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Corporate Governance Mechanisms and Their Influence on Earnings Management Practices

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Abstract

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This study aims to comprehensively review the relationship between corporate governance mechanisms and earnings management practices through a literature review approach. Effective corporate governance is believed to reduce managerial incentives to manipulate financial reporting, which may mislead stakeholders. This research analyzes key dimensions of governance, such as board structure, institutional ownership, and the effectiveness of audit committees, to assess their influence in limiting earnings management behavior. Based on a review of several journal articles published, the findings indicate that strong governance mechanisms are consistently associated with a significant reduction in earnings management, both accrual-based and real activities-based. Although contextual variations exist across countries and industries, empirical evidence shows that an active board, independent and competent audit committees, and the presence of institutional investors serve as critical factors in curbing opportunistic managerial behavior. The results of this review are expected to provide theoretical insights and practical implications for regulators, academics, and business practitioners in strengthening governance frameworks and improving the quality of financial reporting.

1. Introduction

In an increasingly complex and competitive global business environment, transparency and accountability in financial reporting have become a primary concern for various stakeholders. Reliable financial reporting is necessary to support rational decision-making by investors, creditors, and other external parties. One of the central issues in modern financial reporting is the practice of earnings management, which refers to actions taken by management to manipulate financial statements, although still within the boundaries of accounting rules, to achieve certain objectives such as profit targets, performance-based compensation, or maintaining stock prices. While technically legal, this practice often misleads investors by obscuring the true economic condition of the company and ultimately risks diminishing the quality of the financial information presented (Reurink, 2019). To address this challenge, corporate governance emerges as a crucial mechanism designed to limit management's leeway in conducting earnings management.

Corporate governance encompasses a set of principles, structures, and processes used to direct and control company activities with the primary goal of creating long-term value and safeguarding the interests of shareholders and other stakeholders (Fenwick et al., 2019). Various international institutions and academic researchers have emphasized the importance of effective board of commissioners structures, the role of independent audit committees, and institutional ownership as part of oversight mechanisms that can enhance the integrity and reliability of company financial reports. A number of literatures indicate that earnings management practices are more likely to occur in companies with weak governance systems. For example, the presence of independent boards of commissioners and a high frequency of board meetings have been proven to reduce incentives for earnings management (Kirana et al., 2020). Conversely, high managerial ownership, while potentially aligning managers' interests with shareholders, in many cases creates conflicts of interest that increase management's incentives to manipulate earnings to maintain their positions and compensation.

The phenomenon of major accounting scandals such as Enron and WorldCom in the early 2000s serves as clear evidence that weak oversight and ineffective governance practices can lead to significant losses for investors and erode public trust in capital markets. In various developing countries, including Indonesia, the issue of corporate governance oversight remains a serious challenge. This is primarily due to company ownership structures that tend to be concentrated in controlling shareholders, a lack of independence of the board of commissioners, and weak internal and external oversight systems. Global literature also shows that the impact of governance mechanisms on earnings management practices is not always uniform across different countries or industry sectors. The effectiveness of these mechanisms is highly influenced by contextual factors such as the legal system, regulatory quality, and the level of rule enforcement in each jurisdiction.

Research conducted by Eriandani et al. (2020) highlights that the existence of an active audit committee with accounting expertise can significantly reduce accrual-based earnings management practices. However, in developing markets such as Nigeria and Indonesia, weak governance remains the main root cause of high levels of manipulation in financial reporting. Within this framework, this literature review aims to review and synthesize various empirical research findings regarding the relationship between corporate governance mechanisms and earnings management practices. This study is important not only from a theoretical perspective to enrich academic understanding but also provides practical contributions for regulators, investors, and company management. The findings of this review are expected to serve as a basis for formulating policies that strengthen corporate oversight systems and improve the overall quality of financial reporting.

2. Literature Review

2.1. Concept of Earnings Management

Earnings management is defined as efforts made by management to influence financial statements to achieve certain objectives, such as meeting profit targets or maintaining stock prices. Beyer et al. (2019) argue that earnings management occurs when management uses judgment in financial reporting to alter accounting estimates. This action is often done with the aim of influencing external parties' perceptions of the company's performance. Earnings management can be carried out through two main approaches: accrual-based earnings management and real earnings management. The accrual-based approach involves adjustments to accounts in financial statements that do not involve cash flows, while the real earnings management approach is carried out through operational decisions that directly affect the company's cash flows.

The level of earnings management is influenced by various internal and external factors. Internal factors include pressure from executives, compensation systems dependent on achieving profit targets, and company ownership structures that can affect management incentives. Meanwhile, external factors include capital market conditions, applicable regulations, and corporate governance mechanisms. It is important to note that earnings management is not always opportunistic; in some cases, management does it to signal positive information to the market. However, when done aggressively and continuously, this practice can lead to misleading financial statement presentation and ultimately harm investors and decrease market trust in the integrity of company financial information.

2.2. Corporate Governance Mechanisms

Corporate governance mechanisms include structures and processes designed to direct and control the company to operate in accordance with the interests of shareholders and other stakeholders. These mechanisms are divided into two main categories: internal mechanisms and external mechanisms. Internal mechanisms include the structure of the board of commissioners, the existence of an audit committee, and share ownership by internal parties. Meanwhile, external mechanisms include market regulations, pressure from investors, and the influence of mass media on corporate behavior. Research shows that a strong board of commissioners structure, especially with the presence of independent commissioners, can effectively limit earnings management practices.

For example, Aleqab and Ighnaim (2021) found that the higher the proportion of independent commissioners on the board, the lower the company's tendency to manipulate earnings. In addition, an active and competent audit committee has also been proven to significantly reduce the potential for earnings management (Wan Mohammad & Wasiuzzaman , 2020). On the other hand, institutional ownership plays an important role in strengthening the effectiveness of governance, as large institutions tend to demand transparency and exercise strict oversight over management policies. However, managerial ownership has an ambivalent nature. High share ownership by management can align the interests between managers and owners (alignment effect), or it can enable opportunistic behavior (entrenchment effect) (Arthur et al., 2019).

2.3. Relationship Between Governance and Earnings Management

Most studies agree that effective corporate governance contributes to the reduction of earnings management practices. Research by Di Vito and Trottier (2022) confirms that strengthening governance mechanisms, such as independent board structures and strong internal audits, can decrease companies' tendency to manipulate earnings reports. Studies in the Middle East found that the presence of an independent audit committee serves as an effective control tool in dealing with earnings smoothing practices. However, not all aspects of governance show consistent results. Orazalin (2020) notes that gender diversity on the board of directors does not always have a significant influence on limiting earnings management. Its effectiveness largely depends on the local cultural and regulatory context.

Studies in developing countries such as Nigeria and Indonesia show that the mere existence of an independent board is not sufficient. The effectiveness of the board is influenced by meeting frequency, member experience, and access to internal information. In addition, some studies also mention that companies facing high financial distress tend to continue earnings management, even with good governance structures (Zadeh et al., 2022). This indicates that economic motivations can weaken the oversight function of governance. The literature reviewed concludes that governance mechanisms serve as mitigation tools against earnings management. However, their effectiveness depends on the institutional context and the combination of governance elements, not just a single factor.

3. Method

This research uses a literature review approach which aims to identify, evaluate, and synthesize empirical research findings regarding corporate governance mechanisms and their influence on earnings management practices. This approach was chosen because it allows researchers to summarize theoretical and empirical developments over a certain period without collecting primary data. The research focus is directed at scientific articles published, and originating from reputable international journals indexed in Google Scholar. The selection of sources was carried out systematically based on topics related to aspects of governance mechanisms such as board structure, audit committee, ownership structure, and governance index, as well as their relationship with earnings management.

Keywords used in the search process include: “corporate governance”, “earnings management”, “audit committee”, “independent board”, and “ownership structure”. The selection process was carried out in several stages. First, initial identification was performed on selected and reputable articles that matched these keywords. Second, articles were filtered based on publication year. Third, content evaluation was conducted to ensure direct relevance to the main topic. The final stage yielded several articles deemed most relevant for further analysis.

Each article was analyzed using a thematic approach to identify patterns of relationships between variables in corporate governance mechanisms and earnings management practices. The variables reviewed included board size and composition, the presence of independent audit committees, institutional and managerial ownership structures, financial distress intensity, as well as firm size and leverage as control variables. In addition, the type of earnings management used in each study, whether accrual-based or real, was also considered to understand the specific influence of each governance element on the form of earnings management undertaken by the company. However, as a literature review, this study has limitations because it relies on the availability and quality of secondary data. Therefore, the results cannot be generalized without confirmation through further quantitative studies. Nevertheless, this approach remains useful for identifying gaps in the literature and strengthening the theoretical foundation for future research.

4. Results

Based on the literature analysis of several international journal articles published, it was found that the relationship between corporate governance mechanisms and earnings management practices shows consistency in several key indicators, although variations exist based on geographical context, ownership structure, and industry type. Almost all reviewed studies concluded that strong corporate governance contributes to the reduction of earnings management practices, both accrual-based and real. The two most dominant and significantly influential mechanisms are the presence of independent boards of commissioners and the effectiveness of the audit committee.

Research conducted by Di Vito and Trottier (2022) revealed that companies with more than 50% independent board members tend to report more conservative earnings and are less likely to engage in earnings smoothing practices. This study was conducted on manufacturing companies in Southeast Asia using a panel data regression model to analyze some companies over a five-year period. These findings indicate that the proportion of independent board members is an important indicator in minimizing manipulation of financial statements. These results are reinforced by Itopa et al. (2022) study of non-financial companies in Nigeria. He found that board independence has a significant negative effect on the level of earnings management. However, the effectiveness of the board of commissioners depends not only on its independent status but also on the level of participation and meeting intensity. When the board is passive or rarely holds meetings, the mitigating effect on earnings management becomes insignificant.

The audit committee also plays a key role in overseeing the quality of financial reports. Research by Eriandani et al. (2020) stated that companies with independent audit committees whose members have accounting backgrounds show a lower tendency to engage in accrual-based earnings manipulation. Audit committees with a high frequency of meetings and members with professional certifications, such as CPAs, tend to increase oversight effectiveness, thus inversely correlated with the level of earnings management. In this context, the activity and competence of the audit committee are more important than just its formal existence in the governance structure.

The aspect of institutional ownership is also an important factor widely discussed in the literature. A study by Arthur et al. (2019) revealed that institutional investors can act as active monitors who pressure management to produce more transparent and accurate financial reports. In China, companies with high levels of institutional ownership are more successful in preventing earnings smoothing practices compared to companies whose ownership structure is dominated by families. In Nigeria found that the effectiveness of institutional ownership is not always guaranteed. When institutions have political connections with management or when corporate governance is not transparently implemented, institutional ownership can actually become a tool to legitimize manipulative actions.

Managerial ownership shows a more complex dynamic. In some studies, such as by Zadeh et al. (2022), it was found that high managerial ownership creates an incentive for management to align their interests with those of shareholders. This can reduce the tendency to engage in earnings management. However, a study conducted by de Villiers and Dimes (2021) showed that at high levels of managerial ownership (above 20%), there is a tendency for entrenchment behavior, where managers maintain their positions by manipulating performance to appear successful in the eyes of investors. This indicates that the effect of managerial ownership is non-linear and highly dependent on the context and percentage of ownership.

Companies in a state of financial distress or financial pressure also tend to have a higher propensity for earnings management, especially as a way to conceal declining performance. In a study by Rizani et al. (2022), it was found that companies facing liquidity pressure tend to use real earnings management methods, such as reducing research expenditure and promotional costs, to maintain profit performance. This is a form of short-term strategy to maintain the company's image in the eyes of investors and creditors. Research by Habib et al. (2022) supports this finding by adding that CFOs with low integrity and facing high target pressure are more vulnerable to engaging in earnings management, even if the company's corporate governance structure has been formally established.

Firm size was also found to be a variable that moderates the relationship between governance mechanisms and the level of earnings management. Githaiga et al. (2022) state that large companies with complex board structures and diverse committees tend to have more effective oversight systems, thus reducing the likelihood of earnings management. Conversely, small companies with limited resources often fail to implement governance principles optimally, thereby opening up opportunities for earnings manipulation.

The institutional context also plays an important role in determining the effectiveness of each governance mechanism. In countries with weak law enforcement and low investor protection, the role of internal governance mechanisms becomes crucial as the main bulwark in controlling management. Research by Firman and Widodo (2022) showed that the corporate governance index has a significant negative correlation with abnormal accruals in Southeast Asian countries. These results emphasize the importance of comprehensive and integrated governance implementation, not just as a formality or symbolic gesture.

Gender diversity on the board of commissioners has also begun to be widely studied as a potential governance variable in improving oversight (Meah et al., 2021). Non-financial sector in Nigeria found that boards of commissioners with gender diversity showed better oversight quality, although its statistical significance varied across industries. The main argument used is that diversity in experience, perspective, and leadership styles can help detect potential distortions in financial reports earlier. However, the results of this study still need to be supported by cross-country and sectoral studies to obtain stronger conclusions.

The effectiveness of each governance mechanism also depends on the extent to which these elements work synergistically. A study by Huang et al. (2021) concluded that the interaction between board independence, audit committee effectiveness, and the presence of institutional ownership produces a stronger synergistic effect in curbing earnings management practices compared to when each mechanism stands alone. Synergy among various governance elements allows for the creation of a complementary oversight system and reduces loopholes that management can exploit for opportunistic purposes.

The findings of this literature review emphasize that the success of corporate governance in reducing earnings management practices is largely determined by consistent implementation, active stakeholder involvement, and adequate support from the legal and regulatory system. The diversity of results among developing and developed countries also indicates that the effectiveness of governance mechanisms is highly dependent on adaptation to local characteristics, including cultural aspects, legal systems, and company ownership structures. Thus, governance policies cannot be universal but must be contextual and adaptive to the institutional conditions in each country and industry sector. This research confirms that the role of corporate governance as a mitigation tool against earnings management depends not only on the formal existence of these mechanisms but on the quality of their implementation, the integrity of the actors involved, and the courage to enforce accountability comprehensively. Therefore, governance reform is not enough through regulation alone but also needs to encourage the creation of a culture of transparency and integrity throughout all levels of the corporate organization.

5. Discussion

The results of this literature review indicate that corporate governance plays an important role in limiting management's scope for manipulating financial statements. Effective governance is not only determined by the existence of formal structures such as the board of directors and audit committee but also by the quality, independence, and competence of the actors involved. The presence of independent boards of commissioners, for example, will only have a positive impact if they have adequate access to internal information, can maintain objectivity, and are actively involved in the oversight and strategic decision-making processes. Without active involvement and true independence, their role becomes weak and less effective in controlling potential deviations by management.

The influence of institutional ownership found in this study also reinforces the importance of the presence of institutional shareholders as effective market monitors. When financial institutions invest significantly in a company, they have an economic incentive to ensure the accuracy and integrity of financial reports, as this directly affects the value of their investments. However, the effectiveness of this oversight role is highly dependent on the degree of independence of these institutions from management and the power structure prevailing within the company. If the relationship between institutions and management is too close or political, then the oversight role can become blunted (Carey et al., 2018).

Managerial ownership in this study shows a dualistic influence. On the one hand, share ownership by managers can foster alignment of interests between management and shareholders, as managers have a direct incentive for company performance. However, if the level of this ownership exceeds a certain threshold, entrenchment behavior can occur, where managers strive to maintain their power by manipulating performance to create an impression of success in the eyes of investors (Audia et al., 2022). This phenomenon indicates that corporate governance cannot be understood as a linear system but rather as a dynamic system that needs to be adapted to the ownership structure and company characteristics.

The audit committee also becomes one of the key pillars in controlling the quality of financial reports. When this committee is staffed by members with financial backgrounds, accounting expertise, and sufficient time allocation to carry out their duties, they have the capacity to detect earnings management practices from the early stages (Katmon et al., 2019). Conversely, if the existence of the audit committee is merely symbolic or a formality, then its role is no more than fulfilling regulatory requirements without any real impact on oversight practices.

External factors such as market pressure and the company's financial condition also significantly affect the effectiveness of governance mechanisms (He et al., 2019). In situations of financial distress, management's incentive to engage in earnings management tends to increase significantly. Even in companies with relatively strong governance structures, pressure from investors, profit targets, or changes in market conditions can weaken internal oversight and create loopholes for management to act opportunistically. This shows that the company's external context plays an important role in determining the success or failure of governance mechanisms.

In general, this discussion strengthens the basic assumption in agency theory, namely that governance mechanisms are necessary to align the interests between principals (shareholders) and agents (management). However, the implementation of these mechanisms is not sufficient to be limited to the formation of formal structures such as boards and committees. Active oversight, continuous training for governance actors, and the formation of an organizational culture that supports integrity and accountability are needed as the main foundations of an effective governance system.

6. Conclusion

This literature review concludes that corporate governance mechanisms play an important role in reducing earnings management practices. Key components such as an independent board structure, an active audit committee, and institutional ownership are proven to have a significant influence on the quality of financial reporting. The review of several international journals shows that companies with strong governance tend to be more transparent, more accountable, and have lower levels of earnings management. However, this influence is not uniform in all contexts. The effectiveness of each mechanism highly depends on factors such as firm size, financial pressure, and the legal and oversight culture in each country. For example, an effective independent board in a developed country might not show the same impact in a developing country due to differences in the level of legal enforcement and transparency.

The implication of this research is the importance of improving the structure and quality of corporate governance in developing countries to increase investor confidence and the integrity of financial reports. Governance practices must not only meet formal requirements but also be implemented substantially and consistently. Future research is recommended to examine the interaction among governance mechanisms and how combinations of these mechanisms can mutually reinforce each other in preventing earnings management, especially amid external pressures such as economic crises or regulatory changes.

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