Chapter 3
The Role of Corporate Governance in Mitigating Earnings Management Practices:
A Review Study

Nagat Mohamed Marie Younis
Faculty of Business, University of Jeddah, Saudi Arabia

ABSTRACT

The aim of the research is to clarify the role and importance of corporate governance (CG) mechanisms in mitigating earnings management (EM) practices. To achieve this objective, reference was made to previous studies and relevant research. An analysis was mentioned in accounting about the relationship between agency theory and earnings management clarifying the theoretical framework for earnings management from where the concept, motives, techniques of earnings management, methods of disclosure of earnings management, the risks resulting from earnings management, as well as know corporate governance, in terms of concept, goals, importance, principles, characteristics, and mechanisms of corporate governance, and finally, the role of corporate governance in limiting earnings management practices.

INTRODUCTION

The separation of ownership from corporate management results in an attempt to maximize the economic benefits for each party in company as the shareholders (owners/ principal) seek to preserve the company's assets to maximize the wealth of the owners, while the managers (corporate management/ agent) seek to maximize the rewards by achieving the largest level of profits for the companies that they manage. The agency theory is considered one of the most important theories that explain the behaviors resulting from the shareholders 'relationship with managers, and the accounting and financial information is the most important link between them, as the shareholders seek to review the financial statements to know the financial position of the company, while the management tries to influence the content of the financial

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statements in order to direct decisions to guarantees the realization of personal benefits for them, and this opportunistic behavior is called “Earnings Management”.

As a result of conflicts of interests between the owners and management and the rest of the stakeholders in the company, and according to the principle of rational choice, each party tries to maximize its own benefits over the interests of other, this a problem called the “agency problem”, so “agency theory” came as an attempt to solve that problem and limit management behavior by preferring their personal interests over the interests of other parties (Rodriguez, et al., 2016).

Earnings management has known that it a tool for satisfying the self-interest of the managers, it can be used for the welfare of the stakeholders if it is ethically used. To get the optimum benefit of earnings management, steps should be taken to improve corporate governance. Accounting standards should be revised to there remain no for manipulating earnings and auditors should be more careful in detecting earnings manipulation and their independence should be ensured (Alvarado, et al., 2019). Earnings management involves the manipulation of company earnings towards a pre-determined target. This target can be motivated by a preference for more stable earnings, in which case management is said to be carrying out income smoothing. Opportunistic income smoothing can, in turn, signal lower risk and increase a firm’s market value. Other possible motivations for earnings management include the need to maintain the levels of certain accounting ratios due to debt covenants, and the pressure to maintain increasing earnings and to beat analyst targets. (Wikipedia, 2019)

The successful techniques in earnings management are categorized into several sub-categories as follow: Big Bath Techniques, Cookie Jar Reserve Techniques, “Big Bet on the Future” and “Flushing” the Investment Portfolio, Write-off of Long-Term Operating Assets, Sale/Lease Back, Shrink the Ship, Introducing new standard, Operating versus non-operating Income, Early Retirement of Debt, Use of Derivatives. (Nia, et al., 2015) The companies practice earnings management through a set of methods and techniques, the most important of which are the following: the nature of accounting estimates, flexibility in accounting principles, changing the disclosure pattern used in the financial statements, structuring operations associated with inelastic accounting standards. Rigorous accounting standards, awareness of audit committee, corporate governance and the morality of the stakeholders play a necessary role to control earnings management.

To avoid the agency’s problem, the importance of applying the rules of governance came, especially after the Asian financial crises and the Enron scandal, which was the reason behind the discovery of manipulation of profits by management, which affected the reliability of the published financial statements (Palmer, et al., 2019), the changes in the global markets and the increasing intensity of competition between economic units, globalization and privatization programs that led to the implementation of governance, Therefore, many studies have urged to apply corporate governance mechanisms to provide reliability, honesty, and fairness in the information contained in financial statements, which would enhance financial reports quality, It control cases of fraud and manipulation with the financial statements, and in addition to the insufficient role of accounting standards in facing management practices in manipulating profits, It was necessary to search for ways to facing the earnings management phenomenon, and the solution was what is known as “corporate governance”. (Asogwa, et al., 2019)

Previous studies confirmed that recently there has been increased interest in corporate governance as a result of the transition to market economies, the transfer of capital across borders, the expansion of projects, the separation of ownership from management, and the weakness of internal control systems, especially on the practices of corporate managers, and the resulting collapse of some large economic units, such as Enron, WorldCom, and others, which led to mistrust of investors and stakeholders in the