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The Contribution of Corporate Governance in Mitigating Earnings Management Practices

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Abstract:

The study aims to show the contribution of corporate governance in mitigating earnings management practices. A descriptive-analytical approach was employed, presenting various concepts related to corporate governance and earnings management practices. The study explores the relationship between corporate governance mechanisms and their role in mitigating earnings management practices. The findings indicate that both internal and external governance mechanisms play a crucial role in deterring earnings management practices, enhancing the credibility of financial statements, and building users' trust in these statements.

Keywords: Corporate Governance; Corporate Governance Mechanisms; Earnings Management Practices.

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Introduction

In recent years, the world has witnessed several financial and economic crises that sparked extensive debate across various fields. Questions arose to understand the reasons behind these crises, with the 2008 financial crisis being the most recent example. These crises led to the insolvency of major global companies such as Enron and WorldCom, primarily due to creative accounting manipulations that eroded confidence in financial markets and the information contained in financial reports. Hence, the concept of corporate governance gained increased attention, becoming a central topic in the economies of many countries, whether advanced or developing. Corporate governance encompasses laws and principles governing and unifying the operational mechanisms of companies as corporate governance principles. This subject attracted researchers, resulting in numerous studies from various perspectives. Additionally, it garnered the interest of organizations and regulatory bodies that emphasized the earnings of this concept in regulating financial and managerial activities within companies. This represents the real role of these bodies in protecting shareholders' and investors' capitals, working to prevent financial crises in companies, and safeguarding them from earnings management practices."

Problem Statement

Based on the aforementioned context, the main problem addressed in this research paper can be formulated as follows: How does corporate governance contribute to mitigating earnings management practices?

Significance of the Study

This study derives its significance by addressing the topic of earnings management practices as one of the latest accounting practices that impact the credibility of financial statements, leading to misleading information for users of these statements. This necessitated increased attention to corporate governance and the activation of its internal and external mechanisms to ensure the quality of financial reports and protect the rights of shareholders and stakeholders.

Methodology of the Study

To familiarize ourselves with the subject and address the research problem, we adopted a descriptive methodology. This involved presenting key concepts related to the study variables (corporate governance and earnings management practices). We then explored the relationship between corporate governance and its role in mitigating earnings management practices.

1- Conceptual Framework of Corporate Governance

The issue of corporate governance has gained significant importance since the Asian financial crisis and a series of revelations about companies manipulating their financial statements, such as the Enron scandal, Parmalat, and WorldCom in the United States. This made it one of the crucial issues that garnered the attention of public, private, and professional regulatory institutions, as well as academics and business practitioners of all kinds. Despite the considerable variation in the level of interest between advanced and developing countries, some developing countries have shown suitable interest in this new concept. In many Arab countries, this concept has gained considerable attention, especially after the series of fluctuations and instability witnessed in their financial markets and their accession to the World Trade Organization.

1-1- Definition of Corporate Governance

Corporate governance has attracted practitioners' attention over the past three decades. This concept gained importance after the collapse of major global companies. However, before these events, the agency theory was previously revealed by Jensen and Meckling (1976). According to the agency theory, the purpose of corporate governance is to alleviate conflicts of interest not only between managers and owners but also among all internal and external stakeholders, aiming to maximize shareholder wealth. (Hussein Al-Rassas, 2022, p. 495)

- It has also been defined by the Organization for Economic Co-operation and Development (OECD) in its 2015 meeting with representatives of the G20 countries, corporate governance is " 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 oversight performance are determined". (OECD, G20/OECD Principles of corporate governance, 2015, p. 9)

- Gérard Charreaux, a pioneer in the field of corporate governance, defined it as "a set of mechanisms that have an impact on determining powers and influencing the decisions of managers. In other words, it governs their behavior, actions, and defines their discretionary space when making decisions." (Charreaux & Peter, 2006, p. 7)

- It is also defined as "structures, processes, cultures, and systems that engender the successful operation of organizations." (Chelery Komath , Dogan, & Sayilir, 2023, p. 2)

In conclusion, a comprehensive definition of governance can be inferred as a complete system that determines the laws and principles governing the relationships between key parties in the company, starting from the board of directors, executive management, and shareholders. It also works to control the company's operations and management to achieve transparency, fairness, and, consequently, the company's goals and continuity.

1-2- Principles of Corporate Governance:

The principles of corporate governance set by the G20 and the Organization for Economic Co-operation and Development (OECD) assist policymakers in evaluating and improving the legal, regulatory, and institutional framework of corporate governance. The aim is to support economic efficiency, sustainable growth, and financial stability. These principles include: (Al-Abed, 2022, pp. 95-104)

1-2-1-Ensuring the Existence of an Effective Corporate Governance Framework:

The corporate governance framework should enhance transparency, fairness, market efficiency, and efficient resource allocation. It must be in line with the rule of law, encompass effective oversight and enforcement. Effective governance requires a legal and institutional framework for all market stakeholders to rely on in completing their contractual relationships. This framework may include obligations that can be either optional or mandatory.

1-2-2-Rights and Equal Treatment of Shareholders and the Key Functions of Property Rights Holders:

The governance framework should protect shareholders and facilitate the exercise of their rights. It must ensure equal treatment for all shareholders, including small and foreign shareholders. All shareholders should have the opportunity to receive actual compensation in case of rights violations.

1-2-3-Institutional Investors, Stock Markets, and Other Intermediaries:

The corporate governance framework should provide sound incentives throughout the investment chain and allow stock markets to operate in a manner that contributes to good corporate governance.

1-2-4-The Role of Stakeholders in Corporate Governance Practices:

The governance framework should recognize the rights of stakeholders established by law or resulting from mutual agreements. It should encourage active cooperation between companies and stakeholders in creating wealth, job opportunities, and achieving project sustainability on sound financial foundations. The principle underlying this is that the success of the company and the improvement of its competitiveness result from the collaborative efforts of all stakeholders.

1-2-5-Disclosure and Transparency:

The corporate governance framework should ensure accurate and timely disclosure of all significant matters, including financial position, performance, property rights, and the company's governance practices.

1-2-6- Responsibilities of the Board of Directors:

Corporate governance practices should provide strategic guidance for steering the company. They should ensure oversight of executive management by the board of directors and guarantee accountability of the board to the company and shareholders.

1-2-7- Sustainability and Flexibility:

This principle emphasizes the necessity of enhancing disclosure related to sustainability, including the use of internationally recognized standards and reliable metrics. It advocates the gradual implementation of sustainability disclosure to ensure its continuity. Additionally, guidelines should be provided regarding the concept of relative importance (OECD, Revised G20/OECD Principles of Corporate Governance, 2023)

Most literature agrees on distinguishing between two groups of governance mechanisms: external mechanisms imposed by the external environment of the company, such as external auditing, laws, ethics, societal values, securities markets, and internal mechanisms applied by the company itself to ensure respect for contractual relationships with internal stakeholders (Hamlaoui & Zenini, 2021, p. 2242). We will discuss these mechanisms in detail in the third section.

2- Conceptual Framework of Earnings Management Practices

The accounting literature has presented several concepts related to earnings management, each approached from different perspectives. The scholars have used a wide range of expressions to describe the phenomenon in its various aspects. In this section, we will delve into the concept, nature, motives, and methods of earnings management, along with the risks associated with it.

2-1- **Definition of Earnings Management Practices:**

Various definitions have been proposed for earnings management practices, including the following:

- Mulford and Comiskey defined it as: "The active manipulation of accounting results with the purpose of creating an altered impression of business performance, distorting the true financial performance of the company to achieve the desired outcome" (Mulford & Comiskey, 2002, p. 59)

- Healy & Wahlen offered a more comprehensive definition. According to their definition: "earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports either to mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers." (Ghazali, Shafie, & Sanusi, 2015, p. 192)
- Earnings management is described as "a process of taking deliberate steps within the bounds of accepted accounting principles, generally accepted, with the aim of achieving the required level of declared profits in financial statements" (Al-Fayoumi, Abuzayed , & Alexander, 2010, p. 29)

Based on the preceding definitions, the following definition can be proposed for earnings management practices: it is a set of methods and decisions made by financial statement preparers aimed at directing profits to achieve specific objectives without compromising accepted accounting principles, even if these objectives harm investors or other relevant parties.

2-2- Motives for Earnings Management Practices:

Companies resort to adopting earnings management practices for several motives. In this regard, Beneish (2001) identified two perspectives regarding these practices. He discussed that earnings management is a phenomenon that focuses on controlling financial reports based on opportunistic motives, where managers seek to deceive investors about the actual performance of the company to achieve their personal interests or comply with contractual terms. Alternatively, there are informational motives, where managers use earnings management as a means to influence investors and financial statement users by disclosing information aligned with their expectations about the company's future cash flows.

In the same context, the Positive Accounting Theory provides an explanation for the motives behind earnings management. It assumes that managers, as rational individuals, are expected to take actions and choose alternative accounting policies to maximize their personal benefits, especially in the absence of information symmetry. In other words, if managers are given the freedom to choose among accounting policies used for financial reporting purposes, they are likely to choose policies that maximize their personal benefits. Naturally, various incentives can lead managers to engage in earnings management. From this perspective, Healy

& Wahlen (1999) categorized the motives for managing a company's earnings into four: (Walaa, 2021, pp. 14-15)

2-2-1- Motives Related to Bonus and Incentive Plans:

Executives, who are always seeking to maximize their rewards, may manipulate earnings to achieve the desired level if the current year is weak. They may also reduce earnings if it exceeds the level at which they postpone the increase in profit to years when profits are at a lower level.

2-2-2-Motives Related to Contractual Agreements and Debt Covenants:

Debt contracts, for example, include commitments that the borrower must adhere to during the contract period. Violating these commitments can lead to high costs for the company, such as increased interest rates or additional restrictions on operational investment policies. This compels companies to disclose earnings that comply with these commitments.

2-2-3- Motives Related to Capital Market Expectations:

Capital market expectations, also known as value relevance, refer to the reliability of accounting information's relationship with the company's market value. In this regard, management may have motives to increase reported earnings to match the financial market's expectations or to avoid disclosing losses or performance declines that contradict analysts' expectations, contributing to confirming the company's future expectations.

2-2-4-Regulatory Interventions and Potential Issues:

Some studies have affirmed that companies, in times of recession or economic crises, may deliberately reduce their profits as a way to blame government entities. When the state regulates or sets prices, companies may reduce reported earnings to express the negative impacts of those government policies on companies. Additionally, companies may reduce profits to minimize tax burdens, especially in the case of changes in tax laws, aiming to transfer profits from periods with high tax rates to periods with lower tax rates.

2-3- Earnings Management Methods:

There are three methods for earnings management, as follows (Waqees & Gouali, 2020, p. 15) :

2-3-1- Accruals Management:

The accrual-based accounting system requires managers, according to generally accepted accounting standards, to make various accounting estimates that significantly impact reported profits. Among the accounting estimates that can affect profits in one way or another are:

- Long-term construction contracts require estimates related to the progress of work and the cost of completion. Managers can use optimistic estimates of work progress to inflate profits ;
- Depreciation calculation requires estimating the useful life and scrap value of depreciable assets. Managers can use optimistic estimates for the useful life and scrap value to reduce depreciation expenses, thereby inflating profits ;
- Accounts receivable should be presented at the net realizable value. Therefore, managers can use optimistic estimates for the collectible values to reduce the allowance for doubtful debts and, consequently, inflate profits ;
- Full profits from asset sales should be recognized in the sales period. Managers can manipulate the timing of asset sales, such as securities and financial assets, to support profits ;
- Prepaid costs for asset warranties should be expensed over the warranty period. Managers can reduce current expenses by using optimistic estimates for warranty costs to inflate profits ;
- Treating maintenance expenses as extraordinary expenses, as maintenance is capitalized, can be considered a capital expenditure. Managers can strengthen current profits by treating regular maintenance expenses as extraordinary expenses ;
- Managers can encourage customers to accelerate purchases by reducing prices to increase sales and, consequently, support profits ;
- Inventory should be recorded at cost or market, whichever is lower. Managers can use optimistic market values to reduce inventory value, thereby practicing earnings management.

2-3-2- Choosing an Appropriate Timing for Applying Mandatory Accounting Policies:

When a new accounting standard is issued, a later effective date is set for its application. However, accounting standards usually allow for early adoption of any standard before a specified date, giving companies the opportunity to adopt it early or wait until the specified application date.

2-3-3- Optional Accounting Changes:

This involves transitioning from one accounting method to another.

3- **Contribution of Corporate Governance Mechanisms in Mitigating Earnings Management Practices**

The role of corporate governance lies in alleviating agency problems and reducing agency costs to maximize shareholder wealth. Previous studies have found that companies with good corporate governance exhibit better performance, higher stock liquidity, and a lower likelihood of default. Specifically, effective corporate governance works to mitigate the inconsistency of information among shareholders, external parties, and stakeholders, thereby enhancing the transparency of company information. Since managers tend to have access to privileged information and specific expertise in all aspects of the company's operations, severe ethical risks can arise due to the inconsistency of information between shareholders and external parties. Many studies have confirmed the benefits of governance mechanisms, such as audit committees, characteristics of board members, and external audits, in reducing agency costs and information inconsistency, thereby reducing the opportunity for profit manipulation (Nguyen, Kim, & Ali, 2023, p. 778)

3-1-Contribution of the Board of Directors in Limiting Earnings Management Practices

The Board of Directors is described as one of the most important mechanisms in the company. It bears the responsibility of monitoring, supervising, advising senior management, and leading regulatory affairs to protect the interests of company shareholders. Both the Sarbanes-Oxley Act and stock market rules related to corporate governance suggest that a Board of Directors with more independent members has a lower rate of accounting fraud and earnings management (Attia, Ismail, & Mehafdi, 2022, p. 3) . The literature, both theoretical and empirical, indicates that the effectiveness of the oversight role of board members in limiting opportunistic behaviors of managers in earnings management depends on the presence of certain characteristics. (Tabar, 2019, p. 5)

Accordingly, we attempt to explain the impact of each characteristic of the Board of Directors in regulating earnings management practices, as follows (Walaa, 2021, pp. 90-91):

1- Board Size: Some studies suggest that it is wise to pay attention to the number of board members, keeping it no more than nine individuals in optimal situations. This stems from the idea that large boards often face challenges in communication, task completion speed, and the effectiveness of decisions. Jonsen (1993) stated that a small board improves performance, while boards exceeding (7) or (8) members are less likely to operate efficiently and effectively. Field studies testing the impact of board size on earnings management practices have varied results. While Klein (2002) and Davidson & Dadalf, Xie (2003) found that a larger board benefits a company through the diversity of members' experiences and their ability to deal with the environment better, establishing a correlation between board size and earnings management practices. They concluded that the likelihood of financial statements being subject to earnings management is lower as the board size increases.

2- Independence of the Board of Directors: Independence is the most impactful factor in the effectiveness of the supervisory and oversight board to limit managers' ability to act in their self-interest. Having external members on the board is often more vigilant about the rights of shareholders. This stems from their keenness to enhance their professional reputation regarding their capabilities and experiences in supervising managerial decisions. Numerous studies have highlighted the importance of the independence of the board of directors in regulating managerial opportunistic practices. Chtourou Courtean (2001) demonstrated that earnings management practices leading to increased net profit tend to be lower in companies with boards that include external members.

3- Separation of the Positions of Chairman and CEO: The separation between the roles of Chairman of the Board and CEO is an effective means to reduce agency costs and improve performance. This is achieved by subjecting the performance of executives to the scrutiny of the board members, motivating managers to enhance their performance and align it with the goals of shareholders. This separation ensures continuity in their positions, receiving agreed-upon rewards, and stands in contrast to the integration of roles. Merging these roles places the company under the control of one person, allowing them to manipulate information about the company's activities presented to the board in a way that aligns with their goals. This weakens the board's role and effectiveness in overseeing managers, increasing the impact of information asymmetry. Jensen (1993) emphasized that the manager should not hold the position of the board chairman, as this would compromise their ability to separate their personal interests from those of the shareholders.

4- Number of Board Meetings (Activity): Although there is no specific number of meetings, board members should convene at least four times a year to approve interim financial statements. The frequency of board meetings has been used in previous studies as an indicator of the board's activity and diligence. Boards that convene frequently are likely to be more committed to performing their duties in line with shareholder interests, allocating more time to study and control complex issues such as earnings management, conflicts of interest, and managerial monitoring. Conversely, inactive boards that rarely convene are less effective in overseeing managers, lacking sufficient time to address such intricate matters due to their limited time available for routine plan reviews.

3-2-Contribution of Audit Committees to Mitigating Earnings Management Practices:

The importance of the audit committee in enhancing the quality of financial reports has gained increasing recognition in recent years. Numerous studies have affirmed its role in supporting the credibility of financial data, considering it an oversight tool created to bridge information gaps between management and stakeholders. One of its primary duties is the regular oversight of managerial opportunistic practices. According to the literature on audit committees, the committee's characteristics are what effectively determine its efficiency. The optimal size of the audit committee and the appropriate combination of skills and knowledge are crucial to supporting the committee's ability to identify and prevent earnings management. Companies with audit committees and a higher percentage of independent members with backgrounds in corporate or investment banking have lower rates of earnings management based on merit.

The following section of this paper will explore how the audit committee affects earnings management procedures by studying the impact of the committee's independence, expertise, and the number of its activities (Heidi Mahmoud, Mohamed Moustafa, & Mohamed Bahaa, 2022, p. 1442)

3-2-1-Independence of the Audit Committee:

The independence of committee members is deemed necessary for the audit committee to exercise its judgment neutrally regarding the company's financial reports. It can also serve as a feature to reduce contracting costs. Companies with entirely independent audit committees are less likely to engage in aggressive earnings manipulation. In fact, it has been confirmed that when the board is less independent, and there is no audit committee, companies tend to engage in fraudulent financial reporting. Therefore, an independent audit committee is expected to be more effective in preventing earnings manipulation. The minimum number of audit committee members is three, with one of them being an independent commissioner who also serves as the committee's chair. Several criteria related to independent members which consist in: (1) Should not have a familial relationship with board members, commissioners, or major shareholders, (2) Should not have a direct or indirect employment relationship with the company, (3) Should not be a direct or indirect shareholder in the company or other public companies, (4) Should not have been responsible for directing and oversight the company's activities at least six months before appointment. These criteria are essential to significantly isolate the member from the control of specific parties.

A study conducted by (Bedard et al. 2004) examined the possibility of engaging in earnings manipulation between companies with 100% independent audit committee members compared to those with a majority of independent members. They found that companies with 100% independent audit committee members were less likely to engage in aggressive earnings manipulation. Results of a study conducted in Malaysia by Saleh et al. (2007) also demonstrated that a company is less inclined to engage in earnings manipulation if all audit committee members are independent (Melinda Lydia & Billy Ivan, 2019, p. 88) .

3-2-2-The Relationship between Financial Expertise of Audit Committee Members and Earnings Management Practices:

The results of many previous studies have shown that audit committee members with experience in financial report preparation, along with previous experience as members of other audit committees, contribute to supporting external auditors in case of disputes between them and management over matters considered material from the auditor's perspective. These matters impact the credibility of financial statements. An audit committee consisting of members with financial expertise is more effective in overseeing management actions and limiting their ability to report earnings in a way that serves their own interests through creative accounting practices. This indicates a positive relationship between the financial expertise of audit committee members and the quality of financial reports. It is considered that the likelihood of earnings manipulation is linked to having an audit committee with weak financial expertise. Companies with audit committee members with good financial experience are less likely to undergo a process of financial report restatement. The greater the financial expertise of audit committee members, the less prevalent earnings management practices become (Fadawi, 2014, p. 252).

3-2-3-Relationship between Audit Committee Activities and Earnings Management Practices: To achieve the desired benefits of the independence and expertise of the audit committee, the committee must be effective and active in carrying out its duties and responsibilities. Many studies have addressed the topic of audit committee activity, with most studies using the number of audit committee meetings as a measure of committee activity. Examining the relationship between audit committee activity and the likelihood of financial reporting manipulation, we can conclude that companies with audit committees meeting at least twice annually have a lower likelihood of facing penalties due to financial reporting issues. The increase in the frequency of meetings contributes to enhancing the quality of financial reports. This is because a higher number of meetings provides audit committee members with more time to better assess financial reports. It is observed that the number of audit committee meetings positively influences the improvement of financial report quality, indicating a positive impact on earnings management practices (Fadawi, 2014, pp. 252-253)

Audit committees are among the most important internal and control mechanisms in companies due to their vital role in ensuring the quality of financial reports and protecting the rights of shareholders. They also play a fundamental role in limiting earnings management practices through the execution of their assigned tasks.

3-3-Contribution of Internal Audit to Mitigating Earnings Management Practices:

Internal audit serves as a daily review of management decisions and actions. The quality of its activities and the efficiency of its procedures limit the management's ability to intervene in the preparation of reports and financial statements. This includes interventions in accounting estimates, choices between alternatives, and accounting policies. Thus, internal audit confronts earnings management practices, improves their quality, and requires a good understanding of the motives and methods of earnings management (Kafous, 2021, p. 123).

Earnings management has led to a crisis of confidence in the accounting and auditing profession and its ability to confront the risks of fraudulent management practices, especially concerning the accounting profit figure, which is the most important accounting information for financial statement users. This has been affirmed by numerous accounting studies. The quality of internal audit activities, including academic qualifications, professional certifications, training, practical experience, knowledge of company operations, organizational independence, and non-participation in executive tasks, is crucial. A well-performing control system contributes to limiting earnings management and improving its quality. Internal audit gains importance as a governance mechanism due to its positive role in providing warning signals about earnings management. It provides objective confirmation by examining and evaluating financial, operational, and governance activities in management. Moreover, it offers consulting services by providing information to management, along with consultations and recommendations to enhance performance and achieve effective communication between all relevant parties. (Tareq Mohamed Al-Hassan & Kamal Ahmed, 2022, p. 15)

Several studies have emphasized the necessity of having quality standards for internal audit activities, which have been categorized into three criteria: professional competence, objectivity, and performance quality.

- Professional competence can be determined through the following elements (Belkacem Kahouloul, 2020, p. 110):
  - ➢ The educational level attained by the internal auditor;
  - ➢ Professional experience and knowledge of the company's operations and industry;
  - ➢ Level of technical training.

As for the objectivity standards, represented by the presence of an effective internal audit system, it enhances the role of internal auditors in preventing and detecting earnings management practices. This depends on fulfilling the following elements (Boukaba & djinidi, 2019, pp. 216-217):

- Holding regular meetings between the head of internal audit and the audit committee regarding the process of financial statement preparation;
- Establishing a unified financial statement review function consisting of the audit committee, internal auditors, external auditors, and a senior management team regularly assessing the quality, reliability, and integrity of the financial statement preparation process;
- Organizing close cooperation between internal and external auditors through an integrated audit planning process involving the exchange of audit plans, programs, results, and reports;
- Requiring internal auditors to report the results of the financial statement preparation review, especially when there are indicators of earnings management practices, to the audit committee or the board of directors;
- Escalating reports to approved organizational departments or even stakeholders when the audit committee fails to address earnings management results in financial statements for internal auditors through violation reporting programs;
- Enhancing the status of internal auditors as part of corporate governance through senior-level reports;
- Evaluating the efficiency and effectiveness of the internal control structure, especially those related to financial statement preparation;
- Assessing the quality of the financial statement preparation process, including reviewing all annual and quarterly financial statements

deposited with securities and stock exchanges and other regulatory authorities;

- Collaborating with the audit committee and external auditors in reviewing management's discretionary decisions, selection judgments, principles, and accounting policies related to financial statement preparation;
- Evaluating the risks and the control environment related to the financial statement preparation process by ensuring that updates to financial statement preparation risks and associated controls are sufficient and effectively reviewed.

Under today's world developments, especially the increased competition among institutions, no institution can afford the high costs resulting from ignoring and neglecting the risks of earnings management practices, whether in the short or long term. To prevent such practices, the role of internal auditors must be strengthened, given their leadership role in detecting and raising awareness within the institution's management and staff about the risks of earnings management and the importance of early detection. Therefore, institutions must expand the responsibilities of internal auditors to include duties related to both oversight and investigating to better protect the institution from the consequences of earnings management and fraudulent financial statements. Ultimately, it is not the sole responsibility of internal auditors to pinpoint the location of earnings management, but it is essential to focus on prevention and detection.

3-4-Contribution of External Audit in Limiting Earnings Management Practices

The increase in scandals has led to the imposition of higher quality standards for auditing as a key strategy to verify the occurrence of earnings management. Numerous studies have emphasized the central role of external audit in deterring earnings management behavior by enhancing the credibility of financial reports prepared by management, benefiting stakeholders. Given the agency problem inherent in the contracting theory between shareholders and managers, external auditors are appointed and engaged to uncover material misstatements, thus eliminating or minimizing agency costs, such as earnings management. As stipulated in the International Standard on Auditing (ISA) No. 240, "The Auditor's Responsibilities Relatedw to Fraud in an Audit of Financial Statements" issued by the International Auditing and Assurance Standards Board (IAASB) affiliated with the International Federation of Accountants (IFAC), the primary responsibility lies in the management or those charged with governance in the entity to ensure the prevention and detection of fraud. This is usually achieved through the establishment of excellent internal controls. Additionally, external auditors bear the challenging task of planning and conducting the audit process to minimize audit risks under specific circumstances (Soyemi, Olubukonla, & Adeyemi, 2020, p. 33)

To study the relationship between external audit and earnings management practices, some studies have analyzed the relationship between certain characteristics related to the external auditor's profession and their impact on earnings management practices. These characteristics include their independence, professional skills, reputation, and the size of the auditing firm, among which we mention:

3-4-1-Relationship between Independence and Objectivity of External Audit in Earnings Management Practices:

Neutrality, objectivity, and independence of the external auditor are considered the cornerstone of the trust added by their report to the financial statements of the entity. Independence begins with the start of the audit process and ends with the completion of the final stage, which is the preparation of the reports. Therefore, the auditor's independence is considered the cornerstone of the auditing profession and one of the main reasons for its existence. The more the auditor possesses integrity and objectivity, the greater their ability to detect earnings management practices. Conversely, if the auditor's independence is doubted, confidence in the financial statements bearing their certification is shaken, making them difficult to rely on for sound economic decision-making. (Saeed Mohammed Saeed, 2011, pp. 89-90)

Relationship between Industry Specialization of External Auditors and Earnings Management Practices: Industry specialization, although limited in value in routine tasks, can be of significant value in complex tasks. An external auditor specialized in the industry of the client's operations has the subject of the audit structured knowledge that helps in building strong and distinctive judgments. This positively reflects on their performance and reduces earnings management practices (Walaa, 2021, p. 93).

3-4-2-Relationship of Qualification and Skill of External Auditors in Earnings Management Practices:

In order to enhance the performance of external audit to limit earnings management practices, there are several mechanisms and conditions, the most important of which are: (IKHLEF & TORCHI , 2020, p. 9)

- Availability of qualified human resources and their training, as such competencies ensure the best achievement of the work assigned to the audit office;

- The auditing profession requires individuals with specific qualifications, possessing awareness of professional culture, and sufficient knowledge of various economic activities and developments in the business environment;
- Audit offices or accounting firms must assess the feasibility of relying on what they provide to the company's management, which is the verification of data and information;
- The auditor's task is not easy, especially considering the complexity of the company's activities and the continuous evolution in production, marketing, and finance methods, which are no longer limited to traditional methods. Topics such as financial statement imaging techniques and disclosures requiring different accounting standards and commitments have become crucial.

3-4-3-Relationship between Fees of External Auditors and Earnings Management Practices:

In some cases, high fees for external auditors are associated with overlooking material violations, while in other cases, high fees may be linked to the additional effort made by the auditor to ensure the integrity of the financial statements. The higher the fees of the external auditor, the more dedicated they are to limiting earnings management practices. (Walaa, 2021, p. 93)

3-4-4-Relationship of the Tenure of External Auditors with Earnings Management Practices:

The length of service weakens the independence of the external auditor and encourages management to engage in earnings management behavior. Therefore, the shorter the tenure of the external auditor, the greater their ability to detect and address earnings management practices. This is in line with the recommendations of the Securities and Exchange Commission (SEC) in 1998, which supported the independence of external auditors and set guidelines to limit the size and tenure of services they provide. (Walaa, 2021, p. 93)

3-4-5-Relationship between the Service Period of External Auditors and Earnings Management Practices:

Many studies have addressed the research aspect related to the retention period of audit firms' clients. The results of these studies lead to two aspects. The first is the negative effects associated with the length of the audit firm's client retention period, resulting in a growing relationship between the audit firm and the management of the audited entity. This negatively affects the independence of the external auditor and the quality of financial reports. Also, there is a decrease in professional skepticism and objectivity in the audit process with an increase in the client retention period. (Al-Qudah, Hamidat, & Al-Harout, 2019, p. 183)

As for the second aspect, which indicates that the length of the audit firm's client retention period has positive effects, the most important of which is the increase in knowledge and experience of the audit team in the client's industry. This facilitates the high-quality execution of the audit process, ensuring its success. Due to the negative effects mentioned earlier, some countries found it necessary to enact laws and guidelines specifying the legal duration for retaining new and existing clients who will undergo re-auditing. France, for example, compels audit firms operating within its territories to retain clients for no more than six years. In Algeria, the tenure of auditors is set at three years, renewable once, according to Article 27 of Law No. 10/01 related to the professions of accounting expert and auditor. (Official Journal, 2010, p. 7)

External audit is considered one of the most important external mechanisms that ensure the quality of financial reports, providing reliable and accurate information to its beneficiaries. It also plays a crucial role in limiting earnings management practices. External auditors conduct necessary tests to verify the accuracy of accounting data and its reflection of the financial operations of the economic entity. This necessitates the presence of independence, competence, and objectivity in external auditors to enable them to detect earnings management practices and take the necessary steps to prevent their occurrence.

Conclusion

Through this research paper, we aimed to highlight the contribution of corporate governance mechanisms in limiting earnings management practices. Each governance mechanism, whether internal or external, plays a significant role in deterring these practices and ensuring the credibility of financial statements, thereby enhancing user trust in these statements.

Several results have been achieved; we mention them in the following points:

- ✓ Corporate governance is a comprehensive system that helps control and manage a company to achieve transparency, justice, and, consequently, the company's goals and continuity;
- ✓ Earnings management involves the managers' ability to manipulate financial statements to achieve personal gain or restructure transactions to change financial reports, with the aim of misleading stakeholders about the actual performance of the company;

- ✓ All corporate governance mechanisms (board of directors, audit committees, internal audit, external audit) contribute integrally to enhancing the corporate governance system, thus creating an environment that limits earnings management practices. The presence of independent board members, an effective oversight system, and competent and experienced auditors all help reduce the likelihood of earnings management practices;
- ✓ Conducting external audits requires careful scrutiny of all elements of financial statements to identify potential fraudulent methods;
- ✓ The independence of board members from management and its operations is crucial for them to perform their duties without any pressure or bias from management. Board members should also have knowledge and understanding of earnings management practices and their detection methods;
- ✓ Financial and accounting expertise, the number of committee members, and audit committee meetings enable a better understanding of the risks associated with earnings management practices. Thus, enhancing the efficiency of audit committees leads to higher audit quality and, consequently, limits fraudulent practices;
- ✓ The scientific competence and objective experience of internal auditors contribute to the effectiveness of internal audit procedures in detecting earnings management practices conducted by company management;
- ✓ Audit committee members should be familiar with the various methods and techniques used in earnings management. They must be capable of identifying indicators of effective earnings management.

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