeze” a social setting (i.e. the circumstances of the initial study) to make it replicable (Bryman & Bell, 2015). Findings derived from semi-structured interviews are not necessarily repeatable since they reflect reality when collected and in a situation which might be subject to change (Saunders et al., 2016). Certainly, the circumstances explored in the present study are complex and dynamic. The value of the semi-structured interview is its flexibility (Saunders et al., 2016). Therefore, any attempt to ensure that this research could be replicated by another researcher would not be realistic. To satisfy the criterion of reliability, the researcher should document the research procedure explicitly (Saunders et al., 2016). Therefore, this chapter discusses in detail the interview procedure and the data analysis.

Validity is another important criterion by which to assess the quality of a study. Validity is about the quality of the data and the results. In quantitative research, the validity is internal and external (Bryman, 2016). External validity is the extent to which the finding of the study can be generalised, while the internal validity refers to the credibility of the causal relationships between the independent and dependent variables. For qualitative research, validity is complicated; therefore, some scholars suggest the use of the quantitative validity criteria (external and internal) but with the addition of construct validity to the evaluation (Modell, 2005). Construct validity has been defined by Modell (2005) as “whether theoretical concepts are adequately reflected by the operational definitions and measures of empirical phenomena”.

6.5.3 First quantitative phase: questionnaire survey

6.5.3.1 Questionnaire survey

Surveys are one of the most widely used methods of data collection in social science research (Blaxter et al., 2006). It is an efficient method if the researcher clear about what information is required (Sekaran, 2003). It is better to use the survey method together with other methods, such as interviews, to investigate a specific issue (Jankowicz, 2004). It is an appropriate data collection method for the Bahraini context, since people feel free to express their perceptions without disclosing their identities. As mentioned earlier, the survey is used in this study to gain the perceptions of different stakeholders regarding issues related to the quality of reported earnings in Bahrain (including concepts, characteristics and determinants).

A survey can be classified in terms of the way it is administrated: self-administered and interviewer-administered questionnaires (Saunders et al., 2009) (Figure 6.2). In turn, there are three types of self-administered questionnaire: internet-mediated, postal, and personally delivered and collected. And there are two types of interviewer-administered questionnaire: telephone and structured interview.

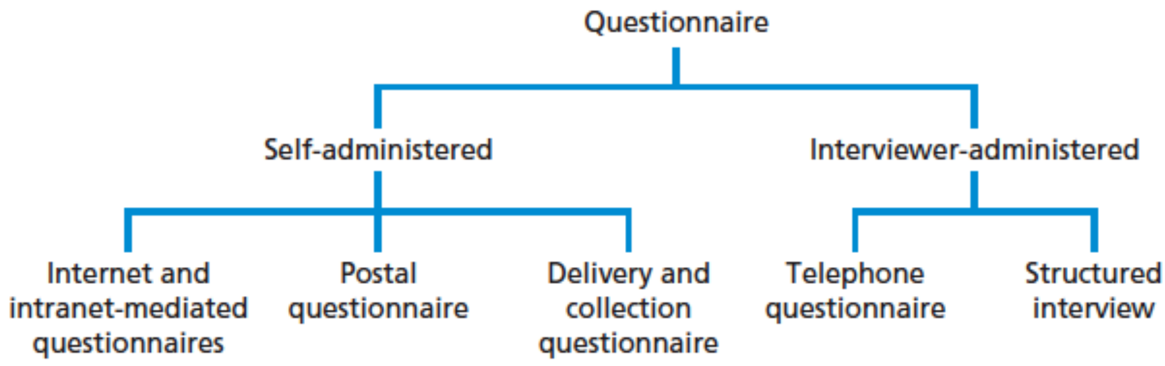


Figure 6.2. Types of Questionnaire: Source: Saunders et al. (2009, p. 363)

For the purpose of this study, internet questionnaires were employed. This type of questionnaire has been used extensively in recent studies. The reasons for choosing this type of questionnaire are: it costs less than other methods, it is easier to distribute, and it is easier for respondents to complete.

A questionnaire survey was emailed to respondents and returned by email through the Survey Monkey platform. In addition to the instructions provided by the researcher, the platform provided additional notes to assist the respondent in understanding the questions and in answering them. Moreover, it allowed the researcher to amend the survey whenever he wanted and to send automatic reminders.

Despite the above-mentioned advantages, the internet questionnaire has been criticised by some researchers on the grounds that it does not reach the respondent inbox (it often goes into the junk box), the email list is not updated, and some target respondents do not use the new technology (email). However, the researcher took these drawbacks into consideration during the distribution process. For example, the email list was reviewed and revised many times. In addition, the researcher contacted the respondents, as much as he could, by telephone to make sure that they had received the survey.

6.5.3.2 Survey design

Earnings quality has been investigated using various methodologies. However, few studies have used a questionnaire survey and interviews. This study followed Dichev et al. (2013), with some modifications, in using a survey to investigate different aspects of earnings quality.

In order to achieve the study objectives, the questionnaire was designed to obtain the perceptions of respondents regarding earnings quality. This study tries to overcome some of the problems in the survey conducted by Dichev et al. (2013). Dichev et al. (2013) targeted CFOs only; however, the present study targeted different groups of stakeholders involved in financial reporting and corporate governance. Therefore, the study used three different versions of the survey to specifically target three main groups (managers and those responsible for preparing financial reports, regulators and policy-makers, and other users of financial reports, such as creditors, analysts, auditors, investors, academics and board members). The reason for designing three different versions was that some questions were relevant only to a specific group of stakeholders and different stakeholders might have different perceptions of a specific issue. The questionnaires are reproduced in Appendix 2.

The survey's questions cover the following main issues (a few of these were excluded in the versions of the questionnaire given to managers and preparers of financial reports and regulators and policy-makers):

- The use of reported earnings;
- Definition of earnings quality;
- The factors that influence the quality of earnings;
- The features or characteristics of "high-quality earnings";
- Amendments to existing standards that might improve the quality of earnings;
- The motives for managing earnings;
- Ways of distinguishing between high-quality and low-quality earnings.

The survey questions were both open-ended (to provide some flexibility for participants in their responses) and closed-ended (e.g. requesting respondents to choose the answer they agreed with most, from a set of presented answers). The reason for the mix is that the closed-ended questions gain a higher response rate in Bahrain and the open-ended questions can provide more insight for some issues if the respondents are willing to add more. Some closed-ended questions used a five-point Likert scale (Saunders et al., 2007). With regard to the open-ended questions, the survey was designed, by using the features readily available on the Survey Monkey platform, in a way that allowed respondents to skip additional information (optional boxes) if they did not wish to add more.

Moreover, in order to increase the response rate, the researcher attached a cover letter (reproduced in the Appendix 3) with the questionnaire from the University of Nottingham requesting the recipient to participate in the study by completing the survey. The cover letter provided some background information about the research team, the study's aims and objectives, and confirming to the participants the confidentiality of the information they provided.

6.5.3.3 Pilot test and administration

Before starting data collection, it is important "to ensure the measurement error is kept to a minimum" (Field, 2009, p. 11). Reliability and validity indicate the quality of the measuring instrument used. Regardless of the method of data collection used, reliability and validity should be tested (Kimberlin & Winterstein, 2008). Reliability refers to the consistency and stability of the measure (Sekaran, 2003). A method of data collection is considered reliable when it is reused and produces the same results. Therefore, the reliability and validity of the questionnaire have been examined.

There are three main factors are involved in considering the reliability of a measure (Bryman, 2016):

- Stability: whether the measure's results are stable over time.
- Internal reliability: whether the indicators that make up the scale or index are consistent.
- Inter-rater reliability: whether the subjective judgement involved maintains its consistency.

There are several ways to measure the reliability of an instrument. The most common way, which has been used in this study, is Cronbach's alpha. Cronbach's alpha is a coefficient that "presents the average of all possible split-half correlations, and so measures the consistency of all items" (Gray, 2017, p. 389). Consistency is measured by this coefficient using a scale from 0.00 (very unreliable) to 1.0 (perfectly reliable). The results for the Cronbach's alpha used in this study is attached in Apendix 5.

Validity, on the other hand, is a more complex concept. Bryman and Bell (2015, p. 170) define validity as "whether or not an indicator (or set of indicators) that are devised to gauge a concept measures that concept". The validity of a questionnaire can be affected by the wording of the questions it contains, the sequence of the questions, and the whole structure or design (Gray, 2017). The questions should cover only the research area, as asking irrelevant questions increases the length of the questionnaire, which will affect the response rate and consequently affect the ability to generalise the findings.

It is highly recommended to test the reliability and validity of the questionnaire before it is distributed, as a pilot study provides opportunities to refine the questionnaire (Bell, 2005). The questionnaire should be tested to ensure that all questions are clear to the participants; if not, then the necessary amendments can be made. Furthermore, it is good practice to test the time it takes for the participant to complete the questionnaire. Hence pre-testing the questionnaire increases validity and reliability and thus reduces biases (Sekaran, 2003). Therefore, the survey was validated by undertaking a pilot study which assisted in making sure that relevant questions were asked clearly and that all issues were covered. The survey was pilot tested with 12 academic staff and four PhD students at the University of Nottingham, which is considered to be sufficient according to Fink (1995), who suggests that 10 is an acceptable number for a pilot study.

Questionnaire surveys can be administered by mail, in person, by telephone, or electronically. Because of some constraints, this study administered it electronically, through a web-based survey using Survey Monkey. Online questionnaire survey has particular advantages with regard to cost and the wide geographical distribution that can be achieved. Moreover, it further strengths, such as application to both business-to-consumer and business-to-business settings, flexibility in format (i.e. email, link, transfer to website etc.), speed and timeliness, technological innovation, convenience (the respondents can answer at their own time), ease of data entry and analysis, diversity of question formats (i.e. single and multiple response question, multimedia format, open-ended questions etc.), low administration cost, ease of follow-up, controlled sampling, large sample easy to obtain (from databases), control of answer order, required completion of answers, tailoring of the survey (Evans & Mathur, 2005). On the other hand, there are some weaknesses of the online questionnaire survey which need to be taken into consideration, such as its perception as junk mail (Evans & Mathur, 2005) and low response rates (Fricker & Schonlau, 2002). Therefore, reminder email was sent to minimise these problems (the email reproduced in Apendix 1).

6.5.3.4 Sample selection

Based on the research questions and objectives of this study, the population comprises all individuals involved in financial reporting and corporate governance in Bahrain. However, it was difficult to construct the sampling frame, which is a complete list of all individuals within the population and from which the sample would be drawn. As a result, a non-probability sampling technique, which is common in business research, was used for this study to decide the sample size (Saunders et al., 2016). The researcher used his own judgement to select the sample size, which is called purposive sample. Specifically, the researcher followed the critical-case sampling technique, whereby individuals considered important for this study were selected for the sample. This technique was used at this stage of data collection as the objective was to understand what is happening and to make logical generalisations (Saunders et al., 2016). Because of the limited resources and the limited access to relevant individuals in Bahrain, the number of questionnaires distributed was 380.

6.5.3.5 Data analysis

There are two methods of data analysis: parametric and non-parametric. The nature and characteristics of the data determine the analysis method that should be used. For instance, the following three assumptions must be met in the data in order to use parametric tests (Balian, 1982):

- Normality: the sample must be drawn from a normally distributed population.
- Homogeneity of variance: the variance or standard deviation of the dependent variable should be equal within the group.
- Continuous form of the dependent variables: the discrete form of the dependent variables cannot follow a normal distribution (essential to meet the first assumption). Therefore, categorical dependent variables cannot be tested using parametric techniques because of their nominal or ordinal nature.

When all these assumptions are met, and the variables under analysis are measured on an interval scale, parametric tests are more powerful (Siegel, 1956). However, if any of the above-mentioned assumptions are not met, then non-parametric tests are more appropriate (Balian, 1982). Siegel (1956) indicates that non-parametric tests remain as alternative tests when the previous assumptions are not applied. Also, Newbold, Carlson, and Thorne (2013) suggest that for questionnaire surveys the non-parametric test is more suitable, as the data are mainly nominal and ordinal data and so do not meet the normality assumption.

Accordingly, non-parametric tests were adopted to analyse the questionnaire survey data in this study. The following statistical techniques were applied:

- Descriptive statistics include the analysis of the frequencies and percentages of responses, mean score (for each group), overall mean score (for all groups), the ranking of an overall mean score, standard deviation (for each group) and overall standard deviation (for all groups).
- The Kruskal-Wallis test, which is non-parametric, was used to determine whether the perceptions of the three groups of respondents (i.e. managers and preparers of financial reports, regulators and policy-makers, and other users of financial reports) differ significantly or not. In addition, ANOVA one-way test (which is a parametric test) was used to determine the differences between the parametric and non-parametric tests and as a sensitivity test.

SPSS software has been used to analyse the survey findings and prepare the descriptive statistics and the parametric and non-parametric tests.

6.5.4 Second quantitative phase: analysis of secondary data

Secondary data are useful because they provide a better understanding and explanation of the research problems. Where secondary sources are available, time and money are saved in the collection of data. However, it is important to make sure that these data are consistent with the research objectives (Bryman and Bell, 2015).

In this part of the study, the researcher investigates the impact of corporate governance mechanisms on the quality of reported earnings, by constraining earnings management, after exploring and eliciting respondents' perceptions. This part focuses on the characteristics of the board of directors, characteristics of the audit committee, factors related to external audit, and the company's ownership structure.

6.5.4.1 Sample and data

In order to test the hypotheses, the study consists of all Bahraini listed companies (the entire population) for a period spanning the implementation of the 2011 code of corporate governance. The study covers the financial years from December 2005 to December 2016. The code of corporate governance was introduced at the beginning of 2011 and its implementation started in December 2011, and so the study period comprises two equal sub-periods, before and after implementation of the code. Moreover, there are no accessible data for the period before December 2005.

The sample is restricted to non-financial listed companies, since financial and insurance companies are required to follow specific accounting and regulatory requirements which differ substantially from those for non-financial companies; in addition, they have specific practices and operations, and it is difficult to define their normal and abnormal accruals, as Klein (2002a) mentioned. The financial data (secondary data) for all companies are obtained from the Datastream database.

Information on corporate governance and missing financial data were manually collected from annual reports. The researcher collected the annual reports from companies' headquarters. For all companies in the sample, the researcher carefully cross-checked the Datastream data with the published annual reports in order to ensure reliability and accuracy.

After the above-mentioned exclusions, the final sample consists of 201 firm-year observations from 2005 to 2016. Variable numbers of the 201 initial firm-year observations had insufficient data to estimate the different measures of earnings quality: 41 for predictability; 45 for abnormal accruals; 67 for smoothness; and 75 for persistence.. This leaves a final sample of: 160 firm-year observations for predictability; 156 firm-year observations for abnormal accruals; 134 firm-year observations for smoothness; and 126 firm-year observations for persistence.

6.5.4.2 Variable design and measurement

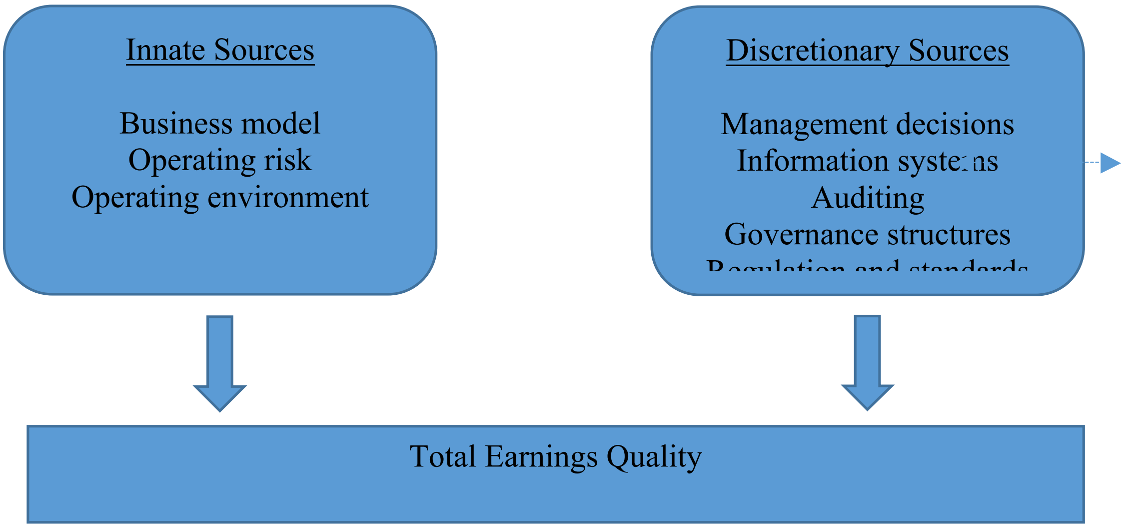
6.5.4.2.1 Dependent variable

The empirical literature uses a variety of measures for earnings quality and each measure captures a latent construct of earnings quality. Each measure is appropriate for a specific decision-making process. Prior literature has classified measures of earnings quality as either "accounting-based" or "market-based". Measures of earnings quality can be influenced by both innate and discretionary determinants (Figure 6.2). Innate determinants are related to the company's financial performance (business element), while discretionary determinants are related to the accounting system (accounting element). However, innate and discretionary determinants are related, and it is difficult to distinguish between the two types because all measures of earnings quality are affected by the firm's fundamental performance (business element) and the accounting system (accounting element), but they are not influenced by these factors equally. Therefore, the choice of measure of earnings quality will depend on the research question and the availability of data and estimation models (Francis et al., 2008).

Several factors influence the quality of reported earnings. These factors have been classified into two categories: innate and discretionary (or reporting) determinants. Innate determinants arise from business models and the environment (Dichev et al., 2013), and are not influenced by management or individuals. Innate determinants are related to the company's financial performance (business element). Examples of these innate determinants are: business model, operating risk, operating environment, firm size, the length of operation cycle, cash flow variability, intangibles intensity, incidence of negative earnings realisations, and capital intensity (Dechow & Dichev, 2002; Francis et al., 2008).

On the other hand, discretionary determinants arise from: managers' decisions relating to the preparation of financial reports (Dechow et al., 2010); governance activities, including compensation arrangements, ownership structures, and actions of the board of directors (Francis et al., 2008); monitoring activities, including internal and external audit (Francis et al. , 2013); and regulations and reporting standards (Holthausen, 2009). Discretionary (or reporting) determinants are related to the accounting system (accounting element). It should be noted that innate and discretionary factors are also related. For example, the governance structures are likely influenced by innate factors like the firm's business model (Francis et al., 2008).

Figure 6.2. Schematic overview of the sources of earnings quality and the relation between the innate and discretionary components of earnings quality



Source: Francis, Olsson, and Schipper (2008)

The empirical literature uses several measures for earnings quality (Ewert & Wagenhofer, 2015; Dechow et al., 2010). It has characterised these measures as either “accounting-based” or “market-based” measures, based on the underlying assumptions about the function of earnings. Francis et al. (2004) classified accruals quality, persistence, predictability and smoothness as accounting-based measures because these measures are estimated using accounting data (including earnings, cash, or accruals). Value relevance, timeliness and conservatism are classified as market-based measures because they use returns or prices, in addition to accounting data, in their estimation. The accounting-based measures assume that the function of earnings is to allocate cash flow to the reporting period through accruals, while market-based measures assume that the function of earnings is to reflect economic income, which in turn is represented by the stock returns (Francis et al., 2008).

There is “no conclusion about a single best measure of earnings quality” (Dechow et al., 2010). Prior studies provide little insight into the ability of different measures of earnings quality to capture the same construct, different aspects of the same construct, or different constructs (Ewert & Wagenhofer, 2015). In addition, little guidance has been provided on whether the measures are substitutes or complements for one another (Ewert & Wagenhofer, 2015). Dechow et al. (2010) find that these measures are not substitutes because each measure captures a different construct (properties of earnings) and this can result in inconsistent findings between studies. Therefore, the choice of measure for earnings quality will depend on the research question and the availability of data and estimation models (Francis et al., 2008). For example, research questions linked to the investor’s perceptions of earnings will use value relevance of earnings, while a research question focusing on a direct measure of earnings quality should use measures that are constructed using accounting data only.

In addition, in choosing the appropriate measure, it is important, for some research questions, to distinguish between innate, discretionary and total (both innate and discretionary) factors that influence earnings quality. For example, some studies assume that abnormal accruals, as a measure of earnings quality, reflects the portion of accruals that are not driven by innate factors (business element) but by reporting influences (accounting element) only. However, it is difficult to distinguish between these two types of determinants and identify the source of variation in earnings quality because: the variables meant to capture innate factors (firm fundamentals) may be incomplete; the variables meant to capture innate factors may be correlated with discretionary factors; and the variation might not be associated with either innate or discretionary factors (i.e. noise in the residuals) (Athanasakou & Olsson, 2015). In addition, measures of earnings quality initially designed to separate the discretionary factors, such as abnormal accruals, are influenced by business model volatility (Ball, 2013; Owens, Wu, & Zimmerman, 2017). Therefore, Dechow et al. (2010) believe that all measures of earnings quality are influenced by the firm's fundamental performance (business element) and the accounting system (accounting element), but not by these factors equally.

Based on the research question and data availability, this study uses accounting-based measures, namely, persistence, predictability, smoothness and abnormal accruals as measures for earnings quality, because they represent the best measures of earnings quality for different stakeholders in Bahrain, in that they capture those properties of reported earnings that assist them most in their decision-making process. Market-based measures are not used because stakeholders in Bahrain did not mention them as important measures for earnings quality in Bahrain. This was expected, as these measures are more appropriate for more efficient markets (the Bahraini stock market is not as efficient as the US or UK markets) where the share price and return play a significant role in the quality of reported earnings. The variables used in this study are summarised in Table 6.2.

- **Persistence**

Following previous research (e.g. Lev, 1983; Francis, LaFond, Olsson, and Schipper, 2004), earnings persistence is measured in this study as the slope coefficient ($\beta_{1,j}$) in the following model:

$$\boldsymbol{X_{j,t} = \beta_{0,j} + \beta_{1,j}X_{j,t\text{-}1} + \varepsilon_{j,t}} \quad \textbf{(9)}$$

Where $X_{j,t}$ measured as firm *j*'s net income before extraordinary items in year *t* divided by the weighted average number of outstanding shares during year *t* (equal to adjusted earnings per share). For each firm-year, persistence is calculated over rolling five-year windows. This procedure yields firm- and year-specific estimates of $\beta_{1,j}$, which capture the persistence of earnings. Values of $\beta_{1,j}$ close to 1 imply highly persistent earnings, while values close to 0 imply highly transitory earnings.

- **Predictability:**

Predictability is derived from the firm-year specific of the above equation (persistence model). Following Lipe (1990) and Francis et al. (2004), this study uses the square root of the error variance from the persistence equation. Large values of predictability imply less predictable earnings.

$$\boldsymbol{\sqrt{\sigma^2}(\varepsilon_j)} \quad \textbf{(10)}$$

- **Smoothness:**

The smoothness measure follows Leuz, Nanda, and Wysocki (2003). Leuz et al. (2003) examine the ratio of the standard deviation of net income before extraordinary items scaled by beginning total assets to the standard deviation of cash flow from operations scaled by beginning total assets.

$$\boldsymbol{\sigma}\left(\boldsymbol{NIBE}_{j,t}\right) / \ \boldsymbol{\sigma}\left(\boldsymbol{CFO}_{j,t}\right) \quad \textbf{(11)}$$

Standard deviations are calculated over rolling five-year windows. Larger values of smoothness indicate less earnings smoothness.

- **Abnormal accruals:**

The modified Jones model is used in this study to capture the abnormal accruals that represent the distortion component of accruals. The following model (Dechow et al., 1995) is used:

$$\boldsymbol{TA}_{j,t} = \boldsymbol{\beta}_1 + \boldsymbol{\beta}_2 \left(\Delta\, \boldsymbol{REV}_{j,t} \text{-} \Delta\, \boldsymbol{REC}_{j,t}\right) + \boldsymbol{\beta}_3\, \boldsymbol{PPE}_{j,t} + \boldsymbol{\varepsilon}_{j,t} \quad \textbf{(12)}$$

Where $TA_{j,}$ are total accruals for firm *j* in year *t*, $\Delta\, REV_{j,t}$ is the change in net sales (net sales in year *t* less sales in year *t*-1), $\Delta\, REC_{j,t}$ is the change in net receivables (net receivables in year *t* less net receivables in year *t*-1) and $PPE_{j,t}$ is gross property, plant and equipment. All variables in the model are scaled by lagged total assets. The absolute error term (residual) from this model is the abnormal accruals. It should be noted that this study measures total accruals as the difference between income before extraordinary items and net cash flow from operating activities.

6.5.4.2.2 Independent variables

The variables and their measurement used in this study are summarised in Table 6.2. The independent variables are derived from the literature. Seven variables that represent the attributes of the board of directors are the board size, number of meetings, outsider directors, independent outsider directors, politically connected directors, the existence of a remuneration and nomination committee, and the independence of the remuneration and nomination committee. The size of the board is the total number of board members, the number of meetings is the total number of meetings held by the board during the year, outsider directors is the proportion of non-executive directors to the total number of directors, and independent outsider is the proportion of independent outside board members (relative to the total number of directors).

Following Peasnell et al. (2001), this study defines independent outsider board members as non-executive directors whose "tenure as board members does not exceed 5 years, they are not ex-employees of the company or related to senior management, they are not lawyers, financial advisors, or consultants, and they are not engaged in a reciprocal interlock". Two dummy variables are used to reflect the existence and independence of the remuneration and nomination committee. Following Klein (2002a), the remuneration and nomination committee is considered independent if the CEO does not sit on it.

Similar to Abdul Rahman and Ali (2006), Klein (2002a), Xie et al. (2003), and Peasnell et al. (2001), this study considers the size of audit committee, the number of meetings held by the audit committee, the proportion of audit committee outsider directors, and the proportion of audit committee independent outsiders (outsiders and independent outsiders directors are as defined in the previous paragraph). Two dummy variables are used to capture the effect of external audit. Big4 is a dummy variable that takes the value of one if the company is audited by one of the international big four audit firms (i.e. KPMG, PWC, E&Y, and Deloitte) and zero otherwise. Auditor change or switch is the second dummy variable; it takes the value of one if the company changes its external auditor and zero if it does not.

The concentrated ownership structure is an important feature in Bahraini listed companies. According to prior research, for example Lo, Wong, and Firth (2010), the ownership concentration and type of ownership can capture the effect of controlling shareholders on earnings management. Therefore, this study uses six variables to examine the effect of different types of ownership. These variables are: state ownership, which is the percentage of total shares held by government; family ownership, which is the percentage of total shares held by family (either founding family or private family company); institutional ownership, which is the percentage of total shares held by institutional investors; individual ownership, which is the percentage of total shares held by individuals own 5% or more of the company; managerial ownership, which is the percentage of total shares held by the directors sitting on the board; and blockholder ownership, which is the percentage of total shares held by different shareholders owning 5% or more of the company.

6.5.4.2.3 Controlling variables

In addition to the independent variables discussed earlier, three controlling variables are used in the two models implemented in this study to control for firm's characteristics that might affect the quality of reported earnings. These variables are fundamental for ensuring that the statistical tests concentrate more on the differences created by variations in corporate governance mechanisms. These variables contain firm size, firm performance, and leverage. Hence, this section presents the control variables used in this study.

- Firm size (Natural logarithm of total assets).

Prior studies have presented evidence that large firm size might be an incentive for managers to manage earnings (Pincus & Rajgopal, 2002); however, Becker et al. (1998) suggest that managers in large firms are less motivated to manage earnings because there are monitoring by more investors and financial analysts.

- Firm Performance (Return on Assets)

In consistent with previous studies in financial reporting and corporate governance, this study control for firm’s performance. Firms experiencing financial difficulties and low performance have more incentive to manage earnings (Abdul Rhman & Ali, 2006). In addition, it has been argued that not including performance control variable in this kind of studies might lead to an invalidated model (Kothari, Leone & Wasley, 2005).

- Leverage (Total debt over total assets)

Previouse studies use leverage as a measure for debt covenant violations which represent the firm’s debt structure. Most studies found that leverage is positively related to wrongdoings such as earnings management (Elayan, Li & Meyer, 2008). However, some studies, like Becker et al. (1998), found that leverage is negatively related to earnings management. It is worth to mention that this study does not include other common control variables, such as industry. The reason for excluding these variables is that the sample under investigation is small and having a big number of variables will lower the explanatory power of the model (small degree of freedom).

Table 6.1 Descriptions of dependent variables, explanatory variables, and control variables

Dependent Variable	**Descriptions**
Persistence	the relationship between the current period earnings and the future period earnings has been expressed by Freeman et al. (1982) as: $\text{Earnings}_{t+1} = \alpha + \beta\text{Earnings}_t + \varepsilon_t$
Predictability	= R^2 of the persistence regression
Smoothness	= as the ratio of the standard deviation of net income to its standard deviation of cash flows from operations (Leuz et al., 2003; Francis et al., 2004): $\frac{\sigma(\text{Earnings})}{\sigma(\text{Cash flows})}$
Abnormal Accruals	Obtained using the modified Jones model (1995)
Independent Variables	**Descriptions**
Independent members	= the ratio of independent outsider board members to total members. Outsiders are classified as independent if their tenure as a board members does not exceed 5 years, they are not ex-employees of the firm or related to senior management, they are not consultants, lawyers, or financial advisors, and they are not engaged in a reciprocal interlock.
Outsider Directors	= the ratio of number of outside directors (non-executive) to total members
Board size	= the total number of members on the board
Board meetings	= the number of meetings per year held by board of directors
Politically connected members	= 1 if the board of directors includes at least one politically connected members
Remuneration and nomination committee existence	= 1 if the committee exists on the company, otherwise 0
Remuneration and nomination	= 1 if the CEO does not sit on this committee, otherwise 0

committee independence	
Audit committee outsiders	= the ratio of outsider (non-executive) directors in the audit committee to total committee members
Audit committee independence	= the ratio of independent outsider (non-executive) directors in the audit committee to total committee members. Outsiders are classified as independent if their tenure as a board members does not exceed 5 years, they are not ex-employees of the firm or related to senior management, they are not consultants, lawyers, or financial advisors, and they are not engaged in a reciprocal interlock.
Audit committee size	= the total number of members on the audit committee
Audit committee meetings	= the number of meetings per year held by the audit committee
BIG auditors	= 1 if a company is audited by Big 4 auditors
Auditor change	= 1 if auditor is changed, 0 otherwise
State ownership	= the percentage of total shares held by government
Family ownership	= the percentage of total shares held by family (either founding family or private family company)
Institutional ownership	= the percentage of shares held by institutional investors
Individual ownership	= the percentage of total shares held by individual investors own 5% or more
Managerial ownership	= the percentage of total shares held by executive directors
Blockholder ownership	= the percentage of total shares held by significant shareholders

Control Variables	**Descriptions**
Firm size	= the natural logarithm of total assets at year-end
Leverage	= total debt divided by total assets
Performance (ROA)	= net income (EBIT) divided by the total assets at the beginning of the year

6.5.4.2.4 Regression models

Following Xie et al. (2003), this study develops two regression models to examine the hypotheses. The first model aims to investigate the effect of board characteristics on earnings quality and the second model aims to investigate the effect of audit committee characteristics and external audit factors on earnings quality. The reasons behind the separation are:

- The initial results imply a high correlation between board characteristics and audit committee characteristics and the separation omits collinear variables that affect some important related characteristics;
- Different characteristics of the board and audit committee, like size and frequency of meetings, may substitute for one another.
- Having a large number of variables in a model can have an impact on the power of that model.

$$\begin{aligned} EQ = \quad & \beta_0 + \beta_1\, BSize_{jt} + \beta_2\, BMeeting_{jt} + \beta_3\, BOutsiders_{jt} \\ & + \beta_4\, BIndpendentOutsiders_{jt} + \beta_5\, BPoliticallyConnected_{jt} \\ & + \beta_6\, RNEXIST_{jt} + \beta_7\, RNIND_{jt} + \beta_8\, StateOwn_{jt} + \beta_9\, FamilyOwn_{jt} \\ & + \beta_{10}\, InstitutionalOwn_{jt} + \beta_{11}\, IndividualOwn_{jt} \\ & + \beta_{12}\, ManagerialOwn_{jt} + \beta_{13}\, BlockOwn_{jt} + \beta_{14}\, Size_{jt} \\ & + \beta_{15}\, Leverage_{jt} + \beta_{16}\, Performance_{jt} \end{aligned} \tag{13}$$

$$\begin{aligned} EQ = \quad & \beta_0 + \beta_1\, ACSize_{jt} + \beta_2\, ACMeeting_{jt} + \beta_3\, ACOutsiders_{jt} \\ & + \beta_4\, ACIndpendentOutsiders_{jt} + \beta_5\, Big4_{jt} + \beta_6\, AuditSwitch_{jt} \\ & + \beta_7\, StateOwn_{jt} + \beta_8\, FamilyOwn_{jt} + \beta_9\, InstitutionalOwn_{jt} \\ & + \beta_{10}\, IndividualOwn_{jt} + \beta_{11}\, ManagerialOwn_{jt} + \beta_{12}\, BlockOwn_{jt} \\ & + \beta_{13}\, Size_{jt} + \beta_{14}\, Leverage_{jt} + \beta_{15}\, Performance_{jt} \end{aligned} \tag{14}$$

The models test the hypotheses and aim to explore the time-specific effect on earnings quality of each mechanism of corporate governance. The model allows for time-specific effects as the impact of corporate governance mechanisms may be different or unchanged over time.

6.6 Conclusion

This chapter discusses the researcher's decisions on the methodology followed in this study, along with the procedures followed in collecting, analysing, interpreting and reporting data. At the beginning of this chapter, the underlying philosophical assumptions were addressed. This study adopts mixed-method research, which is widely used in social science, and researchers in the field of accounting call for the combination of different research approaches to study the same phenomenon. Given the research aim and questions, the researcher decided to use qualitative and quantitative methods in this study to enhance the validity and reliability of the findings.

This chapter has outlined the main study procedures. Based on the study's purpose and the research questions, an exploratory sequential mixed-methods research design is implemented. Furthermore, validity and reliability were discussed in the chapter.

In summary, taking into consideration the study's purpose, the research questions and research design, it can be seen that mixed-methods research is the best choice to assess the phenomenon under investigation. The use of different data sources is likely to confirm findings and provide a rich, elaborate understanding.

Chapter 7: Results of Semi-structured Interviews and Analysis of Questionnaire Survey

7.1 Introduction

This chapter presents the analysis of the interview and survey data regarding participants' perceptions of earnings quality in Bahrain. Three groups of respondents were invited to participate in this study: managers and preparers of financial reports; regulators and policy-makers; and other users of financial reports (i.e. investors, analysts, creditors, auditors, board members and academics).

It can be assumed that these groups of participants have sufficient knowledge of reported earnings quality. In addition, they have some influence on the integrity of financial reporting. Managers are aware of the ways in which they can influence the quality of reported earnings. Regulators issue and enforce regulations on financial reporting. Other users such as academics specialised in accounting and finance are presumed to be knowledgeable about financial reporting from their research or being advisors and board members, and auditors are expected to be familiar with aspects of financial reporting in Bahrain. Therefore, obtaining the perceptions of these three groups should enhance our understanding of the different aspects of the quality of reported earnings in Bahrain. This knowledge could be useful to different users, especially regulators and policy-makers in developing the rules, regulations, standards, and educational and training programmes regarding financial reporting. These could improve the credibility of financial reports generally and reported earnings specifically.

Twenty-five semi-structured interviews were conducted to gain insights into the quality of financial reports generally and reported earnings specifically in Bahrain. Interviews were undertaken during the fieldwork in Bahrain between December 2016 and January 2017. Following the interviews, a questionnaire survey was used to gain the perceptions of different issues related to the quality of reported earnings in Bahrain, to supplement the information gathered from the interviews and to generate further insights.

The remainder of this chapter is organised as follows. Section 7.2 provides background information on the participants. Section 7.3 presents participants' perceptions of the use of reported earnings and their views related to defining and measuring earnings quality. Section 7.4 reports participants' perceptions of the determinants of earnings quality. Section 7.5 reveals the impact of standards on improving the quality of reported earnings. Section 7.6 presents participants' perceptions of the reasons for earnings management, and red flags to detect such management. Section 7.7 summarises the findings presented in this chapter.

7.2 Descriptive statistics of respondents

7.2.1 Descriptive statistics of survey respondents

It is important to present the background information about the survey respondents before discussing the findings of the survey. As mentioned, the survey was distributed to three groups (Table 7.1): managers and preparers of financial reports, regulators and policy-makers, and other users of financial reports. . Over the course of three months or so, the survey was distributed electronically (by email) to 380 potential respondents. The number of potential participants in each group was restricted by the total population size and the limited access to the targeted participants' emails. Of the 380 distributed surveys, 114 were returned. The 30% response rate is similar to that in other studies (e.g. Elbanna & Child, 2007), as response rates to surveys in the Middle East generally ranges between 30% and 50%. One respondent in the first group returned a survey but did not complete any part of it and so this is not included in the analysis.

Table 7.1: Distribution of Respondents to the Questionnaire Survey

Groups	Issued		Received		Response Rate (%)
	No.	%	No.	%	
Managers and Financial Reports Preparers	73	19.21%	23*	20.18%	31.51%
Regulators and Policy-Makers	37	9.74%	15	13.16%	40.54%
Other Financial Reports Users	270	71.05%	76	66.67%	28.15%
Total	380	100%	114	100%	30.00%

*23 surveys were received from the first group but only 22 were usable

Table 7.1 shows that the regulators and policy-makers group had the highest response rate (40.54%), followed by the managers and preparers of financial reports in second place (31.51%) and other users of financial reports in third (28.15%). This finding is consistent with a prior expectation that regulators and policy-makers would be the group most willing to participate in the survey, based on the researcher's connection with them and their supportive position in relation to researchers in the field of financial reporting. Moreover, managers and the preparers of financial reports and other users of financial reports (specifically auditors and board members) were busy preparing their year-end financial reports and auditing them during the survey period (November to February), which led to their response rates being lower in comparison with regulators and policy-makers.

Table 7.2 presents the work experience of the survey respondents. It shows that more than one-third (34.51%) had between 10 and 19 years of experience in the field. Table 7.2 also shows that the numbers of respondents with 4 to 9 years and of those with 20 or more years of experience are equal (26.55% of the total respondents). Only 7.08% of the respondents had less than four years of experience in the field.

Table 7.2: Respondents' Length of Experience and Age

The length of experience	Managers		Regulators		Other Users		Total	
	No.	%	No.	%	No.	%	No.	%
Less than 4 years	2	9.09%	0	0.00%	6	7.89%	8	7.08%
4 - 9 years	6	27.27%	5	33.33%	19	25.00%	30	26.55%
10 - 19 years	6	27.27%	6	40.00%	27	35.53%	39	34.51%
20 years or more	8	36.36%	4	26.67%	18	23.68%	30	26.55%
Not specified	0	0.00%	0	0.00%	6	7.89%	6	5.31%
Total	22	100.00%	15	100.00%	76	100.00%	113	100.00%

Age	Managers		Regulators		Other Users		Total	
	No.	%	No.	%	No.	%	No.	%
20 to 29	1	4.55%	2	13.33%	12	15.79%	15	13.27%
30 to 39	9	40.91%	9	60.00%	36	47.37%	54	47.79%
40 to 49	6	27.27%	2	13.33%	14	18.42%	22	19.47%
50 to 59	5	22.73%	0	0.00%	8	10.53%	13	11.50%
60 to 69	1	4.55%	2	13.33%	3	3.95%	6	5.31%
70 and above	0	0.00%	0	0.00%	0	0.00%	0	0.00%
Prefer not to say	0	0.00%	0	0.00%	3	3.95%	3	2.65%
Total	22	100.00%	15	100.00%	76	100.00%	113	100.00%

Table 7.2 also shows that the proportion of managers and preparers of financial reports with over 20 years of work experience in their positions, at 36.36%, was larger than that for regulators and policy-makers (26.67%) and other users of financial reports (23.68%). This finding was expected, as the survey was sent to people holding senior posts in the first group (managers and financial reports preparers) but it was sent to different managerial levels within the other two groups.

Generally, the findings indicate that more than half of the respondents from each of the three groups (63.63%, 66.67% and 59.21% respectively) had work experience of 10 years or more.

From Table 7.2 it can also be seen that approximately half (47.79%) of the respondents were aged between 30 and 39 years. The same age category represents the biggest portion of each of the three groups: 40.91% of managers and preparers financial reports, 60% of regulators and policy-makers, and 47.37% of other users of financial reports. Respondents aged 60 years and above are the smallest portion (5.31%), which is consistent with expectation, as people in Bahrain start retiring when they reach 60 years of age.

Table 7.3: Respondents' Educational Level

Educational Level	Managers		Regulators		Other Users		Total	
	No.	%	No.	%	No.	%	No.	%
High School	0	0.00%	0	0.00%	0	0.00%	0	0.00%
Diploma	0	0.00%	0	0.00%	0	0.00%	0	0.00%
Bachelor	12	54.55%	6	40.00%	13	17.11%	31	27.43%
Masters	6	27.27%	7	46.67%	35	46.05%	48	42.48%
PhD	1	4.55%	0	0.00%	15	19.74%	16	14.16%
Other	3	13.64%	2	13.33%	9	11.84%	14	12.39%
Not specified	0	0.00%	0	0.00%	4	5.26%	4	3.54%
Total	22	100.00%	15	100.00%	76	100.00%	113	100.00%

Table 7.3 presents the distribution of respondents according to their highest academic qualification. The majority of the managers and preparers of financial reports held a bachelor degree (54.55%), 27.27% held a masters degree, 13.64% held a postgraduate professional certificate (e.g. CFA, CPA, ACCA, FRM, PRM, CIA, CMA, CFM, CFE), and only 4.55% had a PhD. As for regulators and policy-makers, 40.00% held a bachelor degree, 46.67% held a masters degree, and 13.33% held a

postgraduate professional certificate. Finally, approximately half (46.05%) of the other users of financial reports held a masters degree, 19.74% had a PhD and 11.84% held a postgraduate professional certificate.

Table 7.4: Respondents' Nationality and Gender

Nationality	Managers		Regulators		Other Users		Total	
	No.	%	No.	%	No.	%	No.	%
Bahraini	18	81.82%	14	93.33%	56	73.68%	88	77.88%
Other	4	18.18%	1	6.67%	17	22.37%	22	19.47%
Not specified	0	0.00%	0	0.00%	3	3.95%	3	2.65%
Total	22	100.00%	15	100.00%	76	100.00%	113	100.00%
Gender	**Managers**		**Regulators**		**Other Users**		**Total**	
	No.	%	No.	%	No.	%	No.	%
Male	21	95.45%	8	53.33%	48	63.16%	77	68.14%
Female	1	4.55%	6	40.00%	25	32.89%	32	28.32%
Not specified	0	0.00%	1	6.67%	3	3.95%	4	3.54%
Total	22	100.00%	15	100.00%	76	100.00%	113	100.00%

The respondents were questioned about their nationality and gender. As indicated in Table 7.4, in all groups most respondents were Bahraini: 81.82% of the managers and preparers of financial reports, 93.33% of regulators and policy-makers, and 73.68% of other users of financial reports. With regard to gender, as shown in Table 7.4, the majority of respondents were male: 95.45% of the managers and preparers of financial reports, 53.33% of regulators and policy-makers, and 63.16% of other users of financial reports.

In summary, most of the respondents had valuable experience in the field, as 87.61% of them had more than four years of work experience. Moreover, the respondents were well qualified, as all of them held at least bachelor degree. Therefore, the respondents' background information suggests that their perceptions would be valuable and adds to the credibility of and confidence in the findings.

7.2.2 Descriptive statistics of participants in the semi-structured interviews

This study used semi-structured interview, as a qualitative approach, as a source of primary data. Twenty-five individual interviews were conducted. It is important to present the background information about the interviewees as it helps in interpreting and comparing the findings. Therefore, Table 7.5 gives some summary descriptive statistics. Face-to-face semi-structured interviews were undertaken in the field from December 2016 to January 2017. The interviews lasted from 45 minutes to 2 hours. Table 7.5 shows that five interviews were conducted with managers and preparers of financial reports, four with regulators and policy-makers, and 16 with other users of financial reports: two creditors (banks), two analysts, two institutional investors, one informed individual investor, three external auditors (two partners and one manager), one internal auditor, one financial advisor and board member, and four academics. Thus, all of the interviewees held managerial positions and some of them held more than one position (especially board members). The majority of the interviewees had more than 15 years of work experience, which adds to the credibility of their perceptions.

Table 7.5: Respondents Participating in the Semi-Structured Interview

Group	Code	Company/ Organisation and Position
Managers and Financial Reports Preparers	AP1	Financial Services Co. / Financial Controller
	AP2	Telecommunication Co. / Chief Financial Officer
	AP3	Real Estate Co. / Financial Controller
	AP4	Tourist Co. / Chief Financial Officer and Board Secretary
	AP5	Industrial Co./ Investor Relation and Corporate Affairs and Financial Controller
Regulators and Policy Makers	PM1	Central Bank of Bahrain / Executive Director
	PM2	Ministry of Commerce and Industry / Assistant Undersecretary
	PM3	Bahrain Bourse / Internal Control and Board Secretary
	PM4	Central Bank of Bahrain / Head
Other Financial Reports Users	US1	Bank/ Credit Manager
	US2	Bank / Credit Risk Manager
	US3	Analyst / Investment firm
	US4	Institutional Investor / Fund Manager and Board member
	US5	Analyst following GCC markets / Head of Research
	US6	Individual Investor
	US7	Institutional Investor / Chief Financial Officer and Board member
	US8	Accountancy Firm / Partner
	US9	Big 4 Accountancy Firm/ Partner
	US10	Big 4 Accountancy Firm/ Manager
	US11	Financial Advisor and Board Member (Audit Com.)
	US12	Ex-Big 4 Accountancy Firm/ Manager and Head of Internal Audit
	US13	Accounting academic at Public University
	US14	Accounting and finance academic at Private University
	US15	Accounting academic at Public University
	US16	Accounting academic at Public University

7.3 The concept and characteristics of earnings quality

7.3.1 How are earnings used?

It is important to understand how earnings are used in Bahrain before covering any other aspects. This analysis is based on theoretical arguments that earnings information is useful for valuation (Barth, Beaver, & Landsman, 2001; Francis, Olsson, & Schipper, 2008), and performance evaluation, stewardship purposes and contracting (Holthausen & Watts, 2001; Armstrong, Guay, & Weber, 2010). Using earnings in valuation models is justified by suggesting that high-quality current earnings provide more useful data for the forecasting metric and result in more accurate valuations (Dechow & Schrand, 2004). The earnings figure also affects investment efficiency (Biddle, Hilary, & Verdi, 2009), the cost of equity capital (Francis et al., 2004) and cost of debt capital (Jiang, 2008). Furthermore, the firm's earnings are also used to monitor the firm's compliance with debt contracts (Li, 2016). Debt contracts are monitored by linking them to accounting measures which facilitate these contracts (Christensen, Nikolaev, & Wittenberg-Moerman, 2016). These measures are used in the formulation and design of the debt contract (Ball et al., 2008).

In addition, the earnings figure reflects the firm's current performance and indicates future performance. Earnings are used to determine executive compensation (Baber, Kang, & Kumar, 1998; Akono & Nwaeze, 2018). Compensation contract designs based on the firm's performance are linked to earnings figures, as they represent a summary of the period performance. Firm performance can affect management movements as well. For instance, earnings restatements can increase management turnover (Desai, Krishnamurthy, & Venkataraman, 2006) and the chances of executives losing their jobs (Karpoff, Scott Lee, & Martin, 2008).

During the interview stage of this study, all the interviewees agreed that earnings are very important for existing and potential investors to value the company and make their investment decisions in Bahrain. An individual investor commented that "I use the profitability information disclosed in the company's financial reports to make my investment decision after I compare the company's profitability with other investments opportunities" (US6). A financial controller said "Investors are the major user of financial reports. They are interested in knowing what the company's earnings per share are in order to make an investment decision" (AP4). An accounting academic added that "Companies are aware of the importance of earnings to the investors; therefore, they include a lot of figures and graphics in their financial reports, which are expensive to prepare, to attract investors by providing easy-to-read profitability information" (US15). A financial analyst believed that analysts are also one group of users, but their usage is limited to the preparation of analysis reports to support investment decisions: "I think analysts only use the financial reports to identify the company's performance to support our investor decisions" (US3). Close to this opinion, other interviewees believed that government agencies (regulators) also use financial reports (including earnings) in Bahrain to prepare statistical reports which support local and foreign investors' investment decisions: "Central Bank of Bahrain is willing to use the financial reports to do its analysis and supply it to the market" (US10).

In addition, the majority of the interviewees also believed that creditors, mainly banks, in Bahrain are the second biggest users of earnings information. Banks review companies' financial reports and especially their profitability to make sure that they will be able to pay back their debt. The profitability of the company will reflect its ability to complete a debt contract with the bank. An external auditor said "The biggest users of financial reports in Bahrain are banks. They are afraid about the money they lent to the company and if the company will be able to repay it" (US8).

Moreover, three of the interviewees (two financial controllers and an internal auditor) believed that earnings are used by the management as well to compare its budgets and plans with the actual results in order to maintain some stability in its performance. They said that their company's board of directors and executive management compare the profitability of the company this year with that in the previous year. One of the financial controllers said: “Internally, we use the financial reports to compare the results of this year and how it improves compared to previous years…. We focus on the segments that provide a lot of revenue and the weak ones and try to fix them by making a balance” (AP4). Therefore, they think that some of the companies use profitability as a determinant for management compensation.

Furthermore, suppliers and customers in Bahrain apparently have little use for earnings figures. Only one interviewee, a financial controller, mentioned that suppliers and customers use earnings figures to make sure of the company’s profitability as an indicator of its stability before doing business with them: “We do not sign a contract with a supplier unless we are confident about its stability, and it is the same with customers who are looking for a stable company to deal with” (AP1).

In addition, two of the interviewees mentioned that existing and potential employees may use the companies’ financial reports to look into its profitability as it is a determinant for their compensation: “Financial reports are also used by potential employees [job applicants] to review the financial position of the company before they go to a job interview to make sure that the company is strong enough” (AP4). Another interviewee added: “Employees are also interested in the financial reports to see the company’s profitability and its ability to pay their salaries and bonuses” (US8).

Table 7.6 shows the survey respondents’ perceptions of the use of earnings in Bahrain. Table 7.6 indicates that the valuation role of reported earnings dominates more than 90% of the responses of all three groups. Respondents think that earnings are important to very important for investors in valuing the company (mean

4.62); moreover, the average rating for this role is statistically greater than the average rating for every other use of earnings. The results are consistent with prior surveys of investors, financial executives and analysts (Kothari, 2001). In addition, the results are in line with the results of an earlier survey of chief executive officers (Dichev et al., 2013). Following closely behind the importance of valuation role of reported earnings, however, are three other uses: contracting, control and stewardship. Support has been found for the importance of earnings: in debt contracts (mean 4.45), for use by the company's own managers (mean 4.12), for use in executive compensation contracts (mean 3.89), and for use by outsiders in evaluating the company's managers (mean 3.71). The results also show that earnings are less important for other stakeholders: employees, suppliers, customers and labour. This support was reflected in their mean scores of 3.50, 3.46, 3.36 and 3.31 respectively.

A non-parametric Kruskal-Wallis test and parametric ANOVA test were carried out to determine whether respondents' perceptions differed significantly between the three groups. The results showed significant differences (at the 5% level). Around 77% of the managers and preparers of financial reports and 60% of the regulators and policy-makers thought that earnings were important or strongly important to "current and prospective customers" in Bahrain. However, this argument was much less frequently found in the responses of other users of financial reports (40.8%). This significant difference was expected, since managers are more aware of their customers' use of their financial reports generally and their earnings specifically and they use their profitability information to provide more confidence to their existing and potential customers, and regulators believe that customers are always referred to the financial reports and the profitability of the company before they engage in any transaction with the company. Moreover, only one of the interviewees mentioned that customers use earnings in Bahrain to make their business decisions.

In addition to the uses raised in the survey, some of the respondents indicated additional uses for earnings in Bahrain. They mentioned that earnings are used for regulatory purposes by the regulators (Central Bank, the Ministry of Commerce and the Bahrain bourse) and rating agencies. Moreover, it will be useful for tax authorities in the near future (as Bahrain currently is a tax-free country). Some respondents indicated that earnings are also useful for research purposes.

In sum, the valuation role of earnings dominates; however, the stewardship, contracting, and control uses are also important in Bahrain. Therefore, earnings in Bahrain are a key metric for a broad range of interested parties, which is consistent with the position adopted by some researchers (e.g. Kothari, Ramanna, & Skinner, 2010), and are not limited to valuation. However, earnings are not used very often by customers and suppliers. Theoretically, the use of reported earnings is justified by agency theory. The principal requires information to evaluate the performance of the company.

Table 7.6: Descriptive Statistics of Respondents' Perceptions about the Importance of Reported Earnings in Bahrain

Questions	Level of importance (percentage)					Mean score	Overall Mean Score	Rank	Standard Deviation	Overall Standard Deviation	Significance tests	
	1	2	3	4	5						Kruskal-Wallis Non-Parametric Test	ANOVA one way Parametric Test
For use by investors in valuing the company	- (-) [-]	- (-) [1.3]	13.60 (6.7) [9.2]	18.20 (13.3) [15.8]	68.20 (80.0) [73.7]	4.55 (4.73) [4.62]	4.62	1	0.739 (0.594) [0.711]	0.701	-	-
For use in debt contracts	- (-) [-]	4.5 (-) [2.6]	13.60 (13.3) [7.9]	27.30 (20.0) [28.9]	54.50 (66.7) [60.5]	4.32 (4.53) [4.47]	4.45	2	0.89 (0.743) [0.757]	0.781	-	-
For use in executive compensation contracts	4.5 (-) [1.3]	9.1 (6.7) [7.9]	22.7 (20.0) [25.0]	31.8 (20.0) [35.5]	31.8 (53.3) [30.3]	3.77 (4.20) [3.86]	3.89	4	1.15 (1.014) [0.989]	1.023	-	-
For use in negotiations with labour	- (-) [13.2]	13.6 (13.3) [19.7]	27.3 (33.3) [23.7]	31.8 (26.7) [28.9]	27.3 (26.7) [14.5]	3.73 (3.64) [3.12]	3.31	9	1.03 (1.042) [1.265]	1.192	-	-
For use by current and prospective customers	- (-) [14.5]	4.5 (6.7) [17.1]	18.2 (33.3) [27.6]	59.1 (40.0) [22.4]	18.2 (20.0) [18.4]	3.91 (3.73) [3.13]	3.36	8	0.75 (0.884) [1.310]	1.149	***	***
For use by current and prospective employees	- (-) [9.2]	13.6 (6.7) [11.8]	31.8 (33.3) [28.9]	36.4 (33.3) [27.6]	18.2 (26.7) [22.4]	3.59 (3.79) [3.42]	3.50	6	0.96 (0.939) [1.225]	1.138	-	-
For use by current and prospective suppliers	13.6 (-) [6.6]	4.5 (-) [15.8]	27.3 (33.3) [31.6]	40.9 (40.0) [23.7]	13.6 (26.7) [22.4]	3.36 (3.93) [3.39]	3.46	7	1.22 (0.799) [1.190]	1.145	-	-
For use by outsiders in evaluating the company's manager	13.6 (-) [5.3]	9.1 (-) [11.8]	13.6 (20.0) [17.1]	50.0 (46.7) [38.2]	13.6 (33.3) [27.6]	3.41 (4.13) [3.71]	3.71	5	1.26 (0.743) [1.153]	1.121	-	-
For use by the company's own managers	4.5 (-) [1.3]	9.1 (-) [2.6]	9.1 (20.0) [21.1]	36.4 (46.7) [28.9]	40.9 (33.3) [46.1]	4.00 (4.13) [4.16]	4.12	3	1.16 (0.743) [0.939]	0.955	-	-

*Level of Influence on a scale of: 1= Not Important to 5= Very Important
** For each potential use of financial reports, three rows of figures are reported. The first row represents the perceptions of managers and preparers of financial reports, the (second row) represents the perceptions of regulators and policy-makers, and the [third row] represents the perceptions of other users of financial reports.
*** Indicates that the distribution of responses among the three groups is statistically significantly different at the 5% level using Kruskal Wallis test and ANOVA on way as an additional test to verify the results.

7.3.2 Qualitative evidence on the concept of earnings quality

Although the term “earnings quality” is widely used in the academic and practitioner communities, there is no universal definition of it. The literature has characterised (and accordingly measured) high-quality earnings as those that: are persistent and a predictor of future earnings (Schipper & Vincent, 2003; Penman & Zhang, 2002); are smooth (Dechow and Scharand, 2004; Francis et al., 2004); are derived from the application of conservative accounting rules (Watts, 2003); do not include special or non-recurring items (Dechow and Schrand, 2004; McVay, 2006); are backed by cash flow (Sloan, 1996; and Dechow and Dichev, 2002); and include small changes in accruals that are not linked to fundamentals (Jones, 1991; Dechow, Sloan, & Sweeney, 1995; Kothari, Leone, & Wasley, 2005).

In this section, the interviewees’ and the survey respondents’ perceptions regarding the meaning of “earnings quality” will be discussed together, as all of them were asked an open-end question and were allowed some freedom in defining earnings quality.

Interviewees gave many definitions of earnings quality. Some mentioned that earnings quality is about providing the different users of financial reports with the required information about the company’s performance to make their relevant decisions. Therefore, the company should disclose its earnings figures with any other necessary information and breakdowns that provide a clear picture of company performance. For example, one interviewee said: “High-quality earnings is what presents to internal and external users beneficial information to allow them to make the right decisions” (US16).

In addition, earnings quality was said to be about providing information about the company's earnings in a timely manner. Providing information late will lessen the validity and significance of reported earnings: "Stakeholders require information about the company's performance in a timely way" (US11) and "Information should be presented at the appropriate time" (US15). Moreover, most of the interviewees agreed that earnings should be consistent, sustainable and stable to be of high quality: "Companies should have some stability in their profitability and overall financial position" (AP1). Furthermore, high earnings quality require financial reports to be prepared according to the accounting standards, IFRS in Bahrain, and in compliance with the regulatory requirements: "High-quality financial reports are reports prepared in accordance with the accounting standards" (US13); "Reports should be based on the accounting standards and the regulatory standards" (PM1); and "It is constructed by complying with the regulations and IFRS" (US8). Some interviewees added that implementing the accounting standards is not enough: companies should be constant in implementing the accounting methods (i.e. reporting choices) to have high-quality earnings and they should have strong justification for any change in their methods: "Companies should have consistency in the accounting methods used.... I will start questioning if the company keeps changing its methods from time to time" (US13).

Moreover, interviewees believed that the quality of reported earnings depends on whether the figures are reliable and realistic: "The reliability, completeness, and relevance of the reported earnings will affect its quality" (US16). Therefore, companies are required to report relevant and realistic information about their profitability and not push users to adjust reported earnings to reflect a more realistic picture of company's performance: "I would adjust the earnings to make them look more realistic to me" (US3). This reveals the importance of having earnings figures that provide a true and fair view of the company's performance: "Reported earnings should reflect a true and fair view about the company's financial position" (US14).

Analysts' believed that high-quality earnings should not include one-time items, as this could mislead the users of the reported earnings and would not reflect the normal performance of the company: "Users should look into the components of profits and see if there is any exceptional, one-off profit [like selling assets] which indicate a jump in the company's profit above average" (US3). Therefore, different users find that reported earnings will be of high quality if they are reported clearly and in a transparent way. It should be easy for different users to understand the profitability of the company and the sources of the reported profit: "High earnings quality should be reported in a transparent and easy-to-understand way…. It should include the sources of return, what is generating the income, and what is making this business profitable" (US4).

Table 7.7 shows the categories and the rank of the collected responses related to the meaning of earnings quality in Bahrain. The most frequently mentioned characteristic of earnings quality is that reported earnings are sustainable, repeatable, recurring, consistent, reliable, predictable and truthful, and reflect long-term trends. The second most common description is that reported earnings accurately reflect economic reality, results from operations and the core business, and are free from manipulation. This is consistent with the notions of "true and fair view" in IFRS and "representational faithfulness" in US GAAP. However, this perception is less helpful operationally (Dichev et al., 2013). The third category comprises descriptions of earnings quality as reported earnings which are free from special or one-time items, not from reserves and fair value adjustments, and market fluctuations; thus, high-quality earnings are free from items that make them unsustainable (which is the flip side of the first category). This reflects the dominance of the sustainability feature of high-quality earnings, given the importance of earnings in the valuation process. In addition, sustainable earnings also assist in credit and managerial decisions, as mentioned previously. It should be noted that the notion of sustainable earnings is closely related to the notion of earnings persistence. The difference is that sustainability is more forward-looking in meaning, while persistence is more of a statistical construct. Previous studies have explored both terms as attributes of earnings (Francis, LaFond, Olsson, & Schipper, 2005; Penman and Zhang, 2002; Skinner and Soltes, 2011); however, it seems 'persistence' is not widely used by practitioners.

The remaining three categories (accurate application of accounting standards, transparency/clarity, and closer to cash flow) score very low compared with the first three categories. In summary, the respondents' answers suggest that, above all, high-quality earnings are reported earnings which are sustainable, consistent, repeatable and predictable.

Table 7.7: Summary of the responses to the open-ended question "What does the concept of earnings quality mean?"

Rank	Concept of earnings quality	Count
1	Sustainable, Repeatable, Recurring, Consistent, Reliable, Reflect long-term trend, Predictable, Truthful	8 (5) [34]
2	Accurately reflects economic reality, results from operations, from core business, free from manipulation	5 (4) [27]
3	Free from special or one-time items, not from reserves and fair value adjustments, market fluctuations	1 - [6]
4	Accurate application of accounting standards (IFRS)	1 - [5]
5	Transparency/clarity	- - [2]
5	Closer to cash flow	1 - [1]

* For each concept of what earnings quality is, three rows of figures are reported. The first row represents the perceptions of managers and preparers of financial reports, the (second row) represents the perceptions of regulators and policy-makers, and the [third row] represents the perceptions of other users of financial reports.

In conclusion, the objective of this section is to obtain the perceptions of the participants of the meaning of 'earnings quality' in Bahrain. To gain deep understanding, an open-ended question was presented in both the semi-structured interviews and the questionnaire survey. The findings indicate that earnings quality can be described by its characteristics. Earnings quality is strongly linked to its sustainability, repeatability, and predictability. These characteristics have been supported by the interviews and survey findings. Theoretically, the problem of information asymmetry lead managers to influence the quality of reported earnings and to act in their own best interest, to maximise their wealth, because managers' goals might compete with those of other stakeholders. Therefore, meeting the above-mentioned characteristics of high-quality earnings reduces the information asymmetry problem and provides the principal with real and transparent information about the company's earnings.

7.3.3 Rank ordering the empirical characteristics of earnings quality

Table 7.8 shows the survey respondents' perception regarding the characteristics of earnings quality in Bahrain. The top choice is that high-quality earnings are useful predictors of future earnings. More than 78% of all three groups of respondents agree to strongly agree that earnings is of high quality if it assists in predicting future earnings (mean 4.06), followed closely by sustainability, where more than 66% of all three groups of respondents agree to strongly agree that high-quality earnings should be sustainable (mean 4.04), and more than 70% of all groups of respondents' agree to strongly agree that earnings is of high quality if it can predict future cash flow (mean 3.97). These features are consistent with the preference for repeatable and persistent earnings captured above. The results are in line with the results of an earlier survey of chief executive officers (Dichev et al., 2013).

Table 7.8 also shows that high-quality earnings: reflect consistent reporting choices over time (mean 3.77); avoid unreliable estimates as much as possible (mean 3.76); do not include one-time or special items (mean 3.62); result from conservative recognition of assets and liabilities (mean 3.59); and have accruals that are eventually realised as cash flows (mean 3.56). These responses are consistent with the qualitative responses. The importance of these characteristics is confirmed in the interviews and supported by the literature, which indicates that high-quality earnings should be consistent and sustainable (e.g. Francis et al., 2004). This reflects the importance of having persistent and smooth earnings that assist in the valuation and prediction process.

Additional characteristics of high-quality earnings are reported in Table 7.8. These include: recognise losses in a more timely manner than gains (mean 3.39); are less volatile than cash flows (mean 3.39); have fewer accruals (mean 3.38); and require fewer explanations in company communications (mean 3.22). The results relating to accruals are surprising given the importance of accruals to the quality of earnings in the literature (for more details see Dechow et al., 2010) but consistent with the role of accruals in solving the timing and mismatching problems (Dechow, 1994). It should be noted that few of the interviewees discussed the effect of accruals on the quality of earnings, which indicates that accruals are not considered an important measure of earnings quality in Bahrain. In addition, the results related to the level of explanations are consistent with the interview findings, in that the majority of the users expect a high level of disclosure, as they believe that high-quality earnings must be transparent and clear, and give detailed disclosures.

A non-parametric Kruskal-Wallis test and parametric ANOVA test were carried out to determine whether respondents' perceptions differed significantly between the three groups. The results showed there are two sets of significant differences (at the 5% level). First, around 73% of the regulators and policy-makers and 56% of the other users of financial reports agree and strongly agree that the earnings figure is of high quality if "accruals are eventually realised as cash flows" . However, this argument was found to be much lower in the response of the managers and preparers of financial reports (31.8%). This significant difference was expected, since managers and preparers of financial reports are the group that establishes the accruals balances and the most group aware of the effect that accruals balances of the companies have on the quality of earnings (smooth earnings). Second, regulators and policy-makers and other users of financial reports showed much higher levels of agreement than the managers and preparers of financial reports that the earnings are of high quality if they "recognise losses in a more timely manner than gains". This is possibly due to their belief that they are reporting loss and gains at the same time period.

Overall, the results of this section indicate that high-quality earnings are sustainable and predict of future earnings and cash flows. Conservative recognition of assets and liabilities, and the inclusion of accruals that are realised as cash flow are also features that have some bearing on the quality of earnings. Moreover, the findings indicate interesting points related to the characteristics of high- quality earnings which are inconsistent with the literature. There was little support for the following characteristics: fewer accruals, require less explanation, and recognise losses in a more timely manner than gains. This is not surprising, because different users of financial reports in Bahrain do not pay much attention to accruals (as noticed in all sections addressing accruals), but are always looking for more detailed disclosure, and Bahrain does not have an efficient market, and so companies report both gain and loss for the same time period (by the deadline set by the regulators) without any distinguish. Theoretically, high-quality earnings reduce the problem of information asymmetry and provide the principal with real and transparent information about the company's earnings. In addition, institutional theory can explain why some characteristics are important in Bahrain but not elsewhere. These characteristics are linked to the conservative culture of Bahraini stakeholders (who are more to give explanation and disclosure).

Table 7.8: Descriptive Statistics of Respondents' Perceptions about the features of "high quality earnings" in Bahrain

Perceptions	Level of agreement (percentage)					Mean score	Overall Mean Score	Rank	Standard Deviation	Overall Standard Deviation	Significance tests	
	1	2	3	4	5						Kruskal-Wallis Non-Parametric Test	ANOVA one way Parametric Test
Are sustainable	4.5 (-) [1.3]	- (-) [2.6]	36.4 (40) [26.3]	4.5 (13.3) [31.6]	54.5 (46.7) [38.2]	4.05 (4.07) [4.03]	4.04	2	1.174 (0.961) [0.938]	0.986	-	-
Are useful predictors of future earnings	- (-) [3.9]	9.1 (13.3) [-]	22.70 (13.3) [14.5]	36.40 (33.3) [44.7]	31.80 (40.0) [36.8]	3.91 (4.00) [4.11]	4.06	1	0.97 (1.069) [0.932]	0.957	-	-
Are useful predictors of future cash flows	- (-) [5.3]	9.1 (6.7) [1.3]	27.3 (33.3) [18.4]	22.7 (26.7) [38.2]	40.9 (33.3) [36.8]	3.95 (3.87) [4.00]	3.97	3	1.05 (0.990) [1.046]	1.039	-	-
Do not include one-time or special items	- (-) [3.9]	4.5 (13.3) [9.2]	54.5 (26.7) [38.2]	18.2 (33.3) [19.7]	22.7 (26.7) [28.9]	3.59 (3.73) [3.61]	3.62	6	0.91 (1.033) [1.120]	1.068	-	-
Are less volatile than cash flows	- (-) [2.6]	18.2 (20.0) [18.4]	36.4 (33.3) [38.2]	27.3 (20.0) [23.7]	18.2 (26.7) [17.1]	3.45 (3.53) [3.34]	3.39	9	1.01 (1.125) [1.053]	1.054	-	-
Result from conservative recognition of assets and liabilities	4.5 (6.7) [-]	9.1 (20.0) [14.5]	31.8 (26.7) [27.6]	27.3 (20.0) [39.5]	27.3 (26.7) [18.4]	3.64 (3.40) [3.62]	3.59	7	1.14 (1.298) [0.952]	1.031	-	-
Recognise losses in a more timely manner than gains	9.1 (-) [6.6]	36.4 (6.7) [15.8]	18.2 (26.7) [32.9]	22.7 (26.7) [21.1]	13.6 (40.0) [23.7]	2.95 (4.00) [3.39]	3.39	9	1.25 (1.00) [1.201]	1.185	***	***

Have accruals that are eventually realised as cash flows	9.1 (-) [2.6]	18.2 (6.7) [6.6]	40.9 (20.0) [34.2]	22.7 (46.7) [38.2]	9.1 (26.7) [18.4]	3.05 (3.93) [3.63]	3.56	8	1.09 (0.917) [0.950]	0.973	***	***
Have fewer accruals (i.e. adjustments for revenue that have been earned but not recorded and expenses that have been incurred but are not recorded yet)	- (-) [5.3]	31.8 (20.0) [11.8]	22.7 (26.7) [38.2]	31.8 (13.3) [28.9]	13.6 (46.7) [15.8]	3.27 (3.53) [3.38]	3.38	10	1.08 (1.060) [1.058]	1.062	-	-
Avoid unreliable estimates as much as possible	9.1 (-) [1.3]	13.6 (13.3) [9.2]	22.7 (26.7) [26.3]	40.9 (13.3) [30.3]	13.6 (46.7) [32.9]	3.36 (3.93) [3.84]	3.76	5	1.18 (1.163) [1.033]	1.077	-	-
Require fewer explanations in company communications (e.g. management discussions and analyses, conference calls etc.)	13.6 (13.3) [6.6]	4.5 (6.7) [21.1]	54.5 (46.7) [27.6]	22.7 (20.0) [25.0]	4.5 (13.3) [19.7]	3.00 (3.13) [3.30]	3.22	11	1.02 (1.187) [1.200]	1.165	-	-
Reflect consistent reporting choices over time	- (6.7) [2.6]	9.1 (13.3) [7.9]	40.9 (33.3) [21.1]	31.8 (33.3) [32.9]	18.2 (13.3) [35.5]	3.59 (3.33) [3.91]	3.77	4	0.91 (1.113) [1.061]	1.038	-	-

*Level of importance on a scale of: 1= Strongly Disagree 2= Weakly Disagree 3= Neutral 4= Weakly Agree 5= Strongly Agree
** For each perception, three rows of figures are reported. The first row represents the perceptions of managers and preparers of financial reports, the (second row) represents the perceptions of regulators and policy-makers, and the [third row] represents the perceptions of other users of financial reports.
*** Indicates that the distribution of responses among the three groups is statistically significantly different at the 5% level using Kruskal Wallis test and ANOVA one way as an additional test to verify the results.

7.4 The determinants of earnings quality

7.4.1 What drives earnings quality?

The quality of earnings is affected by many factors, such as the country's legal environment and the strength of the law enforcement regime. The literature examines the relationship between institutional variables like the legal institutions, capital-market features, enforcement systems, culture, political institutions and societal trust and the cross-country differences in financial reporting (Leuz & Wysocki, 2016). In addition, empirical literature also shows that firm characteristics such as performance, debt, growth and size are associated with earnings quality (Gaio, 2010).

Prior sections have explored the concept and characteristics of earnings quality. This section will investigate the underlying determinants of earnings quality and compared them to the extensive literature on the determinants of earnings quality summarised by Dechow et al. (2010). Interviewees were asked to provide a list of factors that determine the quality of reported earnings. They believed that the factors that influence the quality of reported earnings can be broadly categorised as follows.

- <u>Business model, industry, macroeconomic condition, and size</u>

Many of the interviewees believed that the quality of reported earnings is affected by some factors which are beyond the control of management. However, these factors drive management to report earnings at a certain level of quality. Interviewees expected that the business model of the company would influence earnings quality. For instance, a financial controller said: "The focus is on the financial reports, but these reports are the result of the company's operation. Therefore, we have to look at the operational drivers of the business" (AP2). In addition, they thought that the industry which the company operated in would also affect the quality of reported earnings, as expressed by an academic and analyst: "The quality and type of information presented in the financial reports will differ from sector to another … disclosure in the financial sector [e.g. banks and insurance companies] will be different from disclosure in the non-financial sector [e.g. manufacturing and service companies]" (US16); and "Reported earnings will be different from one industry to another" (US3). Moreover, interviewees believed that the country's overall economic condition would also play a role in determining the quality of reported earnings. An investor mentioned that: "The company is not operating individually, it is part of the market … any event in the market will affect its activities…. In addition, the economic condition of the country will also affect its business and will be reflected in their results and financials" (US6). Furthermore, the size of the company was expected to play a significant role in determining the quality of reported earnings. Big firms usually try to maintain their reputation, as Watts & Zimmerman (1986) mentioned. This was supported by the interviewees. For example, an academic said: "Big companies try to protect their reputation … their reputation is very important to them because these companies try to expand most of the time and this expansion will require them to raise more equity or debt and if they have a good reputation this will make their life much easier, as they will be able to attract more investors" (US16).

- Internal corporate governance mechanisms

Prior studies have supported the relationship between corporate governance mechanisms and earnings quality. In 2011, Bahrain established its code of corporate governance. Most of the interviewees showed their awareness of the importance of these mechanisms in maintaining high-quality financial reporting practices. One of the interviewees, a regulator, said: “You cannot study the quality of the reported earnings before discussing the corporate governance mechanisms in place…. Corporate governance is the umbrella for the financial reporting process” (PM1). This regulator’s opinion was supported by a large number of the interviewees. The reason for this high level of awareness is that the code had been recently established and the majority of the interviewees were taking part in the implementation process and so they had to know about corporate governance mechanisms and their importance.

Interviewees mentioned that corporate governance mechanisms affect the quality of reported earnings in many ways. First, the board of directors sets up sub-board committees which are responsible for overseeing management but which also engage in some day-to-day activities. These committees include: the audit committee, executive committee, and remuneration and nomination committee. The audit committee is one of the factors with the most influence on the quality of financial reports. According to the Bahraini code of corporate governance (Bahrain Corporate Governance Code, 2010), the audit committee in Bahrain is responsible for:

- The selection, appointment, remuneration, oversight and termination where appropriate of the outside auditor, subject to ratification by the company’s board and shareholders. The outside auditor reports directly to the committee.
- Making a determination at least once each year of the outside auditor’s independence, including determining whether its performance of any non-audit services compromised its independence (the committee may establish a

formal policy specifying the types of non-audit services which are permissible), and obtaining from the outside auditor a written report listing any relationships between the outside auditor and the company or with any other person or entity that may compromise the auditor's independence.

- Reviewing and discussing with the outside auditor the scope and results of its audit, and any difficulties the auditor encountered, including any restrictions on its access to requested information and any disagreements or difficulties encountered with management.
- Reviewing and discussing with management and the outside auditor each annual and each quarterly set of financial statements of the company, including judgements made in connection with the financial statements.
- Reviewing and discussing and making recommendations regarding the selection, appointment and termination where appropriate of the head of internal audit and the budget allocated to the internal audit and compliance function, and monitoring the responsiveness of management to the committee's recommendations and findings.
- Reviewing and discussing the adequacy of the company's internal auditing personnel and procedures and its internal controls and compliance procedures, and any risk management systems, and any changes in those.
- Overseeing the company's compliance with legal and regulatory requirements.
- Reviewing and discussing arrangements under which company employees can confidentially raise concerns about possible improprieties in financial

reporting or other matters, and ensuring that arrangements are in place for independent investigation and follow-up regarding such matters.

These responsibilities of the audit committee identify its importance in the financial reporting process. Interviewees reflected the importance of this committee by supporting what is mentioned in the code. One added that: “The existence of an audit committee adds to the credibility of the information presented in the financial reports” (PM4).

Second, the board composition also plays a role in the quality of financial reports. Having independent board members will provide to different stakeholders some confidence in the board’s decisions. These independent board members will protect the minority shareholders’ interests and those of other outsider stakeholders. An academic said: “Independent board members do not have a conflict of interest with the company’s decisions; thus, this will increase the expectation that these members work towards improving company performance” (US15).

Third, the inclusion of competent board members will be helpful for the company. Competent board members will use their knowledge and experience to benefit the company. Interviewees thought that competent members would support those board decisions which are in the best interests of the company.

However, the last two features (i.e. independent and competent board members) involve some cultural issues in Bahrain. Investors believe that appointing board members with a strong alliance will provide them with some guarantee that their decisions will be in their best interest, even if this conflicts with other stakeholders’ interests. Investors sometimes appoint members who are loyal to them even if they are incompetent. One interviewee said: “With regard to the board of directors, we have a culture issue where investors appoint their friends or anyone with a strong alliance as independent directors to act in their best interest … it is not necessary that these members have the required relevant knowledge or experience … investors would like to provide the benefits [compensation] to someone they know” (US12). This will raise a lot of problems, as a financial controller mentioned: “Appointing incompetent members will produce weak business decisions, bad supervision, and unknowledgeable and inexperienced members setting on the audit committee which has responsibility for financial reports” (AP3).

Fourth, some of the interviewees thought that having an internal control system would have an indirect effect on the quality of reported earnings. An internal control system provides the company with specific policies and procedures that should be followed. A board member said: “These policies and procedures will include the terms of proper documentation, authorization, segregation of duties, etc.” (US11). This means that the control system has a clear effect on the process of financial reporting. A regulator said: “The internal control system affects the process of preparing the financial reports … the internal control system will establish the process of preparation which is built on segregation of duties … one person should prepare the report, another should review it, and a third one should approve it” (PM3). Another regulator stated that a weak internal control system would affect the quality of financial reports negatively: “If the internal control system is weak, it will affect the quality of information produced by the company in its financial reports … if the internal control is weak it will lead to weak or incorrect disclosure” (PM1). Again, in Bahrain there is a cultural issue with regard to the internal control system. Bahraini society is known for its strong personal relationships and people’s loyalty in maintaining these relations. Therefore, if internal auditors, for example, discover an issue with the control system because of someone they knows, they might not report this issue, in order to protect this relative or friend. This was stated by a financial controller: “I came across a real case where a risk officer avoided reporting an issue because it would affect his friend” (AP3). Another issue within the internal control system in Bahrain is that the reviewers (e.g. risk manager and internal auditor) avoid reporting negative issues to the board that might impact the CEO because those reviewers might lose their job, because the CEO would have the power to dismiss them.

Fifth, the company’s governance system will affect its level of transparency. Most of stakeholders want a clear picture of the company’s situation. This will depend on the governance system being transparent. A creditor and an analyst stated: “If the company has a good governance system, it will deal with people openly. This will increase its rate of success” (US2); and “The strength of the company’s corporate governance system will determine the management’s transparency and will affect the financial reports consequently” (US5).

Although most of the interviewees believed that these corporate governance mechanisms have an effect on the quality of reported earnings, some stakeholders believe that these mechanisms, in Bahrain, are merely paper exercises, and companies only want to be seen to comply with the laws, rather than engaging in their proper implementation. A number of financial controllers said that the board of directors often tried to do what the regulators asked them to do with no real commitment or change in practice – “only ticking the boxes”. Based on this opinion, some companies are not implementing these mechanisms as expected.

A financial controller concluded: “If the corporate governance of a company is strong, then it’s financial reporting framework will be strong, the internal control will be strong, the internal and external audit function will be strong…. Thus the company will have very sound financial reporting practices and the report will be of high quality” (AP2).

- Ownership structure

This factor is related to the previous one (i.e. internal corporate governance mechanisms). Interviewees believed that the ownership structure would influence the board composition. Controlling shareholders have the power to appoint the board of directors, structure the board sub-committees and influence management decisions. The Bahraini code of corporate governance defines a controlling shareholder as: “any shareholder who holds 10% or more of the share capital or is able to exercise (or control the exercise of) 10% or more of the voting power in the company”. As mentioned above, the board of directors and its committees will have a lot of influence on the quality of reported earnings. Its influence can extend to the external governance mechanisms (i.e. external audit). An external auditor and an investor stated that external auditors report to the audit committee, and that is affected by the ownership structure of the company.

The ownership structure of Bahraini companies is unique. Most Bahraini public companies used to be either state-owned or family companies. These two kinds of structure still have their impact on listed companies. As an investor said: “Previous owners still assume they have control over the company and they will try to continue influencing the company’s operation” (US4). Companies controlled by the government tend to appoint board members who will guide company decisions towards the government's best interest. A number of interviewees mentioned that the government does indeed use its power to influence company decisions. For example, an interviewee said: "Our company is required to support the government's major events, such as the Formula 1 race…. This will help to support the whole economy of course" (AP5). In addition, the government might use its power to increase its profit margin. An interviewee mentioned: "The government used its power through its representatives, on the board generally and audit committee specifically, to increase the company's valuation before it gets listed in the market" (AP3).

Similarly, public companies that used to be family-owned companies often still experience interference from family members. One academic thought that these companies have strong internal control, as families will manage own their own companies well, but that they try to minimise their level of disclosure. Trying not to disclose one's wealth is a cultural issue in Bahrain. This will definitely influence the quality of financial reports. Another academic thought that these companies gain some support and flexibility in implementing the regulations: "Family-owned companies contribute, with the government, to the national economy. They participate in the formation of health centres, sports centres, parks, supporting a lot of government activities etc. … In my opinion, the government compensates these companies with lowering the regulations for them" (US16). The possibility of some flexibility in the application of regulations will influence the reporting requirements and the financial reports accordingly.

Few interviewees, though, mentioned that political factors play a role in the quality of reported earnings – probably because this is a sensitive issue. Some interviewees, though, did state that board members or members of top management with political connections have the power to influence the quality of financial reporting. These parties have some power over the board of director's decisions and can gain an advantage over other stakeholders (because they have more access to information).

- External corporate governance mechanisms (audit)

All of the interviewees believed that the external audit function determines the quality of reported earnings. They believed that the quality of audit will be reflected in the quality of financial reports, as a financial controller said: "The quality of audit will affect the quality of financial reports … the strength of the auditor will be shown in the strength of the financial reports" (AP1). In Bahrain, all stakeholders depend on external auditors to assess the quality of the financial reports. Most of the interviewees thought that the big four audit firms provide a very high standard of audit. An academic said: "I believe that big four audit firms have more [internal] regulations, while small audit firms have some flexibility in their regulations; therefore, the quality of audit by big audit firms will be higher than that by smaller audit firms" (US16). However, a few interviewees had doubts about the quality of audit by the big four firms. Furthermore, some noticed a difference in the quality of audit between the big four firms. A financial controller said: "I have worked with two of the big four audit firms, namely KPMG and E&Y, and I noticed that the quality of the audit is different. The quality depends on the capability of the assigned team" (AP4). But still different stakeholders believed that the big audit firms are better; creditors, for example, prefer their clients' financial reports to be audited by one of the big four. A credit manager said: "We give a client a more favourable opinion if his financials are audited by one of the big four" (US2).

- <u>Accounting standards</u>

Some interviewees discussed the impact of accounting standards on the quality of reported earnings. They had the same opinion in this regard. They thought that the quality of financial reports generally is affected by the accounting standards followed in their preparation. In Bahrain, companies are required to follow the International Financial Reporting Standards (IFRS). Although these standards provide some flexibility, interviewees believed it would add to the quality of these reports. The following are comments from a regulator and an investor: “Financial reports should be prepared in accordance with IFRS in order to be a good report … so if a company does not follow IFRS then its reports are probably not of good quality” (PM4); and “The IFRS provide some room for interpretation … however, it assists in providing good-quality financial reports” (US7). A regulator mentioned that the preparation of financial reports and the auditing process should be based on international standards in order to be of high quality: “In Bahrain, the quality of financial reports depend a lot on the application of international standards in both accounting and auditing” (PM2).

- <u>Regulatory system</u>

Bahraini companies are required by law to prepare the three main financial statements (balance sheet, income statement, and cash flow statement) within three months of the year-end. This was mentioned by some interviewees: “Regulatory bodies, in Bahrain, require companies to prepare their financial reports within 3 months of the year-end” (US16). Regulators investigate companies mostly if concerns have been raised by the stakeholders: “Regulators attend the annual general meeting (AGM), and if anyone asks the company's management and the management reply was not clear then the regulator will follow the company and make sure that nothing wrong is going on" (US8). However, regulators have some weaknesses, including a lack of resources. "In Bahrain, regulators suffer from: lack of resources, lack of experienced staff, and lack of a monitoring process … this leads to the creation of gaps between the financial reports and the regulatory supervision" (PM2). They also need to be more of reactive: "Regulators should be more active by pushing companies to disclose what is important for financial reports users (including the investor community) and try to make them more open and transparent" (US5). Moreover, the enforcement system is weak compared with that in other countries: "If you are a British company, you must follow these practices because if you do not do follow them the employer will fire you and the company will be penalised by the regulators" (AP5). With regard to the setting of regulations, an interesting point was made by a regulator who said that Bahraini regulations are copied from the international versions but without attention given to their suitability for the local context.

A regulator mentioned that there are differences between the regulatory bodies in Bahrain: "There are differences between the regulators…. Each one has its own system and resources … this has been reflected in their strength in the market" (PM3). Therefore, other users feel that the outcome for a specific sector, financial for example, is better than it is for other sectors because companies in that sector have to comply with more than one regulator, with addition requirements: "In Bahrain the financial sector is governed by strict regulations … the financial sector is regulated by an additional regulatory body [the Central Bank of Bahrain] which has more disclosure requirements" (US15).

- <u>Other factors</u>

The quality of reported earnings is also affected by other factors raised by the interviewees. They thought that the level of disclosure would have an effect. The earnings quality will be high if enough explanation supports the earnings figure: “Financial reports will be of good quality if more details are presented … the financial statement should be supported by explanations” (US15); and “The quality of financial reports is affected by the detailed information presented, the structure and classification of the accounting presented in the financial statement … etc.” (AP3).

Moreover, the way financial reports are used will also affect the quality of reported earnings. If the users of financial reports do not depend on these reports in making their decisions and there is no real analysis of its components, then the preparers will not give it due attention during its preparation and this will be reflected on the quality of reported earnings, as noted by the interviewees: “We do not have a lot of informed financial reports users” (US6); and “The financial report have not become as it should be and the reason behind that is its usage … I assume that 99% of the potential users are not analysing the reports and take the results [profit] as presented…. This provides some room for the management to do what they want to do” (US15).

Following Dichev et al. (2013), the survey’s respondents were provided with a number of factors which might affect the quality of reported earnings in Bahrain and asked them to record their thoughts regarding the level of influence of each factor. In addition to the factors included in the Dichev et al. (2013) survey, three more factors were included and one separate question. These additional factors had been raised at the interview stage. These three added factors (listed last in Table 7.9) were presented to two groups only, namely managers and preparers of financial reports and other users of financial reports; regulators and policy-makers were not asked about these as they are the people who produced and established the existing standards and regulations which are under investigation.

Table 7.9 reveals that “firm characteristics” and “company’s board of directors” were thought to have the greatest influence on earnings quality, with 76% of all respondents indicating that earnings quality is either influenced or highly influenced by these factors (mean ratings 4.31 and 4.13, respectively). The support for these factors was marginally higher than that for “the regulator’s enforcement process” and “macro-economic conditions”, with overall means of 4.03 and 3.91, respectively, and over 73% of respondents confirmed that earnings quality is influenced or highly influenced by this factor. It can be noticed from Table 7.9 that more than 60% of the respondents believed that “business model of the company”, “accounting standards” and “company’s industry” are factors that influence or highly influence the quality of reported earnings (means 3.96, 3.91 and 3.81 respectively; and confirmation percentages of 67%, 69% and 65%, respectively).

More than 50% of the respondents thought that “company’s internal controls”, “company’s audit committee”, “company’s external auditor”, “how fast the operating cycle converts accruals to cash flow” and “company’s disclosure policy” are factors that influence or highly influence the quality of reported earnings (means 3.70, 3.67, 3.64, 3.53 and 3.51, respectively; and confirmation percentages of 58%, 58%, 57%, 50% and 53%, respectively). The next popular respondents’ answers are: the existence of concentrated ownership (47%); prospect of litigation (46%); company’s reporting choices (48%); market analysts who follow the company (33%); and private analysts who follow the company (31%). These factors score overall means of 3.47, 3.47, 3.39, 3.10 and 3.02, respectively.

A non-parametric Kruskal-Wallis test and parametric ANOVA test were carried out to determine whether respondents' perceptions differed significantly between the three groups. The results showed three sets of significant differences (at the 5% level). First, around 50% of the managers and preparers of financial reports and 65% of the other users of financial reports thought that "company's industry" influences or highly influences the quality of reported earnings in Bahrain. However, this argument was found to be much higher in the response of the regulators and policy-makers (80%). This significant difference can be explained by the fact that regulators have access to and review all companies' financial reports and they can compare the quality of reported earnings between different industries, while the other two groups are aware of the quality of reported earnings only for the companies they are interested in.

Second, around 36% of the managers and preparers of financial reports and 33% of the regulators and policy-makers thought that "company's external auditor" influences or highly influences the quality of reported earnings in Bahrain. However, this argument was found to be more frequent in the response of the other users of financial reports (67%). This significant difference was expected, since managers and preparers of financial reports think that they are already producing high-quality reports so the external auditors do not add a lot to these reports' quality. In addition, regulators and policy-makers believe that all companies should follow the laws and regulations which ensure the quality of financial reports; therefore, the external auditors do not make a significant difference to the quality of these reports. In contrast, other users of financial reports feel that external auditors are important examiners for the financial reports and that external auditors can detect mistakes or manipulation that might affect the quality of these reports.

Third, around 40% of the regulators and policy-makers and 32% of the managers and preparers of financial reports thought that “the existence of concentrated ownership” influences or highly influences the quality of reported earnings in Bahrain. However, this argument was supported by a bigger percentage of the other users of financial reports (52%). This significant difference was expected, as the regulators believe that the rules and regulations maintain the rights of all stakeholders, so the ownership structure will not have a significant effect and Bahraini law does not allow highly concentrated ownership. Moreover, the managers and users of financial reports thought that they prepare these reports without any bias towards a specific group (e.g. majority shareholders), so the ownership structure will not influence the quality of financial reports. However, other users believe that major shareholders have some control over the company through their seats on the board of directors; therefore, they can influence the financial reporting process.

It has been noted that the interviewees perceived the quality of reported earnings for companies with political connections, which is common in Bahrain, differed from that for companies without political connections. Political connections can provide a company with some flexibility in the application of rules and regulations. Moreover, politically connected board members or managers have some power over the company’s decisions, which include decisions related to financial reporting practices. Therefore, respondents were presented with the following: “It is common practice for board members and/or managers of Bahraini companies to have political connections. In your opinion, does this practice have the potential to affect the quality of earnings?” Around 64% of the managers and preparers of financial reports and 70% of the other users of financial reports agreed that political connection influences the quality of reported earnings in Bahrain. More than 87% of the regulators and policy-makers agreed on this relationship. The reason for this significant difference is that regulators and policy-makers are more aware of the effect of political connections as they are approached by politically connected board members or managers to gain the above-mentioned flexibility in the application of regulations.

Survey respondents were provided with an opportunity to explain their answers to this question. A board member mentioned that appointing politically connected board members or managers may have a positive or a negative influence, depending on whether the member or manager is well qualified or not and the extent to which he or she adheres to corporate governance best practice. A few respondents assumed that politically connected board members and managers would working in the company’s best interest anyway, without consideration of their political stance, so they do not have any effect on the quality of reported earnings.

However, the majority of the respondents believed that these members or managers would use their power to maximise both their own benefits and the government’s interest. They could smooth the company’s operation by softening the regulations and by providing more exposure to profitable projects. Therefore, companies will depend on these connections to maintain or improve their profitability. And by losing these connections, the company’s earnings figures will decline in quality by losing their ability to be sustainable and predictive of future earnings.

Respondents believed that political connections could affect the quality of reported earnings in Bahrain negatively. The government might appoint an incompetent board member who is interested only in the compensation. This board member might add very little to the company. This will weaken the board of directors, which might be unable to lead at a strategic level.

To sum up, the objective of this section is to elicit the perceptions of interview participants and survey respondents of the factors that can influence the quality of reported earnings in Bahrain. The results show that there are some factors that gain strong support from all groups. These factors include: the firm characteristics; corporate governance mechanisms; macroeconomic conditions; and the strength of regulators in enforcing regulations. In addition, the effect of politically connected board members and managers on the quality of reported earnings also gain some support. Some other factors that can influence the quality of reported earnings were raised by study participants that have received little attention in the literature. These include: the level of awareness of the importance of financial reports and monitoring mechanisms (such as corporate governance mechanisms); the ownership structure of the company; and the use of financial reports (most users focus on the earnings figure). Contrary to the findings of previous studies, analysts' forecasts were not felt to influence the quality of reporting earnings much. The reason for this is that Bahrain does not have a large number of analysts and the existing analysts' opinions are not given a lot of consideration by most stakeholders in their decision making. Theoretically, the factors that determine the quality of reported earnings are suggested by agency theory and institutional theory. The quality of reported earnings is affected by the problem of information asymmetry, which can lead managers to influence the quality of reported earnings by acting in their own best interest to maximise their wealth; that is, managers' goals might compete with those of other stakeholders. Shareholders use monitoring tools to reduce the agency problem. However, managers' actions and the monitoring mechanisms are all influenced by contextual factors. The contextual factors include the social system, legal system, economic system and political system. Therefore, the quality of earnings will be indirectly affected by contextual factors.

Table 7.9: Descriptive Statistics of Respondents' Perceptions of the factors that influence earnings quality in Bahrain

Perceptions	Level of Influence (percentage)					Mean score	Overal l Mean Score	Rank	Standard Deviation	Overall Standard Deviation	Significance tests	
	1	2	3	4	5						Kruskal-Wallis Non-Parametric Test	ANOVA one way Parametric Test
Firm characteristics (including the firm's: performance, debt, growth and investment, and size)	- (-) [-]	- (-) [2.7]	36.4 (6.7) [16.0]	13.6 (13.3) [33.3]	50 (80) [48.0]	4.14 (4.73) [4.27]	4.31	1	0.94 (0.594) [0.827]	0.819	-	-
Company's industry	4.5 (-) [2.7]	9.1 (-) [5.3]	36.40 (20.0) [26.7]	40.90 (40.0) [34.7]	9.10 (40.0) [30.7]	3.41 (4.20) [3.85]	3.81	6	0.96 (0.775) [1.009]	0.970	***	-
Macro-economic conditions (i.e. the country's overall economic conditions)	- (-) [-]	4.5 (6.7) [6.7]	22.7 (20.0) [21.3]	50.0 (26.7) [33.3]	22.7 (46.7) [38.7]	3.91 (4.13) [4.04]	4.03	3	0.81 (0.99) [0.936]	0.919	-	-
The business model of the company	4.5 (-) [-]	4.5 (6.7) [8.0]	31.8 (13.3) [25.3]	22.7 (33.3) [30.7]	36.4 (46.7) [36.0]	3.82 (4.20) [3.95]	3.96	4	1.14 (0.941) [0.971]	0.999	-	-
How fast the operating cycle converts accruals to cash flows	- (-) [4.0]	4.5 (-) [14.7]	40.9 (46.7) [34.7]	31.8 (33.3) [26.7]	22.7 (20.2) [20.0]	3.73 (3.73) [3.44]	3.53	10	0.88 (0.799) [1.093]	1.015	-	-
Market analysts who follow the company	4.5 (13.3) [9.3]	22.7 (6.7) [13.3]	40.9 (60.0) [41.3]	22.7 (13.3) [26.7]	9.1 (6.7) [9.3]	3.09 (2.93) [3.13]	3.10	14	1.02 (1.033) [1.070]	1.056	-	-
Private analysts (analysts with institutional investors) who follow the company	9.1 (6.7) [13.3]	22.7 (13.3) [12.0]	40.9 (40.0) [44.0]	18.2 (33.3) [22.7]	9.1 (6.7) [8.0]	2.95 (3.20) [3.00]	3.02	15	1.09 (1.014) [1.103]	1.089	-	-
Company's reporting choices	- (6.7) [5.3]	- (26.7) [10.7]	59.1 (6.7) [37.3]	27.3 (26.7) [28.0]	13.6 (33.3) [18.7]	3.55 (2.93) [3.44]	3.39	13	0.74 (0.961) [1.081]	1.001	-	-

Company's disclosure policy	- (6.7) [6.7]	13.6 (13.3) [10.7]	45.5 (40.0) [24.0]	22.7 (26.7) [36.0]	18.2 (13.3) [22.7]	3.45 (3.27) [3.57]	3.51	11	0.96 (1.100) [1.153]	1.109	-	-
Company's internal controls	4.5 (-) [-]	13.6 (13.3) [12.0]	31.8 (20.0) [30.7]	31.8 (26.7) [29.3]	18.2 (40.0) [28.0]	3.45 (3.93) [3.73]	3.70	7	1.10 (1.100) [1.004]	1.035	-	-
Company's audit committee	4.5 (13.3) [2.7]	9.1 (-) [14.7]	36.4 (26.7) [22.7]	22.7 (26.7) [30.7]	27.3 (33.3) [29.3]	3.59 (3.67) [3.69]	3.67	8	1.14 (1.345) [1.127]	1.157	-	-
Company's external auditor	13.6 (13.3) [2.7]	13.6 (6.7) [10.7]	36.4 (46.7) [20.0]	18.2 (-) [33.3]	18.2 (33.3) [33.3]	3.14 (3.33) [3.84]	3.64	9	1.28 (1.397) [1.091]	1.166	***	-
Company's board of directors	- (6.7) [1.3]	13.6 (-) [2.7]	31.8 (13.3) [14.7]	18.2 (20.0) [36.0]	36.4 (60.0) [45.3]	3.77 (4.27) [4.21]	4.13	2	1.11 (1.163) [0.890]	0.967	-	-
The existence of concentrated ownership	- (20.0) [1.3]	22.7 (6.7) [5.3]	45.5 (33.3) [41.3]	22.7 (33.3) [30.7]	9.1 (6.7) [21.3]	3.18 (3.00) [3.65]	3.47	12	0.91 (1.254) [0.923]	0.963	***	-
Accounting standards (i.e. implementation of IFRS)	4.500 (-) [2.7]	9.100 (-) [6.7]	22.700 (-) [20.0]	31.800 (-) [34.7]	31.800 (-) [36.0]	3.770 (-) [3.95]	3.91	5	1.150 (-) [1.038]	1.063	-	-
Prospect of litigation	9.1 (-) [2.7]	4.5 (-) [5.3]	50.0 (-) [42.7]	31.8 (-) [32.0]	4.5 (-) [17.3]	3.18 (-) [3.56]	3.47	12	0.96 (-) [0.933]	0.939	-	-
The regulator's enforcement process	- (-) [-]	4.5 (-) [4.0]	27.3 (-) [21.3]	40.9 (-) [38.7]	27.3 (-) [36.0]	3.91 (-) [4.07]	4.03	3	0.87 (-) [0.859]	0.861	-	-

*Level of Influence on a scale of: 1= Not at all Influenced by 3= Somewhat Influenced by 5= Highly Influenced by

** For each potential perception, three rows of figures are reported. The first row represents the perceptions of managers and preparers financial reports, the (second row) represents the perceptions of regulators and policy-makers, and the [third row] represents the perceptions of other users of financial reports.

*** Indicates that the distribution of responses among the three groups is statistically significantly different at the 5% level using Kruskal Wallis test and ANOVA one way as an additional test to verify the results.

It is common practice for board members and/or managers of Bahraini companies to have political connections. In your opinion, does this practice have the potential to affect the quality of earnings?	**Yes**	**No**	**Not specified**
Managers and preparers of financial reports	14	8	-
Regulators and policy-makers	13	2	-
Other users of financial reports	53	20	3
Total	**80**	**30**	**3**

7.5 The impact of standard setting on earnings quality

7.5.1 How can standard setting improve?

Accounting standards and the regulatory system are among the most important factors that affect the quality of reported earnings. Therefore, it is important to determine the steps that might be taken to improve the quality of financial reporting generally in Bahrain. Interviewees were asked to offer their suggestions for actions that might improve the quality of reported earnings. One interviewee, an individual investor, stated that Bahrain does not need more regulations: “We do not need more laws but we need more accountability and transparency in the implementation process” (US6). Regulators are not required to issue more regulations, but they have to state clearly the minimum reporting requirements. This was supported by other interviewees. An academic said: “There should be regulatory action, related to financial reporting, that specifies the minimum disclosure requirement” (US15). Many interviewees believed that more attention should be given to the level of disclosure, especially in relation to non-financial information, because it can help to explain the financial information reported by the company. Interviewees made the following comments: “Creditors prefer to have more detailed financial reports with more disclosure to allow them to understand the company’s financial position more clearly” (US2); “We need some improvements on disclosure requirements … we need a lot more disclosure within our financial reports” (US7); and “There should be a focus on non-financial information” (AP2). An investor provided an example of the importance of having detailed disclosure: “Extraordinary items should be clearly mentioned and detailed information should be disclosed in the report rather than having short footnotes describe these figures" (US4). All these comments support the need for more regulations related to the level of detailed disclosure within financial reports.

Another important area in which action should be taken is the strength of the regulators in implementing the existing regulations and their level of involvement in the market. An analyst said: "Regulators should incentivise and push companies to improve their reporting practices further" (US5). However, a board member said: "The regulators are weak in following up companies and making sure of their implementation, although they know that these are their main duties" (US11). Some interviewees added that regulators are more reactive than proactive. For instance: "Regulators do not get involved unless there is a problem … regulators are not aware of and not involved in an issue until it reaches the public and everybody knows about it" (US8).

In addition, some interviewees stated that regulators should review the existing regulations regularly to make sure that they fit the market need and can be implemented by companies smoothly. One academic believed that it is important to "visit the existing regulations to make any necessary amendments to improve them" (US15). A regulator thought that "regulations should be reviewed and updated every two to three years (the period should be mentioned in the regulations themselves) … this will help to see the level of compliance and identify any difficulty in compliance" (PM3). An academic believed that it would be better to involve the practitioners in the standard-setting and review process: "Professionals should play a role in the standard-setting process … it will help a lot if they work together with the regulatory bodies" (US15).

Moreover, it is important for the regulators to introduce international standards and regulations to the local market, to study their ability to be implemented in this market and to make sure that the infrastructure needed for this implementation is available. An academic said: “If the regulators found that the international standards are contradictory to the local legal system, they have to fix the legal system to allow this implementation” (US16). However, a board member and financial advisor thought that it would be better to adjust the standards in a way that fits the local setting: “International standards are not tailored to our environment; therefore, we should consider our requirements, our culture, and the special characteristics or features of our region” (US11).

Finally, interviewees believed that an increase in awareness and the provisiom of training for the board of directors and managers would be useful for the financial reporting process. As a regulator said: “You will not be able to enforce a regulatory system if the other party does not understand its importance” (PM4). An external auditor mentioned that the preparers of financial reports are not aware of the importance of financial reports and how they can benefit the company generally, not only the shareholders. A financial controller said: “We should enhance the board members’ and top management’s knowledge of the importance of their role in the financial reporting process, by providing some training sessions” (AP4).

Following Dichev et al. (2013), the survey’s respondents were asked “Would the following changes in standard setting produce higher-quality earnings?” Respondents were presented with a list of actions that might improve the quality of reported earnings in Bahrain and were asked to show their level of agreement with each of these actions. Only two groups of the survey respondents (namely managers and preparers of financial reports, and other users of financial reports) were asked this question. Regulators and policy-makers have not been asked because they are the people who produced and established the existing standards and regulations and they might be convinced that the existing system is the best achievable and might therefore be unwilling consider making adjustments to it.

Table 7.10 reveals that “issue more detailed implementation guidance” elicited the greatest level of agreement, with 74% of the two groups of respondents indicating that they either agree or strongly agree (mean 4.01). The support for this action was marginally higher than that for “Enforce financial reporting regulations more strictly”, with an overall mean of 3.92 and with over 71% of the two groups of respondents agreeing or strongly agreeing. It should be highlighted that this action was often suggested by the interviewees as well. It can be seen from Table 7.10 that at least half of the respondents agreed or strongly agreed that “expand the use of fair-value reporting” and “modify the current accounting standards to suit the local environment” are actions that might improve the quality of reported earnings (means 3.65 and 3.37, respectively, and agreement percentages of 57% and 50%, respectively).

The next most popular respondents’ answers are: emphasise detailed rules more than concepts and principles” (47%), require more conservative rules (35%); allow reporting choices to evolve from practice (42%); issue more new rules (35%); issue fewer new rules (34%); and allow managers greater professional judgement in preparing financial statements (37%). These actions have overall mean scores of 3.38, 3.25, 3.21, 3.17, 3.06 and 3.04, respectively.

In contrast, “reduce the use of fair-value reporting” and “allow firms to choose either US GAAP or IFRS” elicited the lowest level of agreement from respondents (means of 2.76 and 2.73, respectively). It can be seen that the level of disagreement was greater for these two actions. With regard to the first action, this disagreement can be explained by the fact that that both groups are willing to present and obtain the company's financial position, from its financial reports, based on the current market situation and prices. The disagreement with the second action can be explained by the fact that the two groups would like to see all companies presenting their financial reports based on the same accounting standards, as this will make comparisons much easier. In addition, allowing companies to choose between the two set of stands is not a favourable action for managers and preparers of financial reports, as they would have to be familiar with both sets.

A non-parametric Kruskal-Wallis test and parametric ANOVA test were carried out to determine whether respondents' perceptions differed significantly between the two groups. It is interesting to note that there was a significant difference (at the 5% level) between the two groups with regard to the level of agreement on "enforce financial reporting regulations more strictly". Around 75% of the other users of financial reports agreed or strongly agreed that this action might improve the quality of reported earnings, compared with only 60% of the managers and preparers of financial reports. This significant difference was expected, as managers and preparers of financial reports are the parties under pressure to implement the rules and regulations strictly, while other users of financial reports are willing to obtain financial reports that have been prepared based on high-quality and well-enforced standards.

From both the interviews and survey, it can be concluded that both groups are more interested in sticking with the existing accounting standards and rules and regulations. However, they are willing to improve these standards and regulations by taking actions that help in implementing them properly. Therefore, most of the participants agreed with the actions related to providing more guidance, which would help in implementing the existing standards and actions that would ensure that every company is implementing what it should implement by enforcing the existing standards. Moreover, regulators should review the regulations regularly and make any necessary changes to ensure that it is consistent with Bahraini market requirements. In addition, regulators should disclose clearly their punishments for failure to comply with the regulations, in order to deter company management from intentionally doing something wrong.

Theoretically, the rules and regulations that govern financial reporting are affected by the context of implementation. Institutional theory can explain how the rules and regulations in Bahrain are influenced by the contextual factors. These factors are mainly linked to the legal and social systems in Bahrain.

Table 7.10: Descriptive Statistics of Respondents' Perceptions of Changes That Might Produce "High Quality Earnings" in Bahrain

Perceptions	Level of agreement (percentage)					Mean score	Overall Mean Score	Rank	Standard Deviation	Overall Standard Deviation	Significance tests	
	1	2	3	4	5						Kruskal-Wallis Non-Parametric Test	ANOVA one way Parametric Test
Issue fewer new rules	- (-) [11.8]	27.3 (-) [21.1]	27.3 (-) [36.8]	27.3 (-) [18.4]	18.2 (-) [11.8]	3.36 (-) [2.97]	3.06	9	1.093 (-) [1.166]	1.150	-	-
Issue more new rules	- (-) [3.9]	27.3 (-) [23.7]	36.40 (-) [38.2]	27.30 (-) [19.7]	9.10 (-) [14.5]	3.18 (-) [3.17]	3.17	8	0.96 (-) [1.076]	1.050	-	-
Issue more detailed implementation guidance	- (-) [1.3]	9.1 (-) [7.9]	18.2 (-) [17.1]	40.9 (-) [34.2]	31.8 (-) [39.5]	3.95 (-) [4.03]	4.01	1	0.95 (-) [1.006]	0.994	-	-
Emphasise detailed rules more than concepts and principles	13.6 (-) [5.3]	4.5 (-) [15.8]	45.5 (-) [28.9]	27.3 (-) [28.9]	9.1 (-) [21.1]	3.14 (-) [3.45]	3.38	4	1.13 (-) [1.148]	1.143	-	-
Allow managers greater professional judgement in preparing financial statements	- (-) [14.5]	18.2 (-) [25.0]	45.5 (-) [23.7]	13.6 (-) [26.3]	22.7 (-) [10.5]	3.41 (-) [2.93]	3.04	10	1.05 (-) [1.237]	1.197	-	-
Allow reporting choices to evolve from practice	4.5 (-) [5.3]	18.2 (-) [27.6]	22.7 (-) [28.9]	27.3 (-) [27.6]	27.3 (-) [10.5]	3.55 (-) [3.11]	3.21	7	1.22 (-) [1.090]	1.119	-	-
Allow firms to choose either US GAAP or IFRS	22.7 (-) [25.0]	4.5 (-) [11.8]	45.5 (-) [39.5]	9.1 (-) [18.4]	18.2 (-) [5.3]	2.95 (-) [2.67]	2.73	12	1.36 (-) [1.193]	1.230	-	-

Modify the current accounting standards to suit the local environment	4.5 (-) [6.6]	18.2 (-) [15.8]	31.8 (-) [26.3]	31.8 (-) [35.5]	13.6 (-) [15.8]	3.32 (-) [3.38]	3.37	5	1.09 (-) [1.131]	1.121	-	-
Require more conservative rules	9.1 (-) [2.6]	4.5 (-) [14.5]	59.1 (-) [46.1]	22.7 (-) [25.0]	4.5 (-) [11.8]	3.09 (-) [3.29]	3.25	6	0.92 (-) [0.950]	0.944	-	-
Expand the use of fair-value reporting	- (-) [-]	9.1 (-) [9.2]	31.8 (-) [34.2]	31.8 (-) [42.1]	27.3 (-) [14.5]	3.77 (-) [3.62]	3.65	3	0.97 (-) [0.848]	0.875	-	-
Reduce the use of fair-value reporting	22.7 (-) [7.9]	4.5 (-) [30.3]	50.0 (-) [42.1]	18.2 (-) [17.1]	4.5 (-) [2.6]	2.77 (-) [2.76]	2.76	11	1.15 (-) [0.922]	0.972	-	-
Enforce financial reporting regulations more strictly	4.5 (-) [-]	13.6 (-) [6.6]	22.7 (-) [18.4]	45.5 (-) [39.5]	13.6 (-) [35.5]	3.50 (-) [4.04]	3.92	2	1.06 (-) [0.901]	0.935	***	***

*Level of importance on a scale of: 1= Strongly Disagree 2= Weakly Disagree 3= Neutral 4= Weakly Agree 5= Strongly Agree

** For each perception, three rows of figures are reported. The first row represents the perceptions of managers and preparers of financial reports, the (second row) represents the perceptions of regulators and policy-makers, and the [third row] represents the perceptions of other users of financial reports.
*** Indicates that the distribution of responses among the three groups is statistically significantly different at the 5% level using Kruskal Wallis test and ANOVA one way as an additional test to verify the results.

7.6 Mispresenting earnings

7.6.1 Why manage earnings?

Earnings can be managed to influence the contractual outcomes that rely on reported accounting figures (Schipper, 1989). The literature provides contradictory findings regarding the motives for such manipulation in reported earnings. Therefore, this section will increase the understanding of the motivations for earnings management in Bahrain.

Most of the interviewees agreed that managers might manipulate the earnings figure to improve or at least maintain their compensation. Managers' compensation, in the form of salaries and bonuses, is usually linked to the company's performance. If managers cannot meet the profitability targets set by the board of directors, they might attempt to manage the earnings figure, to maximise their compensation regardless of performance. An academic said in interview: "The compensation is one of the main incentives for management to manage earnings … they are trying to present the company in the best light, to get their compensation … They are trying to get more profit so the shareholders will increase their compensation" (US16). An external auditor added: "CEOs have targets to achieve, bonuses to maintain, and other motives that influence them to manage their earnings because everything is linked to the company's performance".

In addition, managers try to gain job security by meeting the objectives set by the board of directors and top management (high profitability). An academic believed that "managers try to provide a good image for the company to guarantee a contract renewal" (US16), a board member agreed that some managers should make the company's image better (more profitable) to "get their contract renewed" (US11) and another academic added that “managers inside the company can manipulate the profits if they want to continue working for the company” (US15). Therefore, managers are exposed to inside pressure to hit at least some earnings targets: “They might be under pressure from management or the board of directors to meet the budgets” (US11). This might involve an outside source, in that there might be pressure “to meet the investors’ expectations and comply with the regulators’ requirements” (US10). This could drive managers to maintain some consistency and stability in the company’s performance in order to meet these expectations. Managers smooth earnings to minimise unexpected fluctuations in company performance (i.e. earnings): “Managers are motivated to manage earnings in order to meet different expectations; therefore, if they feel that this year’s performance is good but will be bad next year, then they will understate it this year and overstate it next year to maintain stability and be able to meet their targets” (AP1).

Moreover, managers might manage earnings to influence the decisions of different stakeholders. Managers might manage earnings to “please investors” (US13), to “obtain financing from banks” (AP1), to “gain support from authorities” (US7) or to “avoid any decline in the company’s share price” (AP4). Furthermore, a regulator mentioned that some managers feel that managing earnings is not a wrong thing to do, as it is in line with the accounting standards: “Managers might continue managing earnings because they feel that they are doing the right thing” (PM4).

To get a better sense of why managers in Bahrain misuse reporting discretion, only two groups of the survey respondents (namely regulators and policy-makers and other users of financial reports) were asked about the “motivations for companies to use earnings to mispresent economic performance”. Managers and preparers of financial reports were not asked this question as they are the people who might be accused of mispresenting reported earnings. Table 7.11 shows that more than 70% of the respondents in the two groups agreed or strongly agreed with five potential reasons for manipulation in Bahrain. These reasons are: to influence stock price (83.4%); to influence executive compensation (83.5%); to avoid violation of debt covenants (77%); because there is inside pressure to hit earnings benchmarks (70.3%); and because senior managers fear adverse career consequences if they report poor performance (74.7%). This was reflected in the overall mean score for each incentive (4.34, 4.26, 4.10, 3.93 and 3.87, respectively). Thus, consistent with a long stream of the literature which has documented why earnings management occurs: to influence the share price around stock buybacks and IPOs (Teoh, Welch, & Wong, 1998); to ensure management compensation; from fear adverse career consequences [e.g. Burns and Kedia, 2006; Efendi, Srivastava, & Swanson, 2007)]; and to reduce the cost of financing and comply with debt contracts (e.g Li, 2016).

The next most popular respondents' answers are: to influence other stakeholders such as customers, suppliers and employees (60.5%); because there is outside pressure to hit earnings benchmarks (65%); and because there is pressure to smooth earnings (59.3%). These incentives have overall mean scores of 3.78, 3.77 and 3.71 respectively. However, the respondents did not believe that the following factors would much motivate managers to manipulate earnings in Bahrain: because senior managers are overconfident or overoptimistic (44%); because they believe such misrepresentation will likely go undetected (43%); to reduce expectations of future earnings (44%); and because they feel other companies misrepresent performance (30%). This was reflected in overall mean scores of 3.43, 3.25, 3.17 and 3.02, respectively.

To sum up, the results show that the five main incentives for Bahraini managers to manage earnings are: to influence stock price; to influence executive compensation; to avoid violation of debt covenants; because there is inside pressure to hit earnings benchmarks; and senior managers' fear of the adverse career consequences if they report poor performance. All of these incentives stem from the Bahraini conservative culture, which tries to maintain stability in all aspects of life. However, it has been indicated that Bahraini managers do not have high incentives to manage earnings to meet analysts' forecasts or to manage earnings in a similar way to other companies, though these incentives have been observed in prior studies. These findings are consistent with previous literature. For instance, Burgstahler and Dichev (1997) find that managers engage in earnings management to avoid a decrease in earnings, Daniel et al. (2008) indicate managers manage earnings to meet expected dividend levels, and Graham et al. (2005) find that managers engage in earnings management to increase or maintain share prices and meet earnings benchmarks in order to improve the firm's credibility in the market. Moreover, Bergstresser and Philippon (2006) found that managers manage earnings more when they have stock-based incentives and Chamberlain et al. (2014) that companies meet their dividend covenants are practising earnings management. However, the findings contradict with Cheng and Warfield (2005) findings that managers with high equity incentives usually manage earnings to meet analysts' forecasts.

Theoretically, motivations to manage earnings may be explained by agency theory, which expects that the agent will attempt to maximise the objectives of the principal; however, when the agent's objectives conflict with those of the principal, agency theory expect that the agents will attempt to achieve their own objectives and maximise their own interests, rather than the principal's interests. Based on institutional theory, managers are affected by formal and informal pressures to manage earnings.

Table 7.11: Descriptive Statistics of Respondents' Perceptions of the Motivation to Manipulate Earnings in Bahrain

Perceptions	Level of agreement (percentage)					Mean score	Overall Mean Score	Rank	Standard Deviation	Overall Standard Deviation	Significance tests	
	1	2	3	4	5						Kruskal-Wallis Non-Parametric Test	ANOVA one way Parametric Test
To influence stock price	- (-) [2.6]	- (6.7) [6.6]	- (-) [9.2]	- (13.3) [23.7]	- (80.0) [57.9]	- (4.67) [4.28]	4.34	1	- (0.816) [1.053]	1.016	-	-
To influence executive compensation	- (6.7) [1.3]	- (-) [3.9]	- (13.3) [10.5]	- (20.0) [35.5]	- (60.0) [48.7]	- (4.27) [4.26]	4.26	2	- (1.163) [0.900]	0.941	-	-
To avoid violation of debt covenants	- (-) [-]	- (-) [3.9]	- (26.7) [18.4]	- (26.7) [43.4]	- (46.7) [34.2]	- (4.20) [4.08]	4.10	3	- (0.862) [0.829]	0.834	-	-
To influence other stakeholders such as customers, suppliers and employees	- (-) [1.3]	- (13.3) [10.5]	- (6.7) [30.3]	- (46.7) [28.9]	- (33.3) [28.9]	- (4.00) [3.74]	3.78	6	- (1.000) [1.038]	1.032	-	-
To reduce expectations of future earnings	- (-) [1.3]	- (13.3) [28.9]	- (33.3) [38.2]	- (33.3) [22.4]	- (20.0) [9.2]	- (3.60) [3.09]	3.17	11	- (0.986) [0.969]	0.972	-	-
Because there is inside pressure to hit earnings benchmarks	- (-) [-]	- (-) [9.2]	- (20.0) [22.4]	- (40.0) [39.5]	- (40.0) [28.9]	- (4.20) [3.88]	3.93	4	- (0.775) [0.938]	0.912	-	-
Because there is outside pressure to hit earnings benchmarks	- (-) [1.3]	- (-) [10.5]	- (26.7) [25.0]	- (46.7) [40.8]	- (26.7) [22.4]	- (4.00) [3.72]	3.77	7	- (0.756) [0.974]	0.940	-	-

Because there is pressure to smooth earnings	- (-) [1.3]	- (-) [5.3]	- (53.3) [31.6]	- (20.0) [44.7]	- (26.7) [17.1]	- (3.73) [3.71]	3.71	8	- (0.884) [0.861]	0.865	-	-
Because senior managers are overconfident or overoptimistic	- (-) [[1.3]	- (13.3) [17.1]	- (40.0) [38.2]	- (26.7) [26.3]	- (20.0) [17.1]	- (3.53) [3.41]	3.43	9	- (0.990) [1.009]	1.006	-	-
Because they feel other companies misrepresent performance	- (6.7) [2.6]	- (20.0) [23.7]	- (46.7) [43.4]	- (26.7) [27.6]	- (-) [2.6]	- (2.93) [3.04]	3.02	12	- (0.884) [0.855]	0.860	-	-
Because they believe such misrepresentation will likely go undetected	- (6.7) [2.6]	- (26.7) [23.7]	- (40.0) [27.6]	- (13.3) [32.9]	- (13.3) [13.2]	- (3.00) [3.30]	3.25	10	- (1.134) [1.059]	1.071	-	-
Because senior managers fear adverse career consequences if they report poor performance	- (-) [3.9]	- (13.3) [6.6]	- (6.7) [15.8]	- (53.3) [47.4]	- (26.7) [26.3]	- (3.93) [3.86]	3.87	5	- (0.961) [1.016]	1.007	-	-

*Level of importance on a scale of: 1= Strongly Disagree 2= Weakly Disagree 3= Neutral 4= Weakly Agree 5= Strongly Agree
** For each perception, three rows of figures are reported. The first row represents the perceptions of managers and preparers of financial reports, the (second row) represents the perceptions of regulators and policy-makers, and the [third row] represents the perceptions of other users of financial reports.

7.6.2 Detecting earnings management (red flags)

Interviewees described some red flags that could assist in detecting earnings management. Some mentioned that inconsistency in reported earnings is an indicator of earnings management. A financial controller mentioned that differences between the company's current-year earnings and previous-year earnings would raise concern: "I have to compare this year's results with the previous year to make sure of the quality of reported profit, and if I find any unexpected variation that means there is a problem" (AP5). An institutional investor added: "If the profit figure is high and fluctuating from one year to another, then this raises a question mark for me" (US4). A regulator said: "One of the indications is to see a company reporting losses after a highly profitable year; therefore, it is good to go back and identify if there any creative accounting was used by the management to manage the earnings" (PM2). What increases concerns about inconsistency is the absence of explanations for fluctuations: "Each change in the earnings from year to year should be justified and explained; otherwise, it will raise some concerns about the reasons of these changes" (AP5).

Some interviewees added that not only deviations from the company's previous year's performance constituted a red flag but deviations from the market (industry) norm would also be considered a red flag: "It is an indication of earnings management when I see a company recording expenses that are not consistent with the expenses recorded by its peers in the market ... there are benchmarks for each industry and the company is far from them" (US4).

In addition, managers can manipulate the company's reported earnings through the flexibility in selecting between the reporting methods. An academic stated that inconsistency in the choice of methods of reporting indicates a red flag: “When I notice that a company has changed its accounting reporting choices [methods], I will be suspicious about its reported performance” (US13).

The financial analysts believed that there are some important indications (red flags) of earnings management. They thought that earnings was managed if is the following were apparent: inconsistency between the reported earnings and cash flow (“When the cash flow says something while the income says something else, that is a red flag for me” (US5)); extraordinary items without explanation (“When you look at the breakdown for the income figure and find extraordinary items without explanation in the notes, I will be suspicious of the reported earnings” (US3)); and related-party transactions (“Related-party transactions are an important area which I would closely monitor as it can be used by the management to manage their earnings”(US3)). Creditors and some other interviewees, on the other hand, thought that a good red flag for any earnings management would be raised by independent parties (e.g. regulators, external auditors and credit agencies).

Moreover, investors thought that having high management compensation could be a sign of earnings management: “The employees’ compensation is an important sign especially if they are beyond the market average” (US6). Furthermore, some interviewees believed that the users of financial reports could identify some red flags by reviewing the information presented in these reports, for example if they had “huge impairments and provisions, a lot of write-offs, and large outdated accounts receivables” (US12). These signs have a direct impact on the quality of reported earnings.

Table 7.12 shows the categories and the rank of the collected responses related to the signals that can be used to detect earnings management (red flags) in Bahrain. The most frequently offered red flags were:

- Deviation from norms. The first most frequent red flag is that the company's reported financial information deviates both from that in previous periods and from industry norms. This red flag registered 25 responses. Examples include the deviations in some items like volatility in reported earnings, average profitability, revenue growth, growth of investment and level of liquidity. This finding is consistent with the literature, where these indicator is used as a controlling variable.
- Level of transparency. The second most frequent red flag is the level of transparency, which garnered 12 responses. This opinion suggests that companies with a low level of disclosure or vague disclosed information would raise some concerns about the quality of its reported earnings.
- Independents parties' opinions. The third most frequent red flag is the negative opinions of independent parties, such as external auditors, regulators and analysts. This red flag was mentioned eight times. This issue has been discussed in the literature, where auditors' opinions are considered one of the indicators of the quality of reported earnings.
- The existence of one-time or special items. The fourth most frequent red flag is the existence of extraordinary items (one-time items), mentioned seven times. These responses suggested that when the reported earnings contain one or more extraordinary items, this indicates some quality concern. Usually,

these one-time items are not part of the company's operational income, so they can be manipulated more easily than the income generated from the company's core business.

- Other signals. The remaining red flags are: correlations of the reported earnings with the cash flow; change in choice of accounting methods; the existence of accruals; reputation of the company and its management; and deviations from market valuations and economic conditions.

Table 7.12: Summary of the Responses to the Open-Ended Question "How can users of accounts distinguish high-quality and low-quality earnings?"

Rank	Red Flags	Count	Total
1	Deviations from industry norms (peers)/experience (volatility, average profitability, revenue growth, growth of investment, level of liquidity)	7 (6) [12]	**25**
2	Less transparent reporting (missing clear and detailed disclosure)	1 (1) [10]	**12**
3	Independent concerns (auditor's opinion, regulators reports, financial analysts)	- (1) [7]	**8**
4	Existemce of one-time or special items (gain/loss on asset sales, non-recurring items, not from the main operation)	3 - [4]	**7**
5	Correlation of cash flow with reported earnings	3 - [2]	**5**
6	Change in choice of accounting method (policies)	- (1) [2]	**3**
6	Large numbers of accruals	- (1) [2]	**3**
7	Reputation of the company and its management (including the board of directors and audit committee)	- - [2]	**2**
8	Deviations from market valuations and economic conditions	- (1) -	**1**

For each perception, three rows of figures are reported. The first row represents the perceptions of managers and preparers of financial reports, the (second row) represents the perceptions of regulators and policy-makers, and the [third row] represents the perceptions of other users of financial reports.

In conclusion, the objective of this section is to elicit the perceptions of participants regarding the indicators of earnings management (red flags). The following red flags obtained the most support: “inconsistency with the previous year and with the industry and the economy”; “include extraordinary items”; “conflict between earnings movements and cash flow”; “inconsistency in choice of accounting methods”; and “less transparent reporting”. Overall, these red flags are familiar and have been explored in the existing literature. For example, Dichev and Tang (2009) found that large volatility in earnings and Li (2008) find that lack of transparency in financial reporting are indicators of earnings management. However, it is interesting that some stakeholders believe that other signs, which have received little attention in the literature, can indicate earnings management in Bahrain. These include: related-party transactions; changes in management compensation (compared with industry norms and previous years); and opinions of independent third parties (e.g. credit agencies).

Theoretically, indications of earnings management may be explained by agency theory, which expects that the agent will attempt to maximise the objectives of the principal; however, when the agent’s objectives conflict with those of the principal, agency theory expect that the agents will attempt to achieve their own objectives and maximise their own interests, rather than the principal’s interests. Based on institutional theory, managers are affected by formal and informal pressures which will guide them to use different techniques to manage earnings.

7.7 Conclusion

In this chapter, several issues related to the quality of reported earnings in Bahrain have been examined based on 25 interviews and 113 usable responses to a questionnaire survey with different stakeholders. These issues were: the use of reported earnings in Bahrain; definition and measures of earnings quality in Bahrain; the determinants of earnings quality in Bahrain; actions that might be taken to improve the quality of reported earnings in Bahrain; reasons for perpetrating earnings management in Bahrain; and red flags that can assist in detecting earnings management in Bahrain.

With regard to the use of reported earnings in Bahrain, the results indicate that the majority of interviewees and survey respondents (more than 90%) viewed reported earnings as either important or very important for the valuation process. Investors use reported earnings to value a company. Also, there was clear support for the importance of earnings in contracting. Employers depend on reported earnings in determining managers' compensation (stewardship contracting), and creditors use them in approving debt contracts with potential clients. These findings contrast with the respondents' perceptions of the importance of reported earnings to customers, suppliers, employees and labour.

In addition, there was a consensus that high-quality reported earnings in Bahrain should be sustainable, consistent, repeatable and predictable. These characteristics were identified in the qualitative responses (both interviews and questionnaire survey) and were supported by the answers to a quantitative question. These characteristics scored the highest from a list of characteristics provided to the survey respondents. Inconsistent with the literature, there was little support for the following characteristics: "fewer accruals", "required less explanation", and "recognise losses in a more timely manner than gains". This is not surprising because users of financial reports in Bahrain do not give much attention to accruals (as noticed in all sections addressing accruals), but always looking for more detailed disclosure, and Bahrain does not have an efficient market, which means that companies can report both gain and loss for the same time period (by the deadline set by the regulators) without any distinguish.

The factors that have a big influence on the quality of reported earnings in Bahrain are: the firm characteristics; corporate governance mechanisms; macroeconomic conditions; and the strength of regulators in enforcing regulations. In addition, the effect of politically connected board members and managers on the quality of reported earnings also gains some support. There are some other factors that can influence the quality of reported earnings but which have received little attention in the literature. These include: the level of awareness of the importance of financial reports and monitoring mechanisms (such as corporate governance mechanisms); the ownership structure of the company; and the use of financial reports (most users focus on the earnings figure). Unlike in previous studies, analysts' forecast was not found to influence the quality of reporting earnings greatly. The reason is that Bahrain does not have a large number of analysts and the existing analysts' opinions are not given a lot of consideration by most of stakeholders during decision making.

In relation to the actions that might improve the quality of reported earnings in Bahrain, the results indicated that the existing accounting standards and rules and regulations are adequate. However, most of the participants agreed that some action is needed to encourage the proper implementation of the existing standards. Moreover, regulators should periodically review the regulations and make any necessary changes to make sure that they are consistent with the requirements of the Bahraini market. In addition, regulators should disclose clearly their punishments for failure to comply with the regulations, in order to deter managers from intentional wrong-doing.

There was a high level of agreement with the following five main incentives for Bahraini managers to manage earnings: “to influence stock price”; “to influence executive compensation”; “to avoid violation of debt covenants”; “because there is inside pressure to hit earnings benchmarks”; and “because senior managers fear adverse career consequences if they report poor performance”. All of these incentives stem from the Bahraini conservative culture which tries to maintain stability in all aspects of life. However, it Bahraini managers were not found to have particular incentives to manage earnings to meet analysts’ forecasts or to manage earnings in a similar way to other companies, although these incentives have been observed in previous studies, as mentioned in the literature.

Finally, it has been shown that the following red flags, which assist in detecting earnings management in Bahrain, obtained the highest support: “inconsistency with the previous year’s figures, with the industry norms and the national economy”; “includes extraordinary items”; “conflicts between earnings movements and cash flow”; “inconsistency in choice of accounting methods”; and “less transparent reporting”. It is interesting that different stakeholders believe that other signs, which have received little attention in the literature, can indicate earnings management in Bahrain. These include: related-party transactions; changes in management compensation (compared with industry norms and that in previous years); and the opinions of independent third parties (e.g. credit agencies).

Chapter 8: Analysis and Findings of Secondary Data

8.1 Introduction

The previous chapter presented the analysis and findings of the semi-structured interviews and questionnaire survey that aimed to answer the research questions concerning different issues related to the quality of reported earnings in Bahrain. This chapter presents the analysis and findings obtained from the secondary data. The primary purpose of this chapter is to answer the research question related to the impact of corporate governance mechanisms on earnings quality.

Two empirical models have been adopted to test the study's hypotheses. In order to perform the analysis, four measures of earnings quality have been used: persistence, predictability, smoothness and abnormal accruals (i.e. the modified Jones model). In addition, a number of explanatory variables have been included; these relate to the characteristics of both the board of directors and the audit committee, external auditing and the ownership structure. In addition, three control variables have been included: size, performance and leverage.

This chapter is organised as follows. Section 8.2 discusses the descriptive statistics. Section 8.3 presents the empirical results from correlation tests and univariate analysis for two regression models. Section 8.4 provides a concluding discussion.

8.2 Descriptive statistics

8.2.1 Dependent variables: the four measures of earnings quality

The descriptive statistics for the four dependent variables (earnings quality measures) are shown in Table 8.1, which reports the summary statistics for persistence, predictability, smoothness and discretionary accruals.

Table 8.1: Descriptive statistics - dependent variables

Variable	Observations	Mean	Std. Dev.	Min	Max	Median	Skewness	Kurtosis
Persistence	126	0.231	0.707	-2.481	3.196	0.213	0.863	7.512
Predictability	126	0.268	0.261	0.0001	0.998	0.195	1.047	3.390
Smoothness	134	1.060	1.414	0.024	9.157	0.738	3.629	18.658
Discretionary accruals	156	0.0298	0.0367	0.0001	0.171	0.016	2.285	8.107

Table 8.2 compares the means for each measure of earnings quality for the periods before and after the implementation of the code of corporate governance in Bahrain (implemented in 2011). Based on the data available, persistence, predictability and smoothness can be calculated starting from the years 2009 because of the five-year rolling window technique used in this study as suggested in the literature (e.g. Francis et al., 2004; Srivastava, 2014). This results in only two years of observation before implementation of the code and five to six years (depending on the measure used) after. An imbalance problem between the period before and after the implementation of the code is therefore raised. This study follows Chen and Zhang

(2014) in solving this problem by creating five sub-periods for the post-code period. The first post-code period contains only two years (2011 and 2012) in order to be balanced with the pre-code period (2009 and 2010). The other four sub-periods (post-code periods) are created by adding one year up to 2016, this reflecting the possible effect of a specific year during the whole post-code period. The statistics show (in Table 8.2) that the means for the four measures of earnings quality in Bahraini companies is not significantly different for the periods before and after the implementation of the code of corporate governance. This means that the implementation the code, counter to expectation, did not improve the quality of earnings.

Table 8.2: Differences in the measures of earnings quality (means) between the pre- and post-code periods

Periods	Predictability Mean Difference Pre & Post CG Code	Persistence Mean Difference Pre & Post CG Code	Smoothness Mean Difference Pre & Post CG Code	DAC Mean Difference Pre & Post CG Code
Pre 09-10 post 11-12	0.0426	-0.144	0.132	-0.000343
Pre 09-10 post 11-13	0.0252	-0.126	0.155	-0.00328
Pre 09-10 post 11-14	0.0281	-0.148	0.188	-0.00436
Pre 09-10 post 11-15	0.0496	-0.113	0.175	-0.00633
Pre 09-10 post 11-16	-	-	0.154	-0.00683

8.2.2 Independent variables

8.2.2.1 Characteristics of the board of directors

Table 8.3: Descriptive statistics - independent variables (board composition)

Variable	Observations	Mean	Std. Dev.	Min	Max	Median	Skewness	Kurtosis
Independent outsider	133	25.703	25.052	0	100	17	1.0125	3.544
Outsiders	163	86.730	17.665	30	100	90	-1.584	4.998
Board Size	165	8.733	1.474	6	11	9	-0.141	2.065
Board Meetings	91	5.835	2.414	0	16	5	1.614	6.416
Politically connected	158	0.627	0.485	0	1	1	-0.523	1.274
R&N Existence	123	0.602	0.492	0	1	1	-0.415	1.172
R&N Independent	87	0.7356	0.4436	0	1	1	-1.069	2.142

Table 8.4: Descriptive statistics - the difference in independent variables in high and low earnings quality*

Independent Variables	Persistence Mean Difference High vs Low EQ	Predictability Mean Difference High vs Low EQ	Smoothness Mean Difference High vs Low EQ	DAC Mean Difference High vs Low EQ
Independent outsider	-7.120	2.607	1.752	8.400
Outsiders	3.001	2.303	9.547***	3.951
Board Size	-0.343	-0.365	0.464*	-0.00694
Board Meetings	-0.496	-0.553	1.583**	0.568
Politically connected	-0.115	0.0139	-0.113	0.0638
R&N Existence	0.0325	0.0757	0.168	-0.0325
R&N Independence	0.0982	0.119	-0.0342	0.0971

* I have created two groups (high/low earnings quality) where the mean of the earnings quality measure is the cutoff. Then I compared the mean of the dependent variables in the high earnings quality group with the mean of the dependent variables in the low earnings quality group. I conducted t-tests to find if there is a significant difference between the two means (for the dependent variables). This test shows if there is an initial relation (before doing the regression analysis) between the dependent variable and earnings quality

t statistics in parentheses
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Table 8.3 indicates that the average proportion of outside directors is high (87%). These findings show the high compliance rate of Bahraini companies with the code of corporate governance, which recommends that at least 50% of the board of directors are non-executive directors. However, the mean for the percentage of outside directors on the board is significantly different between the high and low earnings quality groups only using the smoothness measure, as Table 8.4 shows.

Although the mean for non-executive directors is high, the mean for independent outside directors is low (26%). This study follows the literature in defining independent outsider board members as those whose tenure as a board member does not exceed 5 years, are not ex-employees of the firm or related to senior management, are not consultants, lawyers, or financial advisors. The main reason for this low percentage of independent outsider directors in Bahrain is that most of the outsider directors sit on the board for more than five years and this make them lose their independence. The mean for the percentage of independent outsider directors on the board is not significantly different in high and low earnings quality groups, as Table 8.4 shows.

Interestingly, no companies in the sample had fewer than six board members. Table 8.3 shows that the average board size consists of nine members (mean 8.7) and a maximum of 11 members. In this regard, companies are complying with the code of corporate governance, which recommends that a company should not have more than 15 members on the board. The mean for the board size is not significantly different between the high and low earnings quality groups, as Table 8.4 shows.

With regard to the number of board meetings, Table 8.3 indicates that the average number of board meetings is about six (mean 5.8). Again, companies are in compliance with the code of corporate governance, which recommends that the board of directors should meet at least four times a year. As Table 8.4 shows, the mean is slightly but significantly higher in the higher earnings quality group under the smoothness measure only.

Interestingly, the study implies that 62.7% of Bahraini companies are politically connected. This finding is not surprising since political figures and their relatives tend to keep their investments inside the country. Contrary to expectation, Table 8.4 shows that the mean for politically connected companies is not significantly different between the high and low earnings quality groups.

According to Table 8.3, Bahraini companies have gradually established the remuneration and nomination committees. Although around 60% of companies have one, Table 8.4 shows that the mean for the presence of this committee is not significantly different between the high and low earnings quality groups.

Finally, Table 8.3 indicates that 73.6% of remuneration and nomination committees in Bahraini companies are independent (neither the CEO nor other executive director sit on this committee). In this respect, the majority of companies are in compliance with the code of corporate governance, which recommends that this committee should include only non-executive directors. In addition, Table 8.4 shows that the mean for remuneration and nomination committee independence is not significantly different between high or low earnings quality groups.

8.2.2.2 Characteristics of the audit committee

Table 8.5: Descriptive statistics - independent variables (audit committee)

Variable	Observations	Mean	Std. Dev.	Min	Max	Median	Skewness	Kurtosis
AC Outsider	110	93.736	16.089	25	100	100	-3.0425	12.0287
AC Independent outsider	100	34.83	31.136	0	100	29	0.6373	2.3950
AC Size	116	3.621	0.901	0	6	3	0.2451	4.9317
AC Meetings	88	4.239	1.104	0	8	4	-0.0694	6.8482
Big 4 Auditor	167	0.749	0.435	0	1	1	-1.1455	2.3130
Auditor Change	158	0.025	0.158	0	1	0	6.0437	37.5260

Table 8.6: Descriptive statistics - the difference in independent variables in high and low earnings quality*

Independent Variables	Persistence Mean Difference High vs Low EQ	Predictability Mean Difference High vs Low EQ	Smoothness Mean Difference High vs Low EQ	DAC Mean Difference High vs Low EQ
AC Outsiders	-0.729	0.865	11.44***	4.864
AC Independent Outsiders	-6.363	4.173	6.192	8.354
AC Size	-0.115	-0.164	-0.121	0.0924
AC Meetings	-0.179	-0.114	0.382	0.455
Big 4 Auditor	-0.249***	-0.00397	-0.00880	-0.0152
Auditor Change	0.0153	-0.0157	0.0192	-0.0178

* I have created two groups (high/low earnings quality) where the mean of the earnings quality measure is the cutoff. Then I compared the mean of the dependent variables in the high earnings quality group with the mean of the dependent variables in the low earnings quality group. I conducted t-test to find if there is a significant difference between the two means (for the dependent variables). This test shows if there is an initial relation (before doing the regression analysis) between the dependent variable and earnings quality.
t statistics in parentheses
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Table 8.5 provides the descriptive statistics of variables relating to the characteristics of the audit committee. On average, 93.7% of the members of audit committees are outside (non-executive) directors. This indicates the compliance of Bahraini companies with the code of corporate governance, which requires companies to have only non-executive directors on the audit committee. Table 8.6 shows that the mean for outside directors on the audit committee is significantly different (under the smoothness measure) between the high and low earnings quality groups.

In line with the findings on the characteristics of the board of directors, reported above, the average proportion of independent outside directors on the audit committee is low (34.8%). The main reason for this is that most of the outsider directors sit in the board for more than five years and this makes them lose their independence. As Table 8.6 shows, the mean percentage of independent outsider directors on the audit committee is not significantly different between the high and low earnings quality groups.

With regard to the size of audit committee, Table 8.5 indicates that the average number of audit committee directors is 3 or 4 (mean 3.62). This finding confirms that companies are in compliance with the code of corporate governance, which recommends that the audit committee should have at least three members. As Table 8.6 shows, the mean audit committee size is not significantly different between the high and low earnings quality groups.

Table 8.5 also indicates that, on average, audit committees meet four times a year (mean 4.24). In this respect, again, Bahraini companies are in line with the code of corporate governance, which recommends that audit committees should meet four times a year. However, contrary to what this study expected, Table 8.6 shows that the mean number of audit committee meetings is not significantly different between high and low earnings quality groups.

Table 8.5 shows that three-quarters of Bahraini companies appoint one of the international big four audit firms to do the external audit (75%). As expected, the mean for the percentage of companies appointing a big four auditor is higher (under the persistence measure) in the high earnings quality group than in the low earnings quality group.

Finally, Table 8.5 shows that Bahraini companies rarely change their external auditor (2.5%). In addition, Table 8.6 indicates that the mean for the percentage of companies changing their external auditors is not significantly different between the high and low earnings quality groups.

8.2.2.3 Ownership structure and control variables

Table 8.7: Descriptive statistics - independent variables (ownership and control variables)

Variable	Observations	Mean	Std. Dev.	Min	Max	Median	Skewness	Kurtosis
State Ownership	166	23.618	27.030	0	78	7.5	0.7175	2.0265
Family Ownership	166	8.751	16.280	0	51	0	1.8525	4.7802
Institutional Ownership	166	15.477	15.892	0	63.3	12.465	1.2152	4.1004
Individual Ownership	166	2.284	4.973	0	17.46	0	1.9435	5.2803
Managerial Ownership	109	10.440	16.704	0	63.9	4.479	2.3926	7.3976
Blockholding Ownership	166	0.910	0.288	0	1	1	-2.8576	9.1660
Size	198	11.553	1.292	9.357	15.074	11.430	1.0118	4.0380
ROA	196	0.084	0.064	-0.155	0.249	0.077	-0.6014	4.7817
Leverage	196	0.061	0.099	0	0.586	0	1.9342	7.3462

Table 8.8: Descriptive statistics - the difference in independent and control variables in high and low earnings quality*

Independent Variables	Persistence Mean Difference High vs Low EQ	Predictability Mean Difference High vs Low EQ	Smoothness Mean Difference High vs Low EQ	DAC Mean Difference High vs Low EQ
State Ownership	-3.000	3.241	5.306	11.01*
Family Ownership	-2.635	1.075	-4.706	-2.629
Institutional Ownership	-1.662	-0.108	-0.778	-1.276
Individual Ownership	-0.00896	-0.565	2.667***	-1.011
Managerial Ownership	-8.023*	-5.300	-10.37**	-5.675
Blockholding Ownership	-0.0201	0.0689	0.149***	0.0151
Control variables				
Size	-0.483*	-0.0879	0.292	0.723***
ROA	-0.0108	-0.00362	-0.0165	0.00867
Leverage	0.0127	0.00614	0.0296*	-0.00147

* I have created two groups (high/low earnings quality) where the mean of the earnings quality measure is the cutoff. Then I compared the mean of the dependent variables in the high earnings quality group with the mean of the dependent variables in the low earnings quality group. I conducted t-test to find if there is a significant difference between the two means (for the dependent variables). This test shows if there is an initial relation (before doing the regression analysis) between the dependent variable and earnings quality.

t statistics in parentheses
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Table 8.7 provides the descriptive statistics of variables relating to ownership structure and the control variables. It shows that Bahraini companies have an average state ownership of 23.6%, family ownership of 8.75%, institutional ownership of 15.48%, individual ownership of 2.28%, managerial ownership of 10.44% and 9% of blockholding ownership. These proportions of various types of ownership are considered high and it is higher than some of the other GCC countries. For example, in Oman the average state ownership for listed companies is 2.94%. Moreover, the average for aggregate ownership structure for other large shareholders (all large shareholders excluding the state) is 44.95% in Oman (Omet, 2005), while in Bahrain it is 45.95%.

Table 8.8 indicates that the mean for state ownership is slightly higher (under abnormal measure) in the high earnings quality group than in the low earnings quality group. In addition, the means for individual ownership and blockholding ownership are significantly different (under the smoothness measure) between the high earnings quality group and the low earnings quality group. Further, the mean for managerial ownership is slightly higher (under the persistence and smoothness measures) in the high earnings quality group than in the low earnings quality group. However, Table 8.8 shows that the means for family ownership and institutional ownership do not significantly differ between the high and the low earnings quality groups.

Table 8.7 also presents the descriptive statistics for the control variables used in this study. The average size (the natural logarithm of total assets at year-end) is 11.55 with a maximum of 15 and a minimum of 9.36. Moreover, ROA is 8.4%, with a minimum of -15.5% and a maximum of 25%, while the average leverage is 6.1%, with a maximum of 58.6%. On the other hand, Table 8.8 shows that the mean of the company size is differs significantly (under the abnormal accruals and persistence measures) between the high and low earnings quality groups. In addition, the mean of leverage is marginally higher (under the smoothness measure) in the high earnings quality group than in the low earnings quality group. However, the mean of ROA is not significantly different between groups.

Before an analysis of correlation coefficients is conducted, the distribution of the variables should be analysed. For statistical analysis, variables should be normally distributed (Keller & Warrack, 2003). Data are normally distributed if the standard skewness is within the range +1.96 to r –1.96 and standard kurtosis is within the range +2 to –2. From the descriptive statistic tables, it can be noted that some variables are not normally distributed. Therefore, all accounting data are winsorised at the 1% level to control for outliers, and variables are log transformed.

8.3 Empirical results

This study employs regression analysis, which is the common technique for multivariate analysis, to test the study hypotheses by examining the effect of different variables on earnings quality, which is the dependent variable. This section will illustrate the correlation between independent variables, as collinearity might affect the regression models, and present the findings from the two regression models.

Before the findings of the correlation analysis and regression results are presented, it should be mentioned again that earnings quality will be higher if: the persistence of earnings is close to one, predictability is low, smoothness is low and absolute abnormal accruals are low.

8.3.1 Correlation coefficients

Analysis of correlation coefficients is important to test the relationship between dependent and independent variables (Abdul Rahman and Ali, 2006). Therefore, Table 8.9 presents the correlation coefficient that checks for the existence of high collinearity between variables using the Pearson test.

As indicated in Table 8.9, predictability is positively correlated with board size, number of board meetings, and the size of the company. In addition, persistence is positively correlated with board meetings, managerial ownership, blockholding ownership, audit committee size, use of a big 4 auditor, size and ROA. Smoothness is negatively correlated with independent outsiders, outsiders, board size, individual ownership, audit committee outsiders, audit committee independent outsiders, use of big 4 auditor, size and leverage. The abnormal accruals variable is also negatively correlated with board size, audit committee outsiders, size and ROA.

Table 8.9 also indicates the significant associations between the independent variables. The highest correlation can be observed between independent outsider directors and audit committee independent outsider directors (84.4%). Therefore, this study designed two regression models that separate the board characteristics from the audit committee characteristics, to avoid the multicollinearity problem. After this separation, there is no high correlation between the independent variables included in each model.

The correlations show that there is no multicollinearity because none of the variables correlates above 0.8; a number of previous studies (Gujarati, 2004; Abdul Rahman, 2006) suggest that 0.9 is not multicollinearity and will not harm the regression analysis. Furthermore, Table 8.10 presents the results of the Variance Inflation Factor (VIF) tests. Kennedy (2008) highlights that VIF of more than 10 points will harm the multicollinearity. However, Table 8.10 shows that there is no variance inflation greater than 10, except in the first model, with two variables, namely state and managerial ownership, which confirms that collinearity is not a problem in this study.

Table 8.9: Pearson correlation matrix

Variables	Predictability	Smoothness	Persistence	DAC	Independent outsider	Outsiders	Board Size	Board Meetings	Politically connected	R&N Existence	R&N Independent	State Ownership	Family Ownership	Institutional Ownership	Individual Ownership	Managerial Ownership	Block Own
Predictability	1																
Smoothness	-0.0105	1															
Persistence	0.404***	-0.257***	1														
DAC	-0.156*	0.261***	-0.0244	1													
Independent outsider	-0.136	-0.245***	0.0725	-0.0296	1												
Outsiders	-0.117	-0.397***	0.0118	-0.0851	0.223**	1											
Board Size	0.216**	-0.331***	0.105	-0.147*	0.0703	-0.200**	1										
Board Meetings	0.378***	-0.00271	0.441***	0.0426	0.154	0.00300	0.169	1									
Politically connected	0.0883	-0.0967	0.187*	-0.0519	0.369***	-0.0115	-0.253***	0.106	1								
R&N Existence	-0.126	0.150	0.0674	0.135	0.161*	-0.138	-0.0680	0.212**	0.223**	1							
R&N Independent	-0.162	0.154	0.0307	-0.0149	0.203*	0.0934	-0.348***	0.0321	-0.146	0.699***	1						
State Ownership	-0.0276	-0.153*	0.139	-0.0843	0.704***	0.363***	-0.0276	0.404***	0.426***	0.283***	0.264**	1					
Family Ownership	-0.0742	-0.0542	0.0947	-0.00097	-0.178**	-0.579***	-0.114	-0.185*	0.117	0.184**	0.00986	-0.357***	1				
Institutional Ownership	0.00229	0.0655	-0.00761	-0.101	0.00533	-0.0548	-0.0736	-0.372***	0.00406	-0.273***	-0.0910	-0.108	-0.306***	1			
Individual Ownership	0.0875	-0.289***	0.0339	-0.0481	-0.131	0.344***	0.0593	-0.127	-0.446***	-0.217**	0.249**	-0.238***	-0.248***	0.299***	1		
Managerial Ownership	0.152	-0.0443	0.201*	-0.0103	-0.108	-0.781***	0.495***	-0.337***	-0.0525	0.184*	0.110	-0.442***	0.787***	-0.106	-0.0302	1	
Blockholding Ownership	-0.0468	-0.128	0.206**	0.0282	0.235***	0.00691	-0.0698	0.0386	0.107	0.154*	0.0759	0.276***	0.123	0.228***	0.145*	0.0164	1

Table 8.9
Continued.

Variables	Predictability	Smoothness	Persistence	DAC	Independent outsider	Outsiders	Board Size	Board Meetings	Politically connected	R&N Existence	R&N Independent	State Ownership	Family Ownership	Institution Ownership	Individual Ownership	Managerial Ownership	Block Own
AC Outsiders	-0.119	-0.755***	-0.0591	-0.340***	0.281***	0.695***	0.0537	-0.0622	0.117	-0.127	0.0332	0.236**	0.0203	-0.129	0.230**	-0.168	-0.08
AC Independent Outsiders	-0.132	-0.227**	-0.0315	-0.0502	0.844***	0.147	0.0175	0.0586	0.404***	0.0593	0.0954	0.629***	-0.00918	0.0218	-0.240**	-0.135	0.15
AC Size	0.191*	-0.0867	0.230**	-0.151	0.0781	0.181*	0.219**	0.148	0.203**	0.0814	0.0249	0.221**	-0.258***	0.114	0.0683	-0.0729	0.05
AC Meetings	0.197	-0.0754	0.142	-0.149	0.108	-0.138	0.169	0.466***	-0.00267	0.321***	0.187	0.171	0.101	-0.322***	-0.205*	0.0310	0.05
BIG4	-0.0670	-0.370***	0.256***	-0.120	0.131	0.000794	0.163**	0.149	0.313***	-0.0999	-0.328***	0.129*	0.282***	-0.120	-0.156**	0.208**	0.25
Auditor Change	0.0409	-0.112	-0.0804	0.0335	0.0619	0.0591	0.0500	-0.0253	-0.124	-0.0412	-0.0283	-0.0126	-0.0732	0.00642	0.227***	-0.0526	-0.08
SIZE	0.152*	-0.270***	0.339***	-0.286***	0.401***	0.0321	0.354***	0.269**	0.384***	0.288***	0.0574	0.456***	-0.00999	-0.0450	-0.185**	0.223**	0.06
ROA	0.0374	-0.132	0.258***	-0.192**	-0.00724	-0.0935	0.187**	0.0406	0.222***	0.0950	-0.477***	0.0161	0.0779	-0.184**	-0.418***	0.0803	-0.11
LEVERAGE	-0.0270	-0.244***	-0.102	-0.108	0.0723	0.195**	0.212***	-0.0266	-0.136*	-0.113	0.361***	0.0789	-0.166**	0.0635	0.339***	0.0149	0.02

Table 8.9
Continued.

Variables	AC Outsiders	AC independent Outsiders	AC Size	AC Meetings	BIG4	Auditor Change	SIZE	ROA	LEVERAGE
AC Outsiders	1								
AC independent Outsiders	0.278***	1							
AC Size	-0.0792	-0.124	1						
AC Meetings	-0.0305	0.165	0.0348	1					
BIG4	0.229**	0.146	0.0888	0.243**	1				
Auditor Change	0.0783	0.0388	-0.0236	0.185*	-0.0915	1			
SIZE	0.263***	0.287***	0.397***	0.230**	0.462***	-0.0646	1		
ROA	-0.135	-0.160	0.0470	0.0207	0.267***	-0.0612	0.260***	1	
LEVERAGE	0.201**	0.00347	0.154*	0.0396	0.0720	0.0793	0.267***	-0.270***	1

t statistics in parentheses
* $p < 0.10$, ** $p < 0.05$, *** $p < 0$.

Table 8.10: VIF Test Results

First Model				Second Model		
Variable	**VIF**	**1/VIF**		**Variable**	**VIF**	**1/VIF**
State Ownership	13.09	0.076		State Ownership	8.64	0.116
Managerial Ownership	11.19	0.089		AC Independent Out.	4.91	0.204
Outsiders	7.68	0.130		SIZE	4.19	0.239
Independent Directors	7.42	0.135		Individual Ownership	3.97	0.252
SIZE	7.11	0.141		LEVERAGE	3.69	0.271
Family Ownership	5.52	0.181		Family Ownership	3.13	0.320
Institutional Ownership	5.4	0.185		BIG Auditors	2.67	0.374
Board Size	4.27	0.234		Institutional Ownership	2.55	0.391
R&N Existence	3.81	0.263		Managerial Ownership	2.51	0.399
Board Meetings	3.72	0.269		AC Outsiders	2.12	0.471
Politically connected	3.15	0.317		ROA	2.11	0.474
LEVERAGE	2.87	0.348		AC Meetings	1.74	0.575
Individual Ownership	2.82	0.354		Blockholding Ownership	1.66	0.604
ROA	1.94	0.516		AC Size	1.57	0.638
R&N Independence	1.61	0.620		Auditor Change	1.21	0.825
Blockholding Ownership	1.42	0.703				
Mean VIF	**5.19**			**Mean VIF**	**3.11**	

8.3.2 Multivariate analysis: first regression model

The first model aims to examine the relationship between board characteristics, ownership structure and earnings quality. The adjusted R^2 value for the model is not very low (39.2% persistence, 36.44% predictability, 80.48% smoothness and 15.6% abnormal accruals); for instance, the adjusted R^2 in Abdul Rahman and Ali (2006) is 12.8%. Rahmat, Iskandar and Saleh (2009) find that low R^2 values in studies examining the characteristics of corporate governance are common. The constant is positive using all measures of earnings quality except persistence, where the constant is negative.

The constant is highly significant under smoothness. Table 8.11 presents the findings for the first regression model.

Table 8.11: Multivariate regression: board characteristics

Variables	Persistence	Predictability	Smoothness	DAC
Independent outsider	-0.0207*** (-3.17)	-0.00513 (-1.46)	0.0238* (1.90)	0.000200 (0.33)
Outsiders	0.00674 (0.71)	-0.00248 (-0.49)	-0.123*** (-6.94)	0.000655 (0.70)
Board Size	-0.0187 (-0.20)	0.0193 (0.38)	-0.156 (-0.96)	-0.0129 (-1.45)
Board Meetings	0.0152 (0.34)	0.0246 (1.01)	-0.0923 (-1.04)	0.00875* (1.99)
Politically connected directors	-0.0753 (-0.35)	-0.00978 (-0.08)	-0.00763 (-0.02)	-0.00530 (-0.26)
R&N Existence	-0.824** (-2.26)	-0.252 (-1.28)	0.231 (0.30)	0.0582 (1.54)
R&N Existence Independence	0.0856 (0.29)	-0.0868 (-0.55)	0.755 (1.32)	-0.0489* (-1.73)
State Ownership	0.0214*** (3.02)	0.00510 (1.34)	-0.0562*** (-3.97)	-0.000172 (-0.25)
Family Ownership	-0.00442 (-0.37)	-0.00466 (-0.72)	-0.0470** (-2.14)	-0.00197* (-1.81)
Institutional Ownership	-0.0101 (-0.69)	-0.00384 (-0.48)	-0.00865 (-0.49)	-0.000189 (-0.13)
Individual Ownership	0.00845 (0.29)	-0.00739 (-0.48)	-0.0411 (-0.77)	-0.00475 (-1.64)
Managerial Ownership	0.0345 (1.70)	0.0110 (1.01)	-0.203*** (-5.17)	0.00334 (1.67)
Blockholding Ownership	0.208 (0.63)	0.0649 (0.36)	0.158 (0.27)	0.0461 (1.57)
Size	0.0294 (0.24)	0.0287 (0.44)	0.599** (2.59)	-0.0262** (-2.12)
ROA	1.502 (1.24)	0.309 (0.47)	-12.52*** (-4.98)	0.0892 (0.70)
Leverage	-1.487 (-1.16)	-0.146 (-0.21)	-3.350 (-1.41)	0.162 (1.39)
_cons	-0.195 (-0.16)	0.0422 (0.06)	9.800*** (4.92)	0.276** (2.27)
R2	0.3920	0.3644	0.8048	0.1560
N	42	42	54	53

t statistics in parentheses
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

8.3.2.1 Board characteristics

8.3.2.1.1 Outsiders

The study hypothesises that there is a positive relationship between the proportion of outside directors on the board and earnings quality. The findings support this assumption using smoothness as the measure of earnings quality. Table 8.11 shows that there is a positive and significant relationship between the proportion of outside directors and earnings quality (the negative signs under predictability and smoothness indicate higher quality earnings). However, this relationship is not significant using other measures of earnings quality. Further explanation of this finding related to the Bahraini context and existing literature is given in the section on the variable 'Independent outsiders', where it is more relevant.

8.3.2.1.2 Independent outsiders

Inconsistent with this study hypothesis, there is a significant but negative relationship between independent outside directors and earnings quality using persistence as a measure of earnings quality. However, there is no significant relationship using other measures of earnings quality. This finding is contradicted to Klein (2002a), Xie et al. (2003) and Peasnell et al. (2005), who found that independent outsiders are positively related to earnings quality. However, this finding is consistent with some studies carried out in Malaysia (Abdul Rahman and Ali, 2006) and Indonesia (Siregar & Utama, 2008), where no significant relationship was detected.

The independent outsider board members are those whose tenure as a board member has not exceeded 5 years, who are not ex-employees of the firm or related to senior management, are not consultants, lawyers, or financial advisors. The finding in relation to independent outsiders represents the Bahraini context better than the finding regarding outsiders did. The reason for this is that the majority of outsider directors in Bahrain serve more than five years on the same board and this influences their independence, as they build relationships with the executive management. Then, the outsider will no longer have a significant impact on the quality of reported earnings.

The interview findings indicated that the business environment in Bahrain has a significant influence on corporate governance practices. The culture, through social relations, in Bahrain has a significant impact on the independence of the board of directors. The independent board members might perform in the best interest of the major shareholders who appointed them to the board. Moreover, these social relations can lead companies to appoint bureaucrats or incompetent directors on the board rather than directors with a relevant professional background. This assumption is supported by Park and Shin (2004), who argue that adding outside directors to the board might not improve governance practices in jurisdictions with a concentrated ownership market and a not well developed labour market.

8.3.2.1.3 Board size

This study shows that the board size is not significantly associated with earnings quality. Table 8.11 indicates that board size is positively but not significantly associated with earnings quality using smoothness and abnormal accruals as measures and negatively but not significantly using persistence and predictability. This finding is different from prior studies, which find that board size is significantly related to earnings quality. However, the relationship in different directions found in this study is supported by some studies. For example, Peanell et al. (2005) and Xie et al. (2003) found that board size is positively related to earnings quality, while Abdul Rahman and Ali (2006) and Kao and Chen (2004) found that board size is negatively related to earnings quality. The interview findings indicated that the business environment in Bahrain has a significant influence on corporate governance practices. The size of the board of directors will not have an influence on earnings quality because board members are maintaining strong relationship with major shareholders and try to meet their interest. This show the strength of monitoring mechanisms which will help in reducing the agency cost and at the same time it shows how the institutional setting can influence these mechanisms.

8.3.2.1.4 Board meetings

Inconsistent with the study hypothesis, the number of board meetings is not significantly related to earnings quality. Moreover, there is a non-significant but negative relationship using persistence measures. However, there is a slightly negative relationship using abnormal accruals and smoothness measures. The finding shows that board activity in Bahrain is not adding to the monitoring mechanism; in contrast, Xie et al. (2003) found that board meeting is associated with high earnings quality. Some of the interviewees believed that the supervisory duties of the board are many and their quarterly meetings are not enough to oversee management; therefore, they establish the board's sub-committees to support the board in overseeing the management, as these committees meet regularly and will be able to fill the gaps between the meetings of the board.

8.3.2.1.5 Politically connected directors

The study assumes that politically connected directors are negatively related with earnings quality. However, Table 8.11 shows that there is a positive relationship between politically connected directors and earnings quality using predictability, smoothness, and abnormal accruals as measures and a negative relationship using the persistence measure. However, this relationship is not significant for any of the measures. This finding is different from what Chaney et al. (2011) found: that politically connected firms have lower earnings quality. However, the justification of this result is that politically connected directors might be insider owners and prior studies highlight the positive association between insider ownership and earnings quality (Ding et al., 2007). This finding is consistent with agency theory, which expects that managerial ownership may reduce agency costs. Some interviewees believed that the quality of reported earnings for politically connected companies will not differ from those for non-politically connected companies, as both are regulated by the same rules and regulations but the politically connected companies might have more restrictions and rules, imposed by the government, to comply with.

8.3.2.1.6 The presence of a remuneration and nomination committee

Inconsistent with the study hypothesis, the presence of a remuneration and nomination committee is not significantly and positively related to earnings quality. Table 8.11indicates that the existence of the committee is negatively related to earnings quality and slightly significant only under persistence measure. This finding contradicts with what Ghosh et al. (2010) found that the existence of a compensation committee improves the quality of reported earnings. These findings can be explained that the existence of remuneration and nomination committee is met by the Bahraini companies to comply with the regulations rather than rather than benefit from this mechanism as a monitoring tool by limiting the management ability to determine their compensation.

8.3.2.1.7 Independence of remuneration and nomination committee

The independence of remuneration and nomination committee is predicted to be significantly and positively related to earnings quality. However, Table 8.11shows that the independence of the committee is marginally and positively related to earnings quality under abnormal accruals measure only. While another measure indicates that this relationship is not significant and negatively associated. These findings consistent with that of Klein (2002a) which concluded that there is no relationship between the presence of the CEO on the committee and the quality of reported earnings. These findings can be explained that the independence of remuneration and nomination committee is met by the Bahraini companies to comply with the regulations but the CEO can still have some influence over the management team’s compensation using the social relations.

8.3.2.2 Ownership structure

8.3.2.2.1 State ownership

Hypothesis 14 expects that the proportion of state ownership is negatively associated with earnings quality. This study finds that state ownership is significantly and positively associated with earnings quality using the persistence and smoothness measures. However, for the predictability and abnormal accruals measures, the relationship is not significant. The finding is consistent with Wang and Yung (2011) and Ding et al. (2007), who found that state-owned companies in China manage earnings less than other companies. This can be explained, as an interviewee suggested, by the fact that the Bahraini government, because of the collectivist culture, aligns its interest with the company’s and society’s interests in general. In addition, some interviewees thought that state-owned companies might have more restrictions and rules to comply with, which would make their reported earnings of higher quality.

8.3.2.2.2 Family ownership

The study assumes that family ownership is negatively related to earnings quality. Table 8.11shows that using the smoothness and abnormal accruals measures, this relationship is slightly significant and positive. However, it is not significant using the persistence and predictability measures. This finding is counter to a finding by Siregar and Utama (2008) that family ownership is associated with earnings being managed. However, it is consistent with Wang (2006), who found that family ownership is associated with higher earnings quality because of the alignment effect, whereby families align their interests with those of other investors and the company. One of the interviewees supported this finding. She said that companies with concentrated family ownership can have high-quality earnings as they have some control over the management and will try to stop any earnings management in order to improve and develop their business. In addition, another interviewee thought that these families would be getting government support and so would be motivated to report high-quality earnings figures.

8.3.2.2.3 Institutional ownership

This study expects that institutional ownership is negatively related to earnings quality. Table 8.11indicates that this relationship is not significant and, moreover, positive using the predictability, smoothness, and abnormal accruals measures and negative using the persistence measure. This finding is consistent with the finding by Peasnell et al. (2005) that there is no relationship between earnings management and institutional investors, but inconsistent with those of some other studies, like that by Yu (2008), who that found institutional investors improve the quality of earnings. A possible explanation for this result is that institutional investors are long-term investors in Bahrain and they are pursuing their private interests in line with the company's best interest. This is consistent with agency theory, which predicts that concentrated ownership will reduce agency costs. This is supported by the alignment effect of concentrated ownership (Ding et al., 2007). In addition, institutional investors in Bahrain do not have the same characteristics as institutional investors in developed countries (covered in the literature), such as culture and experience, that make them strong monitoring mechanisms.

8.3.2.2.4 Individual ownership

Hypothesis 17 states that there is a negative relationship between individual ownership and earnings quality. However, inconsistent with this hypothesis the relationship between individual ownership and earnings quality is positive but not significant, as indicated in Table 8.11. The finding does not confirm the 'large shareholders' effect in preventing earnings management predicted by agency theory. It is consistent with Abdul Rahman and Ali (2006), who were unable to find a significant relationship between the existence of big shareholders and earnings quality. This can be explained by the fact that the Bahraini collectivist culture plays a role in aligning the interests of large shareholders with those of the company and of society in general. In addition, an interviewee believed that individual investors do not have much influence over the quality of reported earnings.

8.3.2.2.5 Managerial ownership

The findings of the study on the effect of managerial ownership are inconsistent with hypothesis 18. Table 8.11 indicates that managerial ownership is significantly and positively related to earnings quality using the smoothness measure. However, this relationship is not significant using the other measures. The justification for the significant relation is that directors are insider owners and prior studies highlight the positive association between insider ownership and earnings quality (Ding et al., 2007). This finding is consistent with agency theory, which predicts that managerial ownership will reduce agency costs.

8.3.2.2.6 Blockholding ownership

Concerning the effect of blockholding ownership on earnings quality, the findings indicate that this relationship is not significant but it is negative using the predictability, smoothness, and abnormal accruals measures, as stated in hypothesis 19. However, this relationship is positive but still insignificant using the persistence measure. The finding does not support the prediction of agency theory that large shareholders will be able to mitigate earnings management. The finding is consistent with Abdul Rahman and Ali (2006), who were unable to detect any significant effect of blockholders on the quality of earnings. Some interviewees supported this finding in the Bahraini context. They said that major shareholders might appoint incompetent board members and these appointments are only based on social relations. Therefore, these incompetent board members will not be able to improve the quality of reported earnings.

8.3.3 Multivariate analysis: second regression model

The second model aims to examine the relationship between earnings quality and both the characteristics of the audit committee and ownership structure. The adjusted R^2 value for the model is not very low (16.91% persistence, 23.24% predictability, 83.96% smoothness and 18.2% abnormal accruals). In comparison with previous studies, the adjusted R^2 in Abdul Rahman and Ali (2006) is 12.8%. Iskandar and Saleh (2009) find that low R^2 in studies examining corporate governance characteristics is common. The constant is positive and significant using the smoothness and abnormal accruals measures but negative and slightly significant using the persistence and predictability measures. Table 8.12 presents the findings for the second regression model.

Table 8.12: Multivariate regression: characteristics of the audit committee

Variables	Persistence	Predictability	Smoothness	DAC
AC Outsiders	0.000290 (0.06)	-0.00318 (-1.39)	-0.0778*** (-12.29)	-0.000583 (-1.59)
AC Independent Outsiders	-0.00677* (-1.78)	-0.00116 (-0.59)	0.00988* (1.91)	-0.0000340 (-0.11)
AC Size	0.0278 (0.26)	0.0827 (1.49)	-0.311** (-2.23)	-0.00901 (-1.07)
AC Meetings	-0.0718 (-0.89)	-0.0278 (-0.67)	-0.0205 (-0.20)	-0.00421 (-0.70)
Use of 'big 4' auditor	-0.134 (-0.69)	0.0139 (0.14)	-0.741** (-2.51)	0.00796 (0.47)
Auditor Change	0.325 (0.67)	0.00855 (0.03)	0.0456 (0.06)	-0.0406 (-0.93)
State Ownership	0.00699 (1.17)	0.000527 (0.17)	-0.0379*** (-4.51)	0.000292 (0.57)
Family Ownership	0.00723 (0.94)	0.00179 (0.45)	-0.0113 (-1.04)	-0.000774 (-1.20)
Institutional Ownership	0.000339 (0.05)	-0.00258 (-0.76)	-0.0176** (-2.21)	-0.000674 (-1.28)
Individual Ownership	0.00315 (0.11)	-0.00965 (-0.66)	-0.0284 (-0.85)	-0.00312 (-1.31)
Managerial Ownership	0.00222 (0.18)	0.000879 (0.14)	-0.0957*** (-6.30)	0.000797 (0.90)
Blockholding Ownership	0.254 (0.67)	0.112 (0.58)	-0.446 (-0.86)	0.0261 (0.87)
SIZE	0.240** (2.34)	0.103* (1.97)	0.541*** (3.68)	-0.0194** (-2.20)
ROA	0.760 (0.62)	-0.187 (-0.30)	-11.67*** (-6.07)	0.0967 (0.87)
LEVERAGE	0.0218 (0.02)	0.333 (0.61)	-3.842*** (-3.07)	0.121 (1.53)
_cons	-2.571** (-2.47)	-0.932* (-1.75)	6.638*** (4.22)	0.330*** (3.57)
R2	0.1691	0.2324	0.8396	0.1820
N	54	54	68	67

t statistics in parentheses
* p < 0.10, ** p < 0.05, *** p < 0.01

8.3.3.1 Characteristics of the audit committee

8.3.3.1.1 Outsiders

The study hypothesises that there is a positive relationship between the proportion of outside directors on the audit committee and earnings quality. The findings support this assumption using smoothness as the measure of earnings quality. Table 8.12 shows that there is a positive and significant relationship between the proportion of outside directors and earnings quality. However, this relationship is not significant using the other measures of earnings quality. This supports the finding in other studies that audit committee independence is positively related to earnings quality (Klein, 2002a; Bedard et al., 2004; Piot and Janin, 2007). This finding is consistent with agency theory, which expects that appointing non-executive directors in the board may reduce agency costs.

8.3.3.1.2 Independent outsiders

Inconsistent with this study hypothesis, there is a slightly significant but negative relationship between independent outside directors and earnings quality using persistence and smoothness as measures of earnings quality. However, there is an insignificant and positive relationship using the other quality measures. Prior research has shown that audit committee independence is positively related to earnings quality (Klein, 2002a; Bedard et al., 2004; Piot and Janin, 2007); therefore, the finding of this study contradicts these previous studies. However, the finding is consistent with Abdul Rahman and Ali (2006), who found that there is no significant relation between earnings quality and the independent of the audit committee in Malaysian companies. In addition, Peasnell et al. (2005) did not find sufficient evidence of the impact of an audit committee in preventing earnings management.

The independent outsider board members are whose tenure has not exceeded 5 years, who are not ex-employees of the firm or related to senior management, are not consultants, lawyers, or financial advisors. The finding of independent outsiders is representing the Bahraini market more than outsiders' finding did. The reason for this assumption is that the majority of outsider directors in Bahrain serve more than five years in the same board and this influence their independence as they build some relationships with the executive management. Therefore, the outsider will not have a significant impact on the quality of reported earnings anymore. Interviewees believed that audit committee members can have a significant influence over the quality of earnings if they are independent but they should have some expertise in the field (accounting or finance) to be able to make this difference, which is not the case in some of the Bahraini companies.

8.3.3.1.3 Committee size

This study shows that the size of the audit committee is not significantly associated with earnings quality. Table 8.12indicates that the committee size is positively but not significantly associated with earnings quality using smoothness and abnormal accruals measures and negatively but not significantly using persistence and predictability. The finding is inconsistent with prior studies that showed that audit committee size is an important element that affects the quality of earnings. Lin et al. (2006) found that audit committee size is related to fewer earnings restatements. However, this finding is similar to the findings reported by Xie et al. (2003), Bédard et al. (2004), and Abbott et al. (2004), who found that the size of the audit committee has no significant relationship with earnings quality. This can be explained that the size of the committee might not have an impact on the effectiveness of the committee's practices in reducing the agency cost.

8.3.3.1.4 Committee meetings

Inconsistent with the study hypothesis, the number of audit committee meetings is not significantly related to earnings quality. There is a non-significant but positive relationship using the predictability, smoothness, and abnormal accruals measures, and non-insignificant and negative relationship using the persistence measure. The finding is not surprising, since most previous studies have not found a significant relationship between the number of audit committee meetings and earnings quality. For example, Abdul Rahman and Ali (2006) could not find evidence that the frequency of audit committee meetings has a relationship with earnings quality. Possible explanation for this finding can be that the number of meeting does not have a direct impact over the effectiveness of the committee in limiting the agency cost.

8.3.3.1.5 Use of the big four auditors

The study hypothesises that there is a positive relationship between the use of one of the 'big four' firms for the external audit and earnings quality. The findings provide little support for this assumption using smoothness as the measure of earnings quality. Table 8.12 shows that there is a negative and non-significant relationship between the use of a 'big four' external auditor and earnings quality using the persistence, predictability and abnormal accruals measures. Prior studies argued that big auditors can provide high-quality earnings because of their specialisation of services and effort to maintain their reputation. However, this finding is consistent with Abdul Rahman and Ali (2006), who found no significant relationship between use of the 'big five' auditors and earnings quality in Malaysia. The present finding related to Bahraini market can be justified, as stated by some of the interviewees, by the fact that the ‘big four’ auditors are not all the same in terms of their competence. The quality of audit provided by the big four can vary. In addition, because of the collectivist culture and the social relations in Bahrain, external auditors lose their independence, which affects their performance negatively.

8.3.3.1.6 Change of auditor

The findings indicate that a change of auditor (switch) is not significantly related to earnings quality. Table 8.12 shows that change of auditor has a positive but non-significant relationship using the persistence and abnormal measures, while the predictability and smoothness measures indicate a negative and non-significant relationship. This finding is consistent with Defond and Subramanyam (1998) and Davidson, Jiraporn, and DaDalt (2006), who could not find evidence for the impact of auditor change on earnings management. The present finding related to Bahraini market can be justified by the Companies Law’s requirement where companies have to change the external auditors every five years. Therefore, the reason for changing the auditors is to comply with the regulation rather than having a disagreement with them.

8.3.3.2 Ownership structure

The findings and their explanation in relation to ownership structure are, to a large extent, similar under the two models.

8.3.3.2.1 State ownership

This study expects that the proportion of state ownership is negatively associated with earnings quality. This study finds that state ownership is significantly and positively associated with earnings quality using the smoothness measure, but non-significantly using the persistence, predictability and abnormal accruals measures. The finding is consistent with Wang and Yung (2011) and Ding et al. (2007), who found that state-owned companies in China manage earnings to a lesser degree than other companies. This can be explained by the fact that the Bahraini government, because of the collectivist culture, aligns its interest with those of the company and society in general.

8.3.3.2.2 Family ownership

The study assumes that family ownership is negatively related to earnings quality. Table 8.12 shows that using the persistence, smoothness and abnormal accruals measures, this relationship is non-significant and positively associated. However, it is non-significant and negative using the predictability measure. This finding contradicts that by Siregar and Utama (2008), who found that family ownership is associated with the management of earnings. However, it is consistent with Wang (2006), who found that family ownership is associated with higher earnings quality because of the alignment effect, whereby families align their interests with those of the company and other investors. One of the interviewees supported this finding. She said that companies with concentrated family ownership can have high-quality earnings as they have some control over the management and will try to stop any earnings management in order to improve and develop their business. In addition, another interviewee thought that these families would be getting government support and so would be motivated to report high-quality earnings figures.

8.3.3.2.3 Institutional ownership

This study expects that institutional ownership is negatively related to earnings quality. However, Table 8.12 indicates that this relationship is positively related to earnings quality using all the measures and slightly significant using the smoothness measure. Peasnell et al. (2005) failed to find a significant relationship between earnings management and institutional investors. A possible explanation for this result is that institutional investors are long-term investors in Bahrain and they are pursuing their private interests in line with the company's best interest. This is consistent with agency theory, which predicts that concentrated ownership may reduce agency costs. This is supported by the alignment effect of concentrated ownership (Ding et al., 2007). In addition, institutional investors in Bahrain do not have the same characteristics as institutional investors in developed countries (covered in the literature), such as culture and experience, that makes them strong monitoring mechanisms.

8.3.3.2.4 Individual ownership

This study expects that individual ownership is negatively associated with earnings quality. However, inconsistent with this hypothesis, the relationship between individual ownership and earnings quality is positive but not significant, as indicated in Table 8.12. The finding does not confirm the effect of large shareholders in preventing earnings management predicted by agency theory. It is consistent with Abdul Rahman and Ali (2006), who were unable to find a significant relationship between the presence of large shareholders and earnings quality. This can be explained by the fact that the Bahraini collectivist culture plays a role in aligning the interests of large shareholders with those of the company and society in general.

8.3.3.2.5 Managerial ownership

The findings of the study on the effect of managerial ownership are consistent with hypothesis 18 when smoothness is used as the measure. However, Table 8.12 indicates that managerial ownership is not significantly related to earnings quality using the other measures. The explanation for the significant relation is that directors are insider owners and prior studies highlight the positive association between insider ownership and earnings quality (Ding et al., 2007). This finding is consistent with agency theory, which predicts that managerial ownership will reduce agency costs.

8.3.3.2.6 Blockholding ownership

Concerning the effect of blockholding ownership on earnings quality, the findings indicate that this relationship is not significant but it is negative using the predictability and abnormal accruals measures, that is, in the direction predicted in hypothesis 19. However, this relationship is positive but still insignificant using the persistence and smoothness measures. The finding does not support the prediction of agency theory that large shareholders will be able to mitigate earnings management. The finding is consistent with Abdul Rahman and Ali (2006) and Park and Shin (2004), who were unable to detect any significant effect of blockholders on the quality of earnings. Some interviewees supported this finding in the Bahraini context. They said that major shareholders might appoint incompetent board members and these appointments are only based on social relations. Therefore, these incompetent board members will not be able to improve the quality of reported earnings.

8.3.4 Findings related to the control variables in both models

The study expects that other factors could affect earnings quality. Therefore, the regression models included control variables. This section presents the findings for these control variables in both models. The control variables used in the two models are the same.

8.3.4.1 Size

The findings show that the size of the company has different results in the two models. In the first model, as Table 8.11 indicates, size is slightly significantly and negatively related to earnings quality using the smoothness measure and slightly significantly but positively related using the abnormal accruals measure. However, size is insignificant using the persistence and predictability measures. In the second model, as Table 8.12 indicates, size is negatively and significantly related to earnings quality using the smoothness measure. Predictability shows a slightly significant and negative relationship between company size and earnings quality.

These findings are consistent with those found by Klein (2002b) and Xie et al. (2003) who reported that the size of the firms is significantly related to earnings management. A possible explanation for this result as highlighted by some interviewees that big companies in Bahrain have power within the market and strong relations with the government and regulators; therefore, they do not care a lot about the quality of reported earnings. This means that the size will have a negative relationship with the quality of reported earnings.

8.3.4.2 Performance (ROA)

The findings of the first model, presented in Table 8.11, show that the performance of the company is positively and significantly related to earnings quality using the smoothness measure. However, this relationship is non-significant using the other measures. Performance is also positively and significantly related to earnings quality in the second model using the smoothness measure. However, the other measures show a non-significant relationship, as indicated in Table 8.12. These findings are consistent with prior literature which assume that firms with good performance will have higher earnings quality (Abdul Rahman & Ali, 2006). This can be explained that Bahraini companies with strong performance will not have pressure from the investors to manage earnings in order to report profits.

8.3.4.3 Leverage

Table 8.11 indicates that the level of leverage of the company is not significantly associated with earnings quality in the first model. However, leverage is positively related to earnings quality using the predictability and smoothness measures, and negatively related using the persistence and abnormal accruals measures. The findings of the second model, presented in Table 8.12, show that leverage is positively and significantly related to earnings quality using the smoothness measure. However, it is non-significantly and negatively related to earnings quality using the predictability and abnormal accruals measures, and non-significantly and positively related using the persistence measure.

These findings are mix; therefore, it can be explained in two different ways. The positive relation can be explained that companies with high leverage are working hard to maintain its credit position and its reputations with the creditors as the reputation is one of the most important element for any business in the Bahraini market. On the other hand, the negative relation can be explained that these companies are also trying to maintain its reputation but its performance is weak therefore these companies are pressured to manage earnings.

8.4 Conclusion

The objective of this chapter was to examine the relationship between earnings quality and corporate governance mechanisms and characteristics, including the board of directors, the audit committee, external auditing and ownership structure. The expectation of beneficial corporate governance practices in improving earnings quality was, to a large extent, found to be inaccurate in Bahrain. With the exception of outsider and independent directors, state and managerial ownership, and outsider audit committee directors, none of the corporate governance variables examined in this study had a no significant effect on earnings quality.

The explanation for the non-significant relationships may be the result of board and audit committee members failing to respond fully to their duties. With respect to external audit factors, there is a monopoly in audit services in the Bahraini market and auditors lose their independence when they continue to audit the same company for a long time. In addition, a concentrated ownership structure, with the exception of state and managerial ownership, is less likely to offer good monitoring mechanisms. Overall, corporate governance in Bahrain is at a preliminary phase, and there is lack of knowledge of its importance.

In terms of a theoretical explanation, the findings may be set within the framework of institutional theory, which predicts that companies will adopt practices or regulations (aimed at improving organisational effectiveness) as a result of coercion or imposition from a legislator. However, there is no prediction that the adoption of these regulations will improve organisational effectiveness.

Chapter 9: Summary and Conclusion

9.1 Introduction

The main aim of the study is to explore and identify earnings quality, including its measures and determinants, and to determine the extent to which corporate governance mechanisms can improve the quality of earnings in Bahrain. Semi-structured interviews were conducted to gain insights into issues related to the quality of reported earnings in Bahrain. Following the interviews, a questionnaire survey was used to gain the perceptions of different aspects of the quality of reported earnings in Bahrain to supplement the information gathered from the interviews and to obtain further insights. These primary data were used to develop hypotheses regarding the relationship between corporate governance and earnings quality in Bahrain, and those hypotheses were tested using secondary data.

This thesis started with an overview of the Bahraini context to outline the fundamental underlying issues related to the study. Moreover, from a review of the literature a comprehensive consideration of earnings quality has been offered, and the role of corporate governance has been discussed. In addition, the thesis has presented the theories that provide a scientific basis for this study. Furthermore, a detailed description of the methodology used for this study has been provided. Chapters 7 and 8 have presented the findings of the study.

This chapter presents summary of the findings and conclusion. Section 9.2 provides a review of the study's findings. Section 9.3 gives the theoretical and practical implications and section 9.4 considers the study's potential limitations. Finally, section 9.5 suggests areas for future research.

9.2 Review of the findings

9.2.1 Semi-structured interview and questionnaire survey

9.2.1.1 Use of reported earnings

The investigation into the use of reported earnings in Bahrain is one of the objectives of this study. With the exception of "for use by current and prospective customers", the findings of the questionnaire survey show that there is no significant difference among the groups of respondents regarding their perceptions of the use of reported earnings in Bahrain. Generally, the interviews and survey findings indicate that the valuation role of earnings dominates; however, the stewardship contracting and control by internal managers uses are also important in Bahrain. Therefore, the earnings figure in Bahrain is a key metric for a broad range of interested parties, which is consistent with the position adopted by some researchers (e.g. Kothari, Ramanna, & Skinner, 2010) but not limited to valuation. However, earnings are not used very often by customers and suppliers. Theoretically, the use of reported earnings is justified by agency theory. The principal requires information to evaluate the performance of the company.

9.2.1.2 Definition of earnings quality

One of the objectives of this study is to obtain a definition of high-quality earnings in Bahrain. The interviews and survey findings reveal that stakeholders refer to some qualitative and empirical characteristics of earnings to define its quality. Some participants believe that the earnings figure is of high quality if it assists in decision-making, while others consider the earnings figure to be of high quality if it is sustainable, consistent and stable over time. The qualitative characteristics of financial reports (reliability, completeness and relevance) can also produce high-quality earnings. Some stakeholders think that the earnings figure is of high quality if it is provided to the users in a timely manner, does not include one-time items, and is reported in compliance with regulations and standards. Theoretically, the problem of information asymmetry may lead managers to influence the quality of reported earnings and to act in their own best interest, to maximise their wealth, because managers' goals might compete with those of other stakeholders. Therefore, meeting the above-mentioned characteristics of high-quality earnings reduces the information asymmetry problem and provides the principal with real and transparent information about the company's earnings.

9.2.1.3 Characteristics of high-quality earnings

This part of the study investigates the characteristics of high-quality earnings. With the exception of "recognise losses in a more timely manner than gains" and "have accruals that are eventually realised as cash flows", the findings of the questionnaire survey show that there is no significant difference among the groups of respondents regarding the characteristics of high-quality earnings in Bahrain. Stakeholders in Bahrain think that high-quality earnings are sustainable and predict of future earnings and cash flow. Earnings result from conservative recognition of assets and liabilities, and the inclusion of accruals that are realised as cash flow are also features that have an effect on the quality of earnings. Moreover, the findings raise interesting points related to the characteristics of high-quality earnings which are inconsistent with the literature. There was little support for the following characteristics: fewer accruals, fewer requirements for explanation, and recognition of losses in a more timely manner than gains. This is not surprising, because different users of financial reports in Bahrain do not pay much attention to accruals (as noted here in all the sections addressing accruals), but are always looking for more detailed disclosure; moreover, Bahrain does not have an efficient market, and so companies report both gain and loss for the same time-period (by the deadline set by the regulators) without any difference. Theoretically, high-quality earnings reduce the problem of information asymmetry and provide the principal with real and transparent information about the company's earnings. In addition, institutional theory can explain why some characteristics are important in Bahrain but not elsewhere. These characteristics are linked to the conservative culture of Bahraini stakeholders (who are more to give explanation and disclosure).

9.2.1.4 Determinants of earnings quality

The investigation into the factors that influence the quality of reported earnings in Bahrain is one of the objectives of this study. With the exception of "company's industry", "company's external auditor" and "the existence of concentrated ownership", the findings of the questionnaire survey show that there is no significant difference among the groups of respondents regarding the factors that influence the quality of earnings in Bahrain. The interviews and survey findings reveal that stakeholders believe that the following factors have a big influence on the quality of reported earnings in Bahrain: the firm's characteristics; corporate governance mechanisms; macroeconomic conditions; and the strength of regulators in enforcing regulations. In addition, the effect of politically connected board members and managers on the quality of reported earnings also gains some support. There are some other factors that can influence the quality of reported earnings but that have received little attention in the literature. These factors include: the level of awareness of the importance of financial reports and monitoring mechanisms (such as corporate governance mechanisms); the ownership structure of the company; and the use of financial reports (most users focus on the earnings figure). In contradiction with prior studies, analysts' forecasts were not seen as having much influence on the quality of reporting earnings. The reason for this is that Bahrain does not have many analysts and their opinions are not given a lot of consideration by most stakeholders in decision making.

Theoretically, the factors that determine the quality of reported earnings are suggested by agency theory and institutional theory. The quality of reported earnings is affected by the problem of information asymmetry, which can lead managers to influence the quality of reported earnings by acting in their own best interest to maximise their wealth; that is, managers' goals might compete with those of other stakeholders. Shareholders use monitoring tools to reduce the agency problem. However, managers' actions and the monitoring mechanisms are all influenced by contextual factors. The contextual factors include the social system, legal system, economic system and political system. Therefore, the quality of earnings will be indirectly affected by contextual factors.

9.2.1.5 The impact of standard setting on earnings quality

The investigation into the changes that might produce high-quality earnings in Bahrain is one of the objectives of this study. With the exception of "enforce financial reporting regulations more strictly", the findings of the questionnaire survey show that there is no significant difference among the groups of respondents regarding the changes that might produce high-quality earnings in Bahrain. From both the interviews and the survey, it can be noted that different stakeholders are more interested in sticking with the existing accounting standards and rules and regulations in Bahrain. However, they are willing to improve these standards and regulations by taking actions that help in their proper implementation. Therefore, most of the stakeholders agreed with the actions related to providing more guidance to ensure that every company is implementing what it should, by enforcing the existing standards. Moreover, regulators should review the regulations regularly and make any necessary changes to ensure that they are consistent with the requirements of the Bahraini market. In addition, regulators should disclose their punishments for failure to comply with the regulations, in order to deter company management from intentional wrong-doing. Theoretically, the rules and regulations that govern financial reporting are affected by the context of implementation. Institutional theory can explain how the rules and regulations in Bahrain are influenced by the contextual factors. These factors are mainly linked to the legal and social systems in Bahrain.

9.2.1.6 Motivation to manage earnings

The investigation into the motivation to manipulate earnings in Bahrain is one of the objectives of this study. The findings of the questionnaire survey show that there is no significant difference among the groups of respondents regarding the motives for manipulating earnings in Bahrain. The findings of the interviews and survey show that there is agreement on the following five main incentives for Bahraini managers to manage earnings: to influence stock price; to influence executive compensation; to avoid violation of debt covenants; because there is inside pressure to hit earnings benchmarks; and because senior managers fear adverse career consequences if they report poor performance. These incentives stem from the Bahraini conservative culture, which tries to maintain stability in respects. However, it has been indicated that Bahraini managers do not have much incentive to manage earnings to meet analysts' forecasts or to manage earnings in a similar way to other companies, as observed in prior studies. Theoretically, motivations to manage earnings may be explained by agency theory, which expects that the agent will attempt to maximise the objectives of the principal; however, when the agent's objectives conflict with those of the principal, agency theory expect that the agents will attempt to achieve their own objectives and maximise their own interests, rather than the principal's interests. Based on institutional theory, managers are affected by formal and informal pressures to manage earnings.

9.2.1.7 Red flags that assist in detecting earnings management

The interviews and survey findings show that the following red flags, which assist in detecting earnings management in Bahrain, obtained the highest support: "inconsistency with the previous year and with industry and economy norms"; "include extraordinary items"; "conflict between earnings movements and cash flow"; "inconsistency in choice of accounting methods"; and "less transparent reporting". It is interesting that different stakeholders believe that other signs, which have received little attention in the literature, can indicate earnings management in Bahrain. These include: related-party transactions; changes in management compensation (compared with industry norms and previous years); and opinions of independent third parties (e.g. credit agencies).

9.2.2 Secondary data

The expectation that beneficial corporate governance practices will improve earnings quality was, to a large extent, found to be inaccurate in Bahrain. With the exception of outsider and independent directors, state and managerial ownership, and outsider directors on the audit committee, which did affect earnings quality, none of the other corporate governance variables examined in this study had a significant effect on earnings quality.

Table 9.1. Hypotheses and the findings from the analysis of secondary data

Hypothesis No.	Hypothesis	Findings
1	*There is a positive relationship between board size and earnings quality*	Not supported
2	*There is a positive relationship between board meetings and earnings quality*	Not supported
3	*There is a positive relationship between outsider (non-executive) board members and earnings quality*	Supported at $p < 0.01$ (using smoothness)
4	*There is a positive relationship between independent outsider board members and earnings quality*	Not supported – significant but negatively related at $p < 0.01$ (using persistence)
5	*There is a negative relationship between the presence of politically connected board members and/or manager and earnings quality*	Not supported
6	*There is a positive relationship between the presence of a nomination and remuneration committee and earnings quality*	Supported at $p < 0.05$ (using smoothness)
7	*There is a positive relationship between the independence of the nomination and remuneration committee and earnings quality*	Not supported
8	*There is a positive relationship between audit committee size and earnings quality*	Not supported
9	*There is a positive relationship between audit committee meetings and earnings quality*	Not supported
10	*There is a positive relationship between outsiders on the audit committee and earnings quality*	Supported at $p < 0.01$ (using smoothness)
11	*There is a positive relationship between independence outsiders on the audit committee and earnings quality*	Not supported
12	*There is a positive relationship between use of the international big four auditors and earnings quality*	Supported at $p < 0.05$ (using smoothness)

13	*There is a relationship between a change in auditor and earnings quality*	Not supported
14	*There is a negative relationship between state ownership and earnings quality*	Not supported
15	*There is a negative relationship between family ownership and earnings quality*	Not supported
16	*There is a negative relationship between institutional ownership and earnings quality*	Not supported/supported at $p < 0.05$ (using smoothness)
17	*There is a negative relationship between individual ownership and earnings quality*	Not supported
18	*There is a negative relationship between managerial ownership and earnings quality*	Not supported/supported at $p < 0.01$ (using smoothness)
19	*There is a negative relationship between blockholder ownership and earnings quality*	Not supported

*Hypotheses related to the ownership structures are tested in the two empirical models; therefore, the findings column contains two findings if they are different under the two models.

The explanation for the lack of significant relationships may relate to members of the board and of the audit committee not responding to their duties. With respect to external audit factors, there is a monopoly in audit services in the Bahraini market and auditors lose their independence by continuing to audit the same company for a long time. In addition, a concentrated ownership structure, with the exception of state and managerial ownership, is less likely to offer good monitoring mechanisms. Overall, corporate governance mechanisms in Bahrain are at a preliminary phase and there is lack of knowledge of its importance.

9.3 Contribution

This study contributes to both the financial reporting and the corporate governance literature by providing a theoretical contribution through the exploring of the potential impact of corporate governance on the quality of financial reporting from an institutional perspective. It sheds light on how corporate governance practices affect the quality of financial reports, taking into consideration the contextual or environmental factors that shape these practices. Moreover, it suggests that institutional theory can complement agency theory in describing a number of financial reporting practices. Using institutional theory to describe corporate governance practices in developing countries like Bahrain is more appropriate than using agency theory alone. Furthermore, this study contributes to the methodological development in the field of financial reporting and corporate governance. It provides a practical example of how qualitative and quantitative research approaches can be combined and integrated to investigate a specific phenomenon. In addition, this study contributes to the debate on whether it will be possible to harmonise accounting practices and monitoring mechanisms globally. This research indicates that the efficiency of these practices and monitoring mechanisms differ from one context to another.

9.4 Implications

9.4.1 Theory implications

Agency theory is a dominant theory in the literature on financial reporting and corporate governance. Studies that address the quality of financial reporting and its links with corporate governance have used agency theory to justify the monitoring practices which have been employed to reduce agency costs (conflict of interest between shareholders and management). However, institutional theory views these practices as the result of coercion by legislators, who enforce these practices to improve the companies' effectiveness or to imitate other successful or well-developed economies.

Financial reporting and corporate governance practices have been justified in the literature using both agency and institutional theory. Agency theory supports the separation between ownership and management (agency cost). However, institutional theory suggests that these practices are influenced by formal and informal pressure within the institutional setting. Companies try to model themselves on other organisations to gain legitimacy.

Because of the unique characteristics of the Bahraini context (e.g. legal system, culture, religion, ownership structure, etc.) that can affect the financial reporting practices and the monitoring mechanisms, this study used the two theories (agency and institutional theory) to interpret the study's findings.

The findings related to earnings quality reveal that the measures of earnings quality, the factors that influence earnings quality and the motives to manage earnings in Bahrain can be explained by agency theory. However, in some situations the institutional theory makes better explanation. Some of these practices are influenced by formal or informal pressures that come from the regulators or society. Some regulations and other contextual factors (e.g. culture and social relations) affect these practices. For example, managers are motivated to manage earnings "to influence executive compensation", which is interpreted by agency theory as managers trying to do what is in their best interest. However, the small influence of the "company's external auditor" as a determinant of earnings quality can be interpreted by the institutional theory as indicating that external auditors in the Bahraini context lack independence. Therefore, both agency theory and institutional theory can provide explanations for financial reporting practices in Bahrain.

With regard to the impact of corporate governance practices on improving the quality of reported earnings, the study shows that most of the monitoring practices are not meeting expectation. This is not supported by agency theory, which suggests that, for example, ownership concentration, an audit committee and external audit can reduce agency costs (agency problem) by aligning the interests of the owners and managers with those of the company. However, these findings can be interpreted by institutional theory, which views these governance mechanisms as regulations imposed by legislators, who enforce these practices to improve the companies' effectiveness or to imitate other successful or well-developed economies.

This study provides a theoretical contribution, as it suggests that using institutional theory to describe corporate governance practices is more appropriate than using agency theory in developing countries like Bahrain. Moreover, institutional theory can be used as a complementary theory for agency theory in describing a number of financial reporting practices.

9.4.2 Professional implications

The findings of this study should be of potential interest to different stakeholders, including regulators, investors and auditors, in their attempts to improve the quality of reported earnings and the monitoring mechanisms. Regulators, the Ministry of Commerce, the Central Bank and the Bahrain Bourse can benefit from the findings of this study. They can use the findings to amend existing rules and regulations in order to provide more effective regulatory system. This will increase investor protection so it will satisfy existing investors and attract new ones.

In addition, the findings might contribute to a reduction in earnings management, as it highlights the motivations and techniques used by the managers and the changes in standards that could improve the current situation, and suggests some indicators of potential cases of earnings management. Therefore, regulators can protect the quality of reported earnings specifically and financial reporting generally by taking steps in the regulatory system that mitigate these earnings management practices.

The Bahraini code of corporate governance was established in 2011; therefore, this study can be considered an assessment of the current governance mechanisms. The findings could be used to develop and improve the existing code. The findings from the primary data (the interviews and survey) and the secondary data highlight many issues related to governance mechanisms, such as issues related to board members' independence and their awareness of their responsibilities and duties. Therefore, the findings could be a starting point for a number of actions that should be taken to enhance the effectiveness of the existing mechanisms.

Moreover, the findings indicate some issues related to the role of the audit committee in monitoring financial reporting. The data show that independence, selection process and competence are characteristics of the audit committee and its members that should be taken into consideration in improving the role of this mechanism. In addition, the findings reveal some issues related to the function of external audit. The findings indicate that external auditors are losing their independence, that the big four auditors are monopolising the market and that accountants are not fully prepared for the implementation of the IFRS. Thus, the findings are useful in developing and improving the auditing and accounting profession in Bahrain.

The findings show that there is no relationship between ownership structures and earnings quality. The reasons for the non-significant relationships might be a lack of awareness of most investors in term of their rights and duties. Therefore, the findings can assist regulators in developing and enhancing the awareness and skills of the investors by, for example, holding seminars and conferences regularly and requiring big investors to have plans for continuous learning.

In general, this study contributes to the debate on the global harmonisation of accounting practices and monitoring mechanisms. This research indicates that the efficiency of these practices and monitoring mechanisms differs from one context to another. The reasons for these differences relate to the contextual factors (characteristics) such as the legal/regulatory system, accounting infrastructure, business structures, political system and social and cultural system. For example, Bahrain drew up a reform plan to diversify its sources of income and reduce its oil-dependency. It started by adopting the international corporate governance and financial reporting practices and standards. But the findings of this study show that Bahrain has not achieved the expected results from implementing these practices and standards, because of the contextual factors that need to be taken into consideration during the implementation process. Therefore, the findings can also be a red flag for other oil-exporting countries (including GCC countries) which adopt these practices and standards to attract foreign investment and develop the non-oil parts of their economies.

9.5 Achieving the Research Objectives

This study has two main research objectives. The first involves understanding earnings quality in Bahrain. This will include understanding: the usage of earnings, the definition of earnings quality, measures and characteristics of earnings quality, the impact of standard setting on earnings quality, techniques used to manage earnings and the motives behind them, the red flags used to detect earnings management, and the determinants of earnings quality. The second research objective is to examine the role of corporate governance mechanisms in improving earnings quality in Bahrain.

The study does achieve its objectives. The study's findings reveal that earnings are used for valuing the companies and debt contracts, and for determining managers' compensation. The findings also indicate that high-quality earnings are sustainable, consistent, repeatable and predictable. Moreover, four main factors determine the quality of reported earnings: "firm characteristics", "corporate governance mechanisms", "macroeconomic condition" and "enforce the financial reporting regulations". Furthermore, five incentives that motivate managers to manipulate reported earnings received strong support from the survey respondents. These were: "to influence stock price"; "to influence executive compensation"; "to avoid violation of debt covenants"; "because there is inside pressure to hit earnings benchmarks"; and "because senior managers fear adverse career consequences if they report poor performance". The existing rules and regulations are adequate; however, more guidance on their implementation is needed. Agency theory and institutional theory provide an explanation for financial reporting practices (related to the quality of reported earnings) found in Bahrain.

The expectation that corporate governance practices will enhance the quality of reported earnings was, to a large extent, found to be inaccurate in Bahrain. Moreover, the interviews raised many interesting issues in relation to the effects of corporate governance variables. These findings include: the lack of Board of directors independence, the influence of government on companies' decisions, and the appointment of incompetent board members.

However, it should be noted that the findings of this study should be interpreted with caution in light of the limitations which will be discussed in the following section.

9.6 Limitations

Although this study has several strengths, there are also some limitations. The first, which is related to the collection of the primary data, is that the numbers of participants were small: 25 individuals were interviewed and there were 114 respondents to the survey. This limits the ability to generalise the findings to the entire population in Bahrain. The reasons for the small sample were: it is difficult to access the whole population; it takes a lot of time and effort to include a large portion of the population; and a significant part of the whole population lack knowledge and awareness of financial reporting and corporate governance practices. Therefore, this study attempted to select a balanced number of knowledgeable participants and respondents to represent each group of stakeholders.

Second, although the researcher provided the study participants and respondents with the background to the study and assured them of confidentiality, the interviewees might have been worried when the interviews were taped or notes are taken, as the topic under investigation is considered sensitive. The same problem might occur with the survey respondents.

Third, the study participants might answer questions inaccurately just to show the researcher that they are competent. In addition, the study did not employ a long survey; however, some participants might feel bored if they had to answer too many survey questions or provide random answers to finish quickly. Therefore, this study measures the reliability of the survey using Cronbach's alpha.

Fourth, this study covers the whole population of non-financial listed companies in Bahrain. It excluded financial and insurance companies because they operate under a different regulatory system and are subject to different reporting requirements. Therefore, the findings of this study cannot be generalised to all sectors of the Bahraini market.

Fifth, because of the availability of data, this study investigates earnings quality and the role of corporate governance over 10 years only. This might be too short a period to allow the researcher to capture the effectiveness of these practices.

Sixth, the existing literature indicates that there is no agreed measure for earnings quality and the existing measures have been criticised, as each measure might capture a different property of earnings. This study has used four measures of earnings quality, all mentioned as an important measures by different stakeholders in Bahrain in the interviews and survey findings (more details in the methodology chapter).

Seventh, there are some independent variables that this study should have considered, such as variables relating to audit (e.g. auditor fees, specialist auditors, non-audit fees). However, the lack of available data prevented the researcher from including them.

Eighth, the study did not include some potential control variables in the empirical models; however, this does not affect the results, as the aim of the study is to capture the association between earnings quality and different monitoring mechanisms (corporate governance practices) rather than to examine causality.

Finally, corporate governance mechanisms are quite new; therefore, the findings of this study might not reflect their effectiveness.

Despite these limitations, the study has strengths and contributes to the literature on financial reporting and corporate governance. However, overcoming these limitations might provide a platform for future research.

9.7 Areas for future research

This study makes a considerable contribution to the exploration of earnings quality and the role of corporate governance mechanisms in improving the quality of reported earnings in Bahrain. However, there are several areas that have not been covered by this study, in addition to the above-mentioned limitations, which provide a number of suggestions for future research.

Future research could further investigate the secondary data (regression) findings by using interviews to gain a deeper understanding of the results. Moreover, it is recommended that future research include financial listed companies as well as non-listed companies, as these contribute much to the economy and their practices may be different from those of the non-financial listed companies covered in this study.

Furthermore, the Bahraini code of corporate governance has been implemented only recently; therefore, future research should examine the role of corporate governance over a longer period. Finally, future research should consider extending this investigation to different contexts in order to provide more evidence on earnings quality and the role of corporate governance as monitoring tools from different economies, which will show the effect of the institutional setting (i.e. different contextual factors) on these practices.

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Appendices

Appendix 1

Invitation email for the survey potential participants

Dear (participant surname):

I am part of a team from the University of Nottingham in the UK which is conducting research into financial reporting quality in Bahrain. My name is Abdulla Aljalahma from the University of Nottingham and the University of Bahrain, which is sponsoring this research. The other members of the research team are Professor Elisabeth Dedman, Dr Jing Chen, and Dr Ahmed Derbala, all based at the University of Nottingham. The purpose of this study is to examine the influence of contextual factors on financial reporting quality of which are critical to an effective business environment.

Bahrain is currently working towards the establishment of a transparent business environment that is more attractive to overseas investors. We believe the results of this study will provide important information to policy makers in this context.

Your professional role would make you a valuable contributor for this study and I would very much like to benefit from your insights. In this study, you will be asked to complete an electronic survey (survey link will be provided below). The survey should take only 10 minutes to complete.

This survey has been approved by the Research Ethics Committee at The University of Nottingham. Participation is confidential. All of the response in the survey will be recorded anonymously. The results of the study will form part of my PhD thesis. In addition, they may be published in peer reviewed academic journals, other journals, or be presented in academic conferences. Participants will be provided with an executive summary of the results privately should they wish.

I will be happy to answer any question you have about the study. My email address is: abdulla.aljalahma@nottingham.ac.uk. If you have any questions concerning your rights as a research participant, you may contact the Research Ethics Officer at The University of Nottingham at christopher.carter@nottingham.ac.uk.

Thank you for your time and consideration.

Kind regards

Abdulla Aljalahma

Abdulla.aljalahma@nottingham.ac.uk

+97333339633/ +447776675000

Please click on the survey link below to provide us with your valuable insights:
http://www......com/Survey/U2L.....YM

Appendix 2

The Three survey versions

Earnings Quality in Bahrain (Regulators)

Welcome to Our Survey

Thank you for participating in this survey which should take less than 10 minutes. Your contribution will help us to understand the factors that influence the quality of earnings in Bahrain.

Please be assured that the information you provide in this survey will be anonymised.

Please do not forget to press the "Submit" button at the end of the survey or the information will be lost.

1. Please rate the importance of the following uses of reported earnings in Bahrain:

	Not Important				Very Important
For use by investors in valuing the company					○
For use in debt contracts	○	○	○	○	○
For use in executive compensation contracts					○
For use in negotiations with labour					
For use by current and prospective customers					○
For use by current and prospective employees					
For use by current and prospective suppliers					○
For use by outsiders in evaluating the company's manager					
For use by the company's own managers					○

Please use the space below to indicate any other uses for reported earnings in Bahrain:

2. Please rate the extent to which the following factors influence the quality of earnings in Bahrain:

	Not at all Influenced by		Somewhat Influenced by		Highly Influenced by
Firm characteristics (including the firm's: performance, debt, growth and investment, and size)	○	○	○	○	○
Company's industry	○	○	○	○	○
Macro-economic conditions (i.e. the country's overall economic conditions)	○	○	○	○	○
The business model of the company	○	○	○	○	○
How fast the operating cycle converts accruals to cash flows	○	○	○	○	○
Market analysts that follow the company	○	○	○	○	○
Private analysts (analysts of institutional investors) that follow the company	○	○	○	○	○
Company's reporting choices	○	○	○	○	○
Company's disclosure policy	○	○	○	○	○
Company's internal controls	○	○	○	○	○
Company's audit committee	○	○	○	○	○
Company's external auditor	○	○	○	○	○
Company's board of directors	○	○	○	○	○
The existence of concentrated ownership	○	○	○	○	○

Please use the space below to indicate any other factors that influence the earnings quality in Bahrain:

3. It is common practice for board members and/or managers of Bahraini companies to have political connections. In your opinion, does this practice have the potential to affect the quality of earnings?

◯ Yes

◯ No

Please explain your answer:

4. To what extent do you agree that the following statements capture important features of "high quality earnings"?

	Strongly Disagree	Weakly Disagree	Neutral	Weakly Agree	Strongly Agree
Are sustainable					
Are useful predictors of future earnings					
Are useful predictors of future cash flows					
Do not include one-time or special items					
Are less volatile than cash flows					
Result from conservative recognition of assets and liabilities	◯	◯	◯	◯	◯
Recognise losses in a more timely manner than gains					
Have accruals that are eventually realised as cash flows	◯	◯	◯	◯	◯
Have fewer accruals (i.e adjustments for revenue that have been earned but not recorded and expenses that have been incurred but are not recorded yet)					
Avoid unreliable estimates as much as possible	◯	◯	◯	◯	◯

4

	Strongly Disagree	Weakly Disagree	Neutral	Weakly Agree	Strongly Agree
Require fewer explanations in company communications (e.g. Management's Discussion and Analysis, conference calls etc.)					
Reflect consistent reporting choices over time	◯	◯	◯	◯	◯

Other statements that describe important features of "high quality earnings":

5. Please rate the importance of the following motivations for companies that use earnings to misrepresent economic performance:

	Strongly Disagree	Weakly Disagree	Neutral	Weakly Agree	Strongly Agree
To influence stock price					
To influence executive compensation					
To avoid violation of debt covenants					
To influence other stakeholders such as customers, suppliers and employees					
To reduce expectations of future earnings					
Because there is inside pressure to hit earnings benchmarks	◯	◯	◯	◯	◯
Because there is outside pressure to hit earnings benchmarks					
Because there is pressure to smooth earnings	◯	◯	◯	◯	◯
Because senior managers are overconfident or overoptimistic					
Because they feel other companies misrepresent performance	◯	◯	◯	◯	◯
Because they believe such misrepresentation will likely go undetected					
Because senior managers fear adverse career consequences if they report poor performance	◯	◯	◯	◯	◯

Other important factors that explain why companies misrepresent earnings:

6

6. What does the concept of "earnings quality" mean to you?

7. How could users of accounts distinguish between high-quality and low-quality earnings?

8. Your age group:

- 20 to 29
- 30 to 39
- 40 to 49
- 50 to 59
- 60 to 69
- 70 and above
- Prefer not to say

9. What is your main occupation?

- Policy maker
- Creditor
- Analyst
- Investor
- Financial Reports Preparer and Managers
- Auditor
- Board member
- Academic
- Other*

* Please specify:

10. How many years of experience do you have in this occupation?

- Less than 4 years
- 4 - 9 years
- 10 - 19 years
- 20 years or more

7

11. If you have secondary occupation(s) please select (you can select more than one):

Policy maker

Creditor

Analyst

Investor

Financial Reports Preparer and Managers

Auditor

Board member

Academic

Other*

* Please specify:

12. How many years of relevant experience do you have in total?

- ◯ Less than 4 years
- ◯ 4 – 9 years
- ◯ 10-19 years
- ◯ 20 years or more

13. What is your highest educational qualification?

- ◯ High School
- ◯ Diploma
- ◯ Bachelor
- ◯ Masters
- ◯ PhD
- ◯ Other*

* Please specify:

14. What is your Gender?

- ◯ Male
- ◯ Female

8

15. What is your nationality?

Bahraini

Other*

* Please specify:

16. Please tick the following box if you would like to receive the study summary.

Yes

Your email address

Earnings Quality in Bahrain (Managers)

Welcome to Our Survey

Thank you for participating in this survey which should take less than 10 minutes. Your contribution will help us to understand the factors that influence the quality of earnings in Bahrain.

Please be assured that the information you provide in this survey will be anonymised.

Please do not forget to press the "Submit" button at the end of the survey or the information will be lost.

1

Earnings Quality in Bahrain

1. Please rate the importance of the following uses of reported earnings in Bahrain:

	Not Important				Very Important
For use by investors in valuing the company					◯
For use in debt contracts	◯	◯	◯	◯	◯
For use in executive compensation contracts					◯
For use in negotiations with labour					
For use by current and prospective customers					◯
For use by current and prospective employees					
For use by current and prospective suppliers					◯
For use by outsiders in evaluating the company's manager	◯	◯	◯	◯	◯
For use by the company's own managers	◯	◯	◯	◯	◯

Please use the space below to indicate any other uses for reported earnings in Bahrain:

2. Please rate the extent to which the following factors influence the quality of earnings in Bahrain:

	Not at all Influenced by		Somewhat Influenced by		Highly Influenced by
Firm characteristics (including the firm's: performance, debt, growth and investment, and size)	◯	◯	◯	◯	◯
Company's industry	◯	◯	◯	◯	◯
Macro-economic conditions (i.e. the country's overall economic conditions)					◯

2

	Not at all Influenced by		Somewhat Influenced by		Highly Influenced by
The business model of the company	◯	◯	◯	◯	◯
How fast the operating cycle converts accruals to cash flows	◯	◯	◯	◯	◯
Market analysts that follow the company	◯	◯	◯	◯	◯
Private analysts (analysts of institutional investors) that follow the company	◯	◯	◯	◯	◯
Company's reporting choices	◯	◯	◯	◯	◯
Company's disclosure policy	◯	◯	◯	◯	◯
Company's internal controls	◯	◯	◯	◯	◯
Company's audit committee	◯	◯	◯	◯	◯
Company's external auditor	◯	◯	◯	◯	◯
Company's board of directors	◯	◯	◯	◯	◯
The existence of concentrated ownership	◯	◯	◯	◯	◯
Accounting standards (i.e. implementation of IFRS)	◯	◯	◯	◯	◯
Prospect of litigation	◯	◯	◯	◯	◯
The regulator's enforcement process	◯	◯	◯	◯	◯

Please use the space below to indicate any other factors that influence the earnings quality in Bahrain:

3. It is common practice for board members and/or managers of Bahraini companies to have political connections. In your opinion, does this practice have the potential to affect the quality of earnings?

◯ Yes

◯ No

Please explain your answer:

4. To what extent do you agree that the following statements capture important features of "high quality earnings"?

	Strongly Disagree	Weakly Disagree	Neutral	Weakly Agree	Strongly Agree
Are sustainable					
Are useful predictors of future earnings					
Are useful predictors of future cash flows					
Do not include one-time or special items					
Are less volatile than cash flows					
Result from conservative recognition of assets and liabilities	◯	◯	◯	◯	◯
Recognise losses in a more timely manner than gains					
Have accruals that are eventually realised as cash flows	◯	◯	◯	◯	◯
Have fewer accruals (i.e adjustments for revenue that have been earned but not recorded and expenses that have been incurred but are not recorded yet)					
Avoid unreliable estimates as much as possible	◯	◯	◯	◯	◯

	Strongly Disagree	Weakly Disagree	Neutral	Weakly Agree	Strongly Agree
Require fewer explanations in company communications (e.g. Management's Discussion and Analysis, conference calls etc.)					
Reflect consistent reporting choices over time	○	○	○	○	○

Other statements that describe important features of "high quality earnings":

5. Would the following changes in standard-setting produce higher quality earnings? Earnings quality would increase if the standard setting process were to:

	Strongly Disagree	Weakly Disagree	Neutral	Weakly Agree	Strongly Agree
Issue fewer new rules					
Issue more new rules	◯	◯	◯	◯	◯
Issue more detailed implementation guidance					
Emphasise detailed rules more than concepts and principles	◯	◯	◯	◯	◯
Allow managers greater professional judgment in preparing financial statements					
Allow reporting choices to evolve from practice					
Allow firms to choose either US GAAP or IFRS					
Modify the current accounting standards to suit the local environment					
Require more conservative rules					
Expand the use of fair value reporting					
Reduce the use of fair value reporting					
Enforce financial reporting regulations more strictly	◯	◯	◯	◯	◯

Other important changes in the standard setting environment that would produce higher quality earnings include:

6. What does the concept of "earnings quality" mean to you?

6

7. How could users of accounts distinguish between high-quality and low-quality earnings?

8. Your age group:

- ◯ 20 to 29
- ◯ 30 to 39
- ◯ 40 to 49
- ◯ 50 to 59
- ◯ 60 to 69
- ◯ 70 and above
- ◯ Prefer not to say

9. What is your main occupation?

- ◯ Policy maker
- ◯ Creditor
- ◯ Analyst
- ◯ Investor
- ◯ Financial Reports Preparer and Managers
- ◯ Auditor
- ◯ Board member
- ◯ Academic
- ◯ Other*

* Please specify:

10. How many years of experience do you have in this occupation?

- ◯ Less than 4 years
- ◯ 4 - 9 years
- ◯ 10 - 19 years
- ◯ 20 years or more

11. If you have secondary occupation(s) please select (you can select more than one):

- Policy maker
- Creditor
- Analyst
- Investor
- Financial Reports Preparer and Managers
- Auditor
- Board member
- Academic
- Other*

* Please specify:

12. How many years of relevant experience do you have in total?

- Less than 4 years
- 4 – 9 years
- 10-19 years
- 20 years or more

13. What is your highest educational qualification?

- High School
- Diploma
- Bachelor
- Masters
- PhD
- Other*

* Please specify:

14. What is your Gender?

- Male
- Female

15. What is your nationality?

◯

Bahraini

◯ Other*

* Please specify:

16. Please tick the following box if you would like to receive the study summary.

Yes ☐

Your email address

Earnings Quality in Bahrain (Other Users)

Welcome to Our Survey

Thank you for participating in this survey which should take less than 10 minutes. Your contribution will help us to understand the factors that influence the quality of earnings in Bahrain.

Please be assured that the information you provide in this survey will be anonymised.

Please do not forget to press the "Submit" button at the end of the survey or the information will be lost.

Earnings Quality in Bahrain

1. Please rate the importance of the following uses of reported earnings in Bahrain:

				Not Important	Very Important
For use by investors in valuing the company	○	○	○	○	○
For use in debt contracts	○	○	○	○	○
For use in executive compensation contracts	○	○	○	○	○
For use in negotiations with labour	○	○	○	○	○
For use by current and prospective customers	○	○	○	○	○
For use by current and prospective employees	○	○	○	○	○
For use by current and prospective suppliers	○	○	○	○	○
For use by outsiders in evaluating the company's manager	○	○	○	○	○
For use by the company's own managers	○	○	○	○	○

Please use the space below to indicate any other uses for reported earnings in Bahrain:

2. Please rate the extent to which the following factors influence the quality of earnings in Bahrain:

	Not at all Influenced by		Somewhat Influenced by		Highly Influenced by
Firm characteristics (including the firm's: performance, debt, growth and investment, and size)	○	○	○	○	○
Company's industry	○	○	○	○	○
Macro-economic conditions (i.e. the country's overall economic conditions)	○	○	○	○	○

2

	Not at all Influenced by		Somewhat Influenced by		Highly Influenced by
The business model of the company	○	○	○	○	○
How fast the operating cycle converts accruals to cash flows	○	○	○	○	○
Market analysts that follow the company	○	○	○	○	○
Private analysts (analysts of institutional investors) that follow the company	○	○	○	○	○
Company's reporting choices	○	○	○	○	○
Company's disclosure policy	○	○	○	○	○
Company's internal controls	○	○	○	○	○
Company's audit committee	○	○	○	○	○
Company's external auditor	○	○	○	○	○
Company's board of directors	○	○	○	○	○
The existence of concentrated ownership	○	○	○	○	○
Accounting standards (i.e. implementation of IFRS)	○	○	○	○	○
Prospect of litigation	○	○	○	○	○
The regulator's enforcement process	○	○	○	○	○

Please use the space below to indicate any other factors that influence the earnings quality in Bahrain:

3. It is common practice for board members and/or managers of Bahraini companies to have political connections. In your opinion, does this practice have the potential to affect the quality of earnings?

- ◯ Yes
- ◯ No

Please explain your answer:

4. To what extent do you agree that the following statements capture important features of "high quality earnings"?

	Strongly Disagree	Weakly Disagree	Neutral	Weakly Agree	Strongly Agree
Are sustainable	◯	◯	◯	◯	◯
Are useful predictors of future earnings	◯	◯	◯	◯	◯
Are useful predictors of future cash flows	◯	◯	◯	◯	◯
Do not include one-time or special items	◯	◯	◯	◯	◯
Are less volatile than cash flows	◯	◯	◯	◯	◯
Result from conservative recognition of assets and liabilities	◯	◯	◯	◯	◯
Recognise losses in a more timely manner than gains	◯	◯	◯	◯	◯
Have accruals that are eventually realised as cash flows	◯	◯	◯	◯	◯
Have fewer accruals (i.e adjustments for revenue that have been earned but not recorded and expenses that have been incurred but are not recorded yet)	◯	◯	◯	◯	◯
Avoid unreliable estimates as much as possible	◯	◯	◯	◯	◯

	Strongly Disagree	Weakly Disagree	Neutral	Weakly Agree	Strongly Agree
Require fewer explanations in company communications (e.g. Management's Discussion and Analysis, conference calls etc.)	○	○	○	○	○
Reflect consistent reporting choices over time	○	○	○	○	○

Other statements that describe important features of "high quality earnings":

5. Would the following changes in standard-setting produce higher quality earnings? Earnings quality would increase if the standard setting process were to:

	Strongly Disagree	Weakly Disagree	Neutral	Weakly Agree	Strongly Agree
Issue fewer new rules	○	○	○	○	○
Issue more new rules	○	○	○	○	○
Issue more detailed implementation guidance	○	○	○	○	○
Emphasise detailed rules more than concepts and principles	○	○	○	○	○
Allow managers greater professional judgment in preparing financial statements	○	○	○	○	○
Allow reporting choices to evolve from practice	○	○	○	○	○
Allow firms to choose either US GAAP or IFRS	○	○	○	○	○
Modify the current accounting standards to suit the local environment	○	○	○	○	○
Require more conservative rules	○	○	○	○	○
Expand the use of fair value reporting	○	○	○	○	○
Reduce the use of fair value reporting	○	○	○	○	○
Enforce financial reporting regulations more strictly	○	○	○	○	○

Other important changes in the standard setting environment that would produce higher quality earnings include:

6

6. Please rate the importance of the following motivations for companies that use earnings to misrepresent economic performance:

	Strongly Disagree	Weakly Disagree	Neutral	Weakly Agree	Strongly Agree
To influence stock price	◯	◯	◯	◯	◯
To influence executive compensation	◯	◯	◯	◯	◯
To avoid violation of debt covenants	◯	◯	◯	◯	◯
To influence other stakeholders such as customers, suppliers and employees	◯	◯	◯	◯	◯
To reduce expectations of future earnings	◯	◯	◯	◯	◯
Because there is inside pressure to hit earnings benchmarks	◯	◯	◯	◯	◯
Because there is outside pressure to hit earnings benchmarks	◯	◯	◯	◯	◯
Because there is pressure to smooth earnings	◯	◯	◯	◯	◯
Because senior managers are overconfident or overoptimistic	◯	◯	◯	◯	◯
Because they feel other companies misrepresent performance	◯	◯	◯	◯	◯
Because they believe such misrepresentation will likely go undetected	◯	◯	◯	◯	◯
Because senior managers fear adverse career consequences if they report poor performance	◯	◯	◯	◯	◯

Other important factors that explain why companies misrepresent earnings:

7. What does the concept of "earnings quality" mean to you?

8. How could users of accounts distinguish between high-quality and low-quality earnings?

9. Your age group:

- 20 to 29
- 30 to 39
- 40 to 49
- 50 to 59
- 60 to 69
- 70 and above
- Prefer not to say

10. What is your main occupation?

- Policy maker
- Creditor
- Analyst
- Investor
- Financial Reports Preparer and Managers
- Auditor
- Board member
- Academic
- Other*

* Please specify:

11. How many years of experience do you have in this occupation?

- Less than 4 years
- 4 - 9 years
- 10 - 19 years
- 20 years or more

12. If you have secondary occupation(s) please select (you can select more than one):

- ☐ Policy maker
- ☐ Creditor
- ☐ Analyst
- ☐ Investor
- ☐ Financial Reports Preparer and Managers
- ☐ Auditor
- ☐ Board member
- ☐ Academic
- ☐ Other*

* Please specify:

13. How many years of relevant experience do you have in total?

- ◯ Less than 4 years
- ◯ 4 – 9 years
- ◯ 10-19 years
- ◯ 20 years or more

14. What is your highest educational qualification?

- ◯ High School
- ◯ Diploma
- ◯ Bachelor
- ◯ Masters
- ◯ PhD
- ◯ Other*

* Please specify:

15. What is your Gender?

- ◯ Male
- ◯ Female

16. What is your nationality?

◯ Bahraini

◯ Other*

* Please specify:

17. Please tick the following box if you would like to receive the study summary.

☐ Yes

Your email address

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Appendix 3

Invitation letter for Interviewees

Nottingham University Business School

UNITED KINGDOM · CHINA · MALAYSIA

Nottingham University Business School
Jubilee Campus
Wollaton Road
Nottingham
NG8 1BB UK
t: +44 (0)115 846 6602
f: +44 (0)115 846 6667
www.nottingham.ac.uk/business

Dear Sir/Madam,

I am part of a team from the University of Nottingham in the UK which is conducting research into financial reporting quality and corporate governance in GCC countries. Your role would make you an ideal participant for this project and I would very much like to interview you about your experiences and opinions. My name is Abdulla Aljalahma from the University of Nottingham and the University of Bahrain, which is sponsoring this research. The other members of the research team are Professor Elisabeth Dedman, Dr Jing Chen, and Dr Ahmed Derbala, all based at the University of Nottingham.

The purpose of this study is to examine the influence of institutional settings on financial reporting and corporate governance both of which are critical to an effective business environment. I would like to discuss with you your views on what constitutes 'high quality' financial reporting and 'good' corporate governance and how these may be achieved in GCC.

Bahrain and other GCC countries are currently working towards the establishment of a transparent business environment that is more attractive to overseas investors. We believe the results of this study will provide important information to policy makers in this endeavor and therefore ask you to spare a little of your time to provide us with your valuable insights.

I will be travelling to Bahrain in December 2016 and would like to arrange to meet you and conduct an interview which should take around 45 minutes. I am able to travel to a place convenient for you and I am reasonably flexible about times.

If you approve, I would like to make an audio recording of our discussion. This will not be made available to anybody else, and is purely for the purpose of manufacturing an accurate record. Your participation will remain anonymous and study information will be kept in a secure location. The results of the study may be published or presented in the academic field, but your identity will not be revealed. An executive summary of the results will be sent to you privately should you wish.

I will be happy to answer any question you have about the study. My email address is: abdulla.aljalahma@nottingham.ac.uk. If you have any questions about your rights as a research participant, you may contact the Research Ethics Officer at The University of Nottingham at adam.golberg@nottingham.ac.uk.

Thank you for your consideration. I will call you within the next week to see whether you are willing to participate.

Kind regards

Abdulla Aljalahma

Abdulla.aljalahma@nottingham.ac.uk

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<u>Appendix 4</u>

<u>Interview Questions</u>

Earnings Quality

- How do you define “high quality “reported earnings?
- What are the characteristics and measures of high quality earnings?
- What is the usage of earnings?
- What factors can determine the quality of earnings?
- Do you think that managers manipulate earnings? If yes, what are the motivation to manipulate financial reports? What are the techniques that managers use to manipulate earnings? What are the indicators for the existence of any manipulation in financial reports?

Corporate Governance

- What does corporate governance mean?
- How do you evaluate the quality of corporate governance structure?
- Do you think that there any factor affecting the implementation of CG best practices? Any obstacles?
- How do you evaluate the role of corporate governance mechanisms (board of directors and its supporting committees, specially audit committee) in improving earnings quality specially after introducing the corporate governance code?

Other questions

- What does “audit quality” mean? How can it be measured?
- How do you evaluate the role of auditing in improving earnings quality?
- How do you evaluate the role of ownership structure in improving earnings quality?
- What actions would you recommend in order to improve financial reporting and corporate governance practices (mechanisms)?

Appendix 5

Reliability Test Used for the Survey: Cronbach's Alpha

Descriptive statistics of respondents' perceptions about the features of ''high quality earnings'' in Bahrain	
Questions	**Cronbach's (alpha) (Consistency-Reliability)**
Are sustainable	0.781 (0.880) [0.811]
Are useful predictors of future earnings	
Are useful predictors of future cash flows	
Do not include one-time or special items	
Are less volatile than cash flows	
Result from conservative recognition of assets and liabilities	
Recognise losses in a more timely manner than gains	
Have accruals that are eventually realised as cash flows	
Have fewer accruals (i.e adjustments for revenue that have been earned but not recorded and expenses that have been incurred but are not recorded yet)	
Avoid unreliable estimates as much as possible	
Require fewer explanations in company communications (e.g. Management's Discussion and Analysis, conference calls etc.)	
Reflect consistent reporting choices over time	

Descriptive statistics of respondents' perceptions about the following changes that can produce ''high quality earnings'' in Bahrain	
Questions	**Cronbach's (alpha) (Consistency-Reliability)**
Issue fewer new rules	0.671 (-) [0.497]
Issue more new rules	
Issue more detailed implementation guidance	
Emphasise detailed rules more than concepts and principles	
Allow managers greater professional judgment in preparing financial statements	
Allow reporting choices to evolve from practice	
Allow firms to choose either US GAAP or IFRS	
Modify the current accounting standards to suit the local environment	
Require more conservative rules	
Expand the use of fair value reporting	
Reduce the use of fair value reporting	
Enforce financial reporting regulations more strictly	

Descriptive statistics of respondents' perceptions about the factors that influence earnings quality in Bahrain	
Questions	**Cronbach's (alpha) (Consistency-Reliability)**
Firm characteristics (including the firm's: performance, debt, growth and investment, and size)	0.744 (0.527) [0.868]
Company's industry	
Macro-economic conditions (i.e. the country's overall economic conditions)	
The business model of the company	
How fast the operating cycle converts accruals to cash flows	
Market analysts that follow the company	
Private analysts (analysts of institutional investors) that follow the company	
Company's reporting choices	
Company's disclosure policy	
Company's internal controls	
Company's audit committee	
Company's external auditor	
Company's board of directors	
The existence of concentrated ownership	
Accounting standards (i.e. implementation of IFRS)	
Prospect of litigation	
The regulator's enforcement process	

Descriptive statistics of respondents' perceptions about the importance of reported earnings in Bahrain	
Questions	**Cronbach's (alpha) (Consistency-Reliability)**
For use by investors in valuing the company	0.564 (0.785) [0.832]
For use in debt contracts	
For use in executivecompensation contracts	
For use in negotiations with labour	
For use by current and prospective customers	
For use by current and prospective employees	
For use by current and prospective suppliers	
For use by outsiders in evaluating the company's manager	
For use by the company's own managers	

Descriptive statistics of respondents' perceptions of reasons why some Bahraini firms manipulate their reported earnings	
Questions	**Cronbach's (alpha) (Consistency-Reliability)**
To influence stock price	- (0.817) [0.837]
To influence executive compensation	
To avoid violation of debt covenants	
To influence other stakeholders such as customers, suppliers and employees	
To reduce expectations of future earnings	
Because there is inside pressure to hit earnings benchmarks	
Because there is outside pressure to hit earnings benchmarks	
Because there is pressure to smooth earnings	
Because senior managers are overconfident or overoptimistic	
Because they feel other companies misrepresent performance	
Because they believe such misrepresentation will likely go undetected	
Because senior managers fear adverse career consequences if they report poor performance	