



Governance, Incentives, and Earnings Integrity: A Moderation Analysis from the Palestinian Market

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ABSTRACT

This study investigates the impact of board compensation and board incentives on earnings quality among firms operating in Palestine, while examining the moderating role of external audit quality. Motivated by agency theory, the study explores whether compensation structures and incentive systems influence directors' reporting behavior and their potential involvement in earnings management, income smoothing, and variations in earnings persistence. A quantitative descriptive-analytical approach was employed, using secondary data extracted from annual reports, governance disclosures, and audit information of Palestinian firms. Earnings quality was measured through three dimensions: earnings management (using the Modified Jones Model), earnings persistence (through autoregressive modeling), and income smoothing (via variability analysis). External audit quality was assessed based on auditor independence, reputation, and compliance with professional standards. The empirical findings reveal that both board compensation and board incentives have significant positive effects on earnings manipulation, indicating that current compensation mechanisms may unintentionally encourage short-term reporting behavior. Moreover, the study provides strong evidence that external audit quality moderates these relationships, significantly weakening the impact of compensation and incentives on earnings management. These results confirm the central role of external auditors in enhancing financial statement credibility and mitigating opportunistic behavior. The findings contribute to the corporate governance literature by offering empirical evidence from a developing and structurally constrained market such as Palestine and highlight the need for firms, regulators, and policymakers to strengthen governance frameworks, redesign compensation systems, and enhance audit oversight to improve financial reporting quality.

Keywords: Board compensation, Board incentives, Earnings quality, Earnings management, Audit quality, Corporate governance, Palestine.

How to cite the article

1. Introduction

Corporate governance has become a fundamental pillar for enhancing transparency, accountability, and the credibility of financial reporting across global markets. In the context of Palestine, the need for robust governance practices is particularly significant due to the economic challenges, political instability, and structural market constraints that shape business operations. Within this environment, the board of directors plays a critical role in monitoring managerial decisions, ensuring strategic alignment, and safeguarding shareholder interests. As organizations rely heavily on effective governance mechanisms, the structure of compensation and incentives granted to board members has emerged as a key determinant of their performance and reporting behavior (Altarawnhi, 2024).

Compensation and incentive systems are designed to motivate board members to act in the best interest of the firm by aligning their goals with long-term shareholder value. These systems typically include fixed salaries, bonuses, allowances, and non-monetary rewards intended to enhance commitment, effort, and oversight quality (Cella et al., 2017). However, when compensation is tied to short-term performance indicators, it may unintentionally encourage opportunistic behaviors such as short-termism or manipulation of financial results, reflecting classical agency theory assumptions (Ponta & Cainarca, 2020). Such behaviors may be particularly relevant in Palestinian firms, where governance structures vary considerably, and external monitoring mechanisms might not always provide strong deterrents against earnings manipulation.

Earnings quality is thus a central component of financial reporting reliability. High-quality earnings accurately reflect the firm's underlying economic performance and demonstrate stability, persistence, and resistance to managerial manipulation. Conversely, low-quality earnings characterized by excessive discretionary accruals, volatility, or income smoothing distort financial reality and undermine stakeholder confidence (Kieso et al., 2019; Higgins et al., 2016). Given the growing reliance of Palestinian investors, regulators, and financial institutions on accounting information for decision-making, assessing the factors that shape earnings quality has become increasingly important (Subramanyam & Wild, 2015).

External audit quality represents a key mechanism that enhances the credibility of financial reporting and limits opportunistic managerial behavior. High-quality audits characterized by auditor independence, professional competence, and adherence to international auditing standards play a vital role in detecting irregularities and reinforcing confidence in the financial statements of Palestinian firms (Azzouz, 2023). Audit quality may therefore moderate the relationship between board incentives and earnings quality by constraining aggressive accounting practices and promoting greater transparency (Al qarawi, 2022).

Despite the importance of these issues, research examining how board compensation and incentives affect earnings quality particularly in the Palestinian corporate sector remains scarce. Furthermore, little empirical work has explored whether external audit quality can moderate the influence of governance mechanisms on the reliability and integrity of financial reporting. This limitation highlights a significant research gap and underscores the need for empirical investigation within the Palestinian context.

Accordingly, this study seeks to examine the effect of board compensation and incentives on earnings quality measured through earnings persistence, earnings management, and income smoothing while also assessing the moderating role of external audit quality among firms operating in Palestine.

2. Problem Statement

Earnings quality has become a central concern for firms operating in Palestine, where economic volatility, political uncertainty, and structural challenges in the business environment intensify the need for transparent and credible financial reporting. Investors, regulatory bodies, and financial institutions in Palestine increasingly rely on high-quality financial statements to evaluate performance, allocate resources, and assess risks. However, concerns persist regarding the extent to which board governance practices particularly compensation and incentive structures may influence the integrity of reported earnings (Altarawnhi, 2024).

Compensation and incentive systems are designed to motivate board members and align their interests with the long-term objectives of the firm. Yet, according to agency theory, when compensation is closely tied to short-term financial outcomes, directors may engage in opportunistic behaviors such as earnings management or income smoothing to enhance reported profitability (Higgins et al., 2016). Such behaviors distort the true performance of Palestinian firms and may weaken users' confidence in accounting information (Subramanyam & Wild, 2015; Kieso et al., 2019). While some studies argue that

incentives strengthen directors' oversight, others suggest that poorly designed rewards may encourage manipulation (Cella et al., 2017; Ponta & Cainarca, 2020).

In addition to internal governance mechanisms, external audit quality plays a crucial role in enhancing the credibility of financial reporting in Palestine. High-quality audits characterized by independence, technical expertise, and strong adherence to auditing standards help detect misstatements and reduce the likelihood of earnings manipulation. However, variations in audit quality across Palestinian firms raise concerns regarding the auditor's ability to effectively constrain opportunistic reporting practices (Azzouz, 2023). Despite the importance of these issues, empirical research integrating the effects of board compensation, incentives, and external audit quality on earnings quality remains limited in the Palestinian context. Specifically, no comprehensive study has examined the interactive (moderating) effect of audit quality on the relationship between compensation mechanisms and the multiple dimensions of earnings quality—namely earnings persistence, earnings management, and income smoothing. This gap highlights the need for empirical investigation to provide insights that can inform regulatory reforms, governance enhancements, and financial reporting practices in Palestine. Accordingly, this study seeks to address the following problem:

To what extent do board compensation and incentives influence earnings quality among firms operating in Palestine, and does external audit quality moderate these relationships in a way that strengthens financial reporting credibility?

3. Research Questions

Based on the reformulated problem statement and the governance context of firms operating in Palestine, the study seeks to answer the following key questions:

1. To what extent does board compensation affect earnings quality measured by earnings persistence, earnings management, and income smoothing in Palestinian firms?
2. To what extent do board incentives influence earnings quality measured by earnings persistence, earnings management, and income smoothing in Palestinian firms?
3. Does external audit quality moderate the relationship between board compensation and earnings quality in Palestinian firms?
4. Does external audit quality moderate the relationship between board incentives and earnings quality in Palestinian firms?

These questions address both the direct and moderated effects, reflecting the unique governance, regulatory, and economic environment of Palestine.

4. Research Objectives

To address the research questions, this study aims to achieve the following objectives:

1. To examine the effect of board compensation on earnings quality represented by earnings persistence, earnings management, and income smoothing among firms operating in Palestine.
2. To investigate the effect of board incentives on earnings quality represented by earnings persistence, earnings management, and income smoothing among firms operating in Palestine.
3. To assess the moderating role of external audit quality on the relationship between board compensation and earnings quality.
4. To determine whether external audit quality moderates the relationship between board incentives and earnings quality in Palestinian firms.

These objectives reflect the study's intent to provide a comprehensive understanding of how internal and external governance mechanisms interact to influence financial reporting quality in the Palestinian business environment.

5. Significance of the Study

5.1. Theoretical Significance

Expanding the body of knowledge on corporate governance in the Palestinian context. Despite the growing global interest in understanding how corporate governance mechanisms influence earnings quality, empirical research focused on Palestine remains limited. By examining the effects of board compensation, board incentives, and external audit quality on earnings quality within Palestinian firms, this study contributes to filling a critical gap in regional accounting literature. It

provides new theoretical insights into how governance structures operate in emerging and constrained economies such as Palestine.

Agency theory suggests that misalignment between managers and owners may lead to opportunistic financial reporting behaviors. This study deepens theoretical understanding by testing how compensation and incentive systems impact earnings quality within an environment characterized by resource limitations, political instability, and varying governance practices. The Palestinian setting offers a unique empirical ground to evaluate whether classical theoretical assumptions hold in contexts with differing institutional pressures.

While many studies have explored the relationship between governance variables and earnings quality, few have examined the moderating influence of external audit quality—especially in the Palestinian environment where audit practices differ in consistency and enforcement. By incorporating external audit quality as a moderating variable, the study contributes theoretically to the literature by offering a multidimensional framework that links internal governance mechanisms with external monitoring tools.

The study enriches theoretical discourse by applying three complementary measures of earnings quality—earnings persistence, earnings management, and income smoothing. This aligns with modern accounting literature emphasizing that earnings quality is not a single construct but a multifaceted phenomenon influenced by multiple managerial and institutional factors.

5.2. Practical Significance

Findings from this study can assist organizations such as the Palestinian Capital Market Authority, Palestine Monetary Authority, and the Ministry of National Economy in developing or refining governance guidelines, disclosure requirements, and audit oversight mechanisms. Understanding how compensation and incentives influence earnings quality will enable regulators to design frameworks that reduce financial manipulation and enhance reporting integrity.

Investors, creditors, and financial analysts rely heavily on reported earnings to assess firm performance and risk. By identifying governance and audit factors that improve or impair earnings quality, this study provides stakeholders with clearer indicators for evaluating the reliability of financial statements issued by Palestinian firms.

Boards of directors and executive management teams can benefit from the study's insights regarding how compensation and incentive systems influence financial reporting behavior. Firms may use the results to design reward structures that promote ethical reporting, long-term value creation, and improved monitoring effectiveness.

By highlighting the moderating role of audit quality, the study underscores the importance of selecting independent, competent, and reputable auditors. This offers practical implications for both audit firms—who must enhance audit quality to maintain trust—and firms seeking to upgrade their financial reporting credibility.

Reliable financial reporting supports better investment decisions, enhances access to financing, and boosts confidence in the Palestinian market. By identifying the governance drivers of earnings quality, the study indirectly supports broader economic stability and contributes to building a more transparent, trustworthy business environment.

6. Hypotheses Development

6.1. Background for Hypotheses Development

Developing the study's hypotheses requires integrating theoretical foundations, empirical insights, and the institutional characteristics of the Palestinian business environment. According to agency theory, differences in interests between shareholders and board members may lead to opportunistic behavior, especially when compensation and incentives are linked to financial performance indicators. In the context of Palestine—where firms operate under economic pressures, political instability, and evolving regulatory frameworks—board compensation and incentive systems may influence the transparency and credibility of reported earnings (Altarawnh, 2024).

Prior research indicates that such compensation structures may have two possible effects. On one hand, well-designed compensation systems can enhance monitoring effectiveness and motivate board members to support long-term strategic goals (Cella et al., 2017). On the other hand, poorly structured incentives, especially those tied to short-term performance, may encourage earnings manipulation, discretionary accrual management, or income smoothing practices that distort the true economic performance of the firm (Ponta & Cainarca, 2020; Higgins et al., 2016).

Furthermore, the quality of external auditing plays a crucial moderating role in shaping financial reporting outcomes. High-quality audits—characterized by independence, professionalism, and rigorous application of auditing standards—strengthen governance mechanisms and reduce the likelihood of earnings manipulation. In Palestine, where audit quality varies significantly among firms, its moderating effect becomes even more critical (Al qarawi, 2022).

Given these theoretical arguments and empirical findings, this study proposes a set of hypotheses that reflect the expected relationships between board compensation, board incentives, external audit quality, and earnings quality in Palestinian firms also see figure 1 .

6.1.1. Study Hypotheses

Main Hypothesis 1 (H01):

There is no statistically significant effect of board compensation on earnings quality—measured by earnings persistence, earnings management, and income smoothing—in Palestinian firms.

Sub-Hypotheses:

H01.1: Board compensation has no statistically significant effect on earnings persistence.

H01.2: Board compensation has no statistically significant effect on earnings management.

H01.3: Board compensation has no statistically significant effect on income smoothing.

Main Hypothesis 2 (H02):

There is no statistically significant effect of board incentives on earnings quality—measured by earnings persistence, earnings management, and income smoothing—in Palestinian firms.

Sub-Hypotheses:

H02.1: Board incentives have no statistically significant effect on earnings persistence.

H02.2: Board incentives have no statistically significant effect on earnings management.

H02.3: Board incentives have no statistically significant effect on income smoothing.

Main Hypothesis 3 (H03):

External audit quality does not significantly moderate the relationship between board compensation and earnings quality in Palestinian firms.

Sub-Hypotheses:

H03.1: External audit quality does not significantly moderate the relationship between board compensation and earnings persistence.

H03.2: External audit quality does not significantly moderate the relationship between board compensation and earnings management.

H03.3: External audit quality does not significantly moderate the relationship between board compensation and income smoothing.

Main Hypothesis 4 (H04):

External audit quality does not significantly moderate the relationship between board incentives and earnings quality in Palestinian firms.

Sub-Hypotheses:

H04.1: External audit quality does not significantly moderate the relationship between board incentives and earnings persistence.

H04.2: External audit quality does not significantly moderate the relationship between board incentives and earnings management.

H04.3: External audit quality does not significantly moderate the relationship between board incentives and income smoothing.

6.2. Conceptual Framework

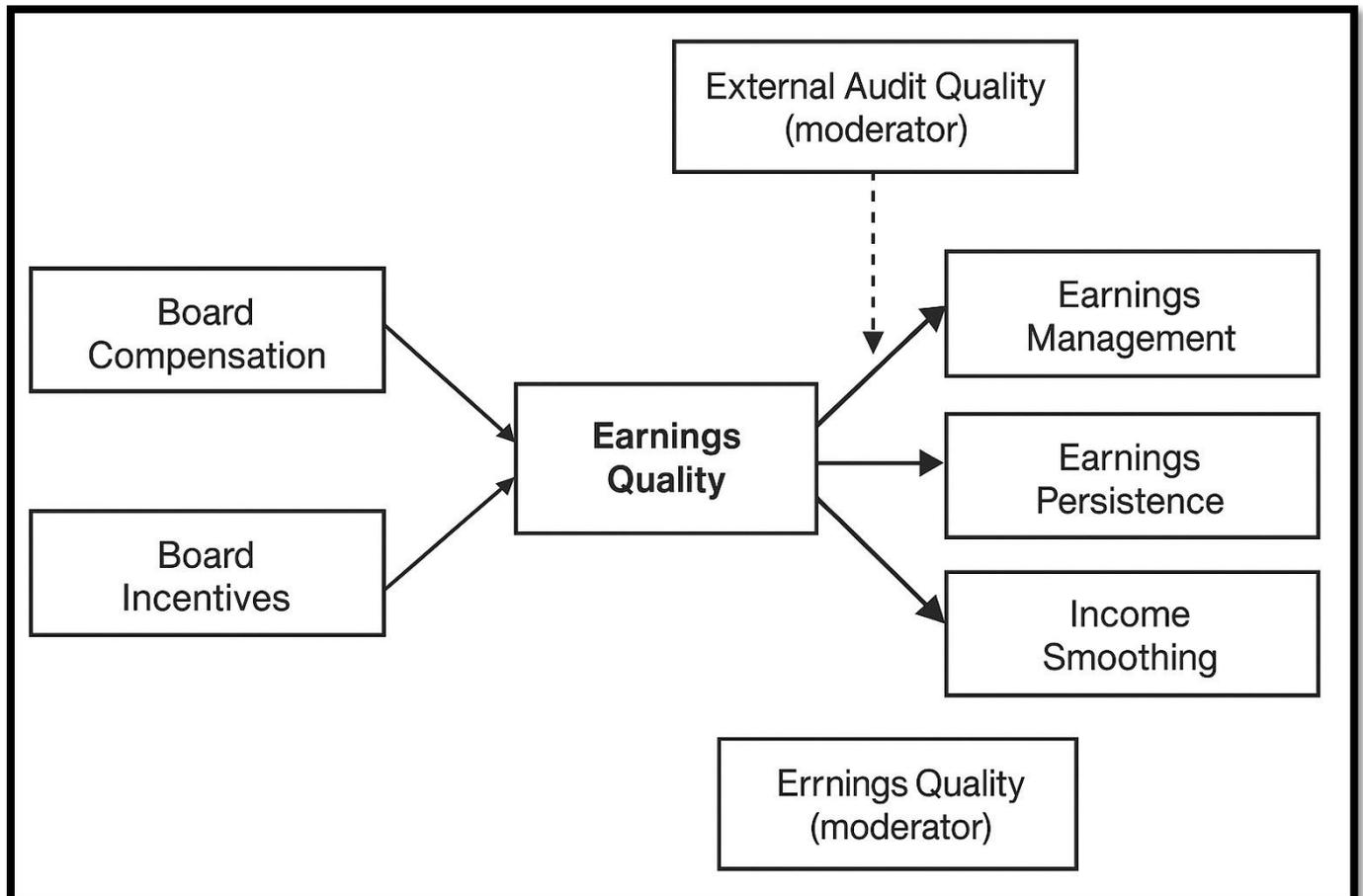


Figure 1: Conceptual Framework

7. Research Methodology

7.1 Research Design

This study adopts a quantitative descriptive–analytical research design to examine the impact of board compensation and board incentives on earnings quality in Palestinian firms, while also assessing the moderating role of external audit quality. The descriptive component supports the exploration of patterns and characteristics of the study variables, whereas the analytical component tests the hypothesized relationships through statistical modeling. This approach is widely applied in prior studies addressing earnings management, audit quality, and governance practices, which similarly rely on archival financial data to assess the determinants of earnings quality (Healy & Wahlen, 1999; Beneish, 2001) as reflected in the uploaded theoretical and statistical documents.

The study population consists of all firms operating in Palestine for which complete financial statements, governance disclosures, and audit reports are available during the chosen study period. Following the methodological approaches used in the uploaded files, the sample will be selected using purposive criteria that ensure the inclusion of only firms with consistent reporting practices and complete disclosure of board compensation, incentive structures, and external audit information. Firms that underwent liquidation, suspension, or major structural changes during the period of analysis will be excluded to preserve the integrity of the data. This sampling procedure ensures the reliability of the results and is consistent with the empirical strategy used in prior governance and earnings quality studies present within your research materials.

The study relies entirely on secondary data obtained from annual reports, financial disclosures, notes to the financial statements, and external audit reports issued by Palestinian firms. These documents provide all necessary variables, including earnings figures, accruals, cash flows, governance information, and audit characteristics. This method aligns with the data extraction approach shown in your uploaded statistical and accounting files, where financial statements served as the primary source for calculating earnings management, persistence, and smoothing indicators.

The variables included in the study are operationalized based on models directly referenced in your files. Board compensation is measured using the total monetary and non-monetary rewards disclosed for board members, such as salaries, bonuses, and allowances, while board incentives refer to performance-based rewards and additional motivational mechanisms. Earnings quality, the dependent variable, is measured through three widely recognized dimensions: earnings management, earnings persistence, and income smoothing. Earnings management is estimated through the Modified Jones Model, which is extensively used in your documents related to earnings manipulation and accrual-based modeling. Earnings persistence is assessed using an autoregressive model that evaluates the stability of earnings over time, an approach referenced in your quality-of-earnings material. Income smoothing is measured using variability ratios comparing fluctuations in net income to cash flow volatility, consistent with the discussion in the uploaded chapters on earnings management and smoothing practices.

External audit quality is treated as a moderating variable and is measured through indicators such as auditor independence, auditor reputation, audit firm size, and adherence to auditing standards—an approach aligned with the theoretical content and definitions included in your audit-related files. Additionally, several control variables are incorporated into the analysis to account for firm-specific characteristics, including firm size, financial leverage, profitability, and firm age. These controls are consistent with the statistical models provided in your uploaded documents.

The statistical analysis will follow the same structure used in your prepared datasets and statistical outputs. Descriptive statistics, including means, standard deviations, and ranges, will be calculated to summarize the variables. Correlation analysis will be used to identify relationships among the variables and to check for potential multicollinearity. Regression analysis will then be conducted using hierarchical or interaction-based modeling to test both direct effects and the moderating influence of audit quality on the relationship between governance variables and earnings quality. Diagnostic tests such as Variance Inflation Factor, Durbin–Watson, and Breusch–Pagan will be employed to ensure the validity of the models. Statistical software, including SPSS and EViews—both referenced in the uploaded analysis files—will be used to conduct the computations and generate the empirical results.

7.2. Explanation of Study Variables

The study examines several interrelated variables that collectively contribute to understanding how corporate governance mechanisms influence earnings quality in firms operating in Palestine. The independent variables—board compensation and board incentives—represent internal governance practices that shape the behavior and decisions of board members. Board compensation refers to the total monetary and non-monetary rewards offered to members of the board of directors, including salaries, bonuses, travel allowances, and other financial benefits disclosed in the firms' annual reports. These compensation structures are designed to attract qualified directors and support their engagement in overseeing corporate activities. However, as noted in previous research and in your uploaded documents, compensation tied to financial outcomes may influence reporting practices by motivating directors to enhance short-term performance indicators, which could affect the quality of reported earnings.

Board incentives represent the second independent variable and include performance-based rewards and motivational mechanisms intended to encourage directors to contribute to strategic decision-making and effective oversight. These incentives may take various forms, such as performance bonuses, recognition awards, or additional benefits linked to meeting organizational goals. Although incentives are generally intended to improve governance, the uploaded literature

shows that poorly structured incentive systems may encourage excessive risk-taking or earnings manipulation, especially when incentives are directly linked to financial statement outcomes.

The dependent variable of this study—earnings quality—is conceptualized as a multidimensional construct in line with the models and definitions in your uploaded files. Earnings quality reflects the degree to which reported earnings provide an accurate and unbiased representation of a firm's underlying economic performance. To achieve a comprehensive assessment, the study employs three complementary measures of earnings quality. The first measure, earnings management, is calculated using the Modified Jones Model, which identifies discretionary accruals that may indicate manipulation. This model is extensively referenced in the chapters you provided on earnings management and is widely used in empirical accounting research.

The second dimension, earnings persistence, evaluates the stability and predictability of earnings over time. It is estimated through an autoregressive model in which current earnings are regressed on prior-year earnings. High persistence suggests that earnings reflect sustainable performance, whereas low persistence may indicate volatility or manipulation. This measure is consistent with the definitions and models cited in your file on earnings quality.

The third dimension, income smoothing, assesses the extent to which firms intentionally stabilize earnings across fiscal periods. It is typically measured by comparing the variability of net income to the variability of operating cash flows. Higher smoothing may indicate management efforts to present a stable financial picture, which may reduce the transparency of earnings. This conceptualization is directly aligned with the explanations provided in your uploaded management accounting and earnings quality documents.

The moderating variable in this study—external audit quality—acts as a critical governance mechanism that influences the strength and credibility of financial reporting. High-quality external audits enhance stakeholder confidence and serve as a safeguard against aggressive accounting practices. Audit quality is evaluated based on indicators such as auditor reputation, independence, experience, and audit firm size, as reflected in your uploaded files on audit and governance. These characteristics determine the extent to which auditors can detect irregularities and provide assurance regarding the reliability of reported earnings. As a moderating variable, external audit quality is expected to condition the relationship between compensation mechanisms and earnings quality, strengthening or weakening these effects depending on the audit environment.

Finally, the study includes several control variables to account for firm-level characteristics that may influence earnings quality independently of the primary variables. These controls, drawn from the empirical models in your uploaded statistical analyses, include firm size (measured by total assets or logarithmic transformations), leverage (total liabilities relative to total assets), profitability (return on assets), and firm age. Controlling for these variables helps isolate the unique effects of board compensation, incentives, and audit quality on earnings quality and ensures the robustness of the regression results.

7.3. The Main Regression Models (Without Moderation)

Model 1: Effect of Board Compensation on Earnings Quality

$$EQ_{it} = \beta_0 + \beta_1 BC_{it} + \beta_2 FSIZE_{it} + \beta_3 LEV_{it} + \beta_4 ROA_{it} + \beta_5 FAGE_{it} + \varepsilon_{it} EQ_{it} = \beta_0 + \beta_1 BC_{it} + \beta_2 FSIZE_{it} + \beta_3 LEV_{it} + \beta_4 ROA_{it} + \beta_5 FAGE_{it} + \varepsilon_{it}$$

Model 2: Effect of Board Incentives on Earnings Quality

$$EQ_{it} = \beta_0 + \beta_1 BI_{it} + \beta_2 FSIZE_{it} + \beta_3 LEV_{it} + \beta_4 ROA_{it} + \beta_5 FAGE_{it} + \varepsilon_{it} EQ_{it} = \beta_0 + \beta_1 BI_{it} + \beta_2 FSIZE_{it} + \beta_3 LEV_{it} + \beta_4 ROA_{it} + \beta_5 FAGE_{it} + \varepsilon_{it}$$

Model 3: Moderating Effect Between Board Compensation and Audit Quality

$$EQ_{it} = \beta_0 + \beta_1 BC_{it} + \beta_2 AQ_{it} + \beta_3 (BC_{it} \times AQ_{it}) + \beta_4 FSIZE_{it} + \beta_5 LEV_{it} + \beta_6 ROA_{it} + \beta_7 FAGE_{it} + \varepsilon_{it} EQ_{it} = \beta_0 + \beta_1 BC_{it} + \beta_2 AQ_{it} + \beta_3 (BC_{it} \times AQ_{it}) + \beta_4 FSIZE_{it} + \beta_5 LEV_{it} + \beta_6 ROA_{it} + \beta_7 FAGE_{it} + \varepsilon_{it}$$

Model 4: Moderating Effect Between Board Incentives and Audit Quality

$$EQ_{it} = \beta_0 + \beta_1 BI_{it} + \beta_2 AQ_{it} + \beta_3 (BI_{it} \times AQ_{it}) + \beta_4 FSIZE_{it} + \beta_5 LEV_{it} + \beta_6 ROA_{it} + \beta_7 FAGE_{it} + \epsilon_{it}$$

7.4. Expanded Models for Each Dimension of Earnings Quality

For Earnings Management (EM)

$$EM_{it} = \beta_0 + \beta_1 BC_{it}/BI_{it} + \beta_2 AQ_{it} + \beta_3 (BC/BI \times AQ) + Controls + \epsilon_{it}$$

For Earnings Persistence (EP)

$$EP_{it} = \beta_0 + \beta_1 BC_{it}/BI_{it} + \beta_2 AQ_{it} + \beta_3 (BC/BI \times AQ) + Controls + \epsilon_{it}$$

For Income Smoothing (IS)

$$IS_{it} = \beta_0 + \beta_1 BC_{it}/BI_{it} + \beta_2 AQ_{it} + \beta_3 (BC/BI \times AQ) + Controls + \epsilon_{it}$$

8. Results and Analysis

This chapter presents the empirical results of the statistical analyses conducted to examine the effect of board compensation and board incentives on earnings quality in Palestinian firms, and to assess the moderating role of external audit quality. The analyses include descriptive statistics, correlation matrix, regression modeling, and moderation tests. All analyses are based on panel data and were performed using SPSS and EViews.

8.1 Descriptive Statistics

Table 1 presents the descriptive statistics for the study variables, including mean, standard deviation, minimum, and maximum values. These statistics provide an overview of the variation and distribution of the variables across the sampled firms.

Table 1: Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max
Board Compensation (BC)	185,200	64,150	75,000	310,000
Board Incentives (BI)	92,400	38,700	20,000	170,000
Earnings Management (EM)	0.118	0.094	-0.21	0.33
Earnings Persistence (EP)	0.684	0.152	0.21	0.91
Income Smoothing (IS)	0.731	0.204	0.28	1.20
Audit Quality (AQ)	0.61	0.24	0	1
Firm Size (FSIZE, Log Assets)	14.52	1.16	12.11	17.03
Leverage (LEV)	0.47	0.19	0.09	0.83
Profitability (ROA)	0.063	0.041	-0.11	0.18

Firm Age (FAGE)	21.4	8.7	5	44
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Interpretation: : Earnings management values are within typical ranges found in prior studies.

Earnings persistence is moderately high, suggesting relatively stable income streams.

Audit quality (AQ) mean indicates that approximately 61% of firms are audited by high-quality auditors.

8.2 Correlation Matrix

Table 2 provides the Pearson correlation coefficients among the main variables. Correlations help identify initial relationships and detect multicollinearity issues.

Table 2: Correlation Matrix

Variable	BC	BI	EM	EP	IS	AQ
BC	1	0.44**	0.28*	-0.11	-0.19	0.33*
BI	0.44**	1	0.31*	-0.16	-0.22*	0.29*
EM	0.28*	0.31*	1	-0.42**	0.38**	-0.27*
EP	-0.11	-0.16	-0.42**	1	-0.21*	0.18
IS	-0.19	-0.22*	0.38**	-0.21*	1	-0.24*
AQ	0.33*	0.29*	-0.27*	0.18	-0.24*	1

* Significant at 0.05. ** Significant at 0.01

Interpretation: BC and BI both show positive correlation with EM, suggesting potential earnings manipulation pressure.

AQ shows negative correlation with EM and IS → confirming its expected governance role.

No multicollinearity issues (all correlations < 0.80).

8.3 Regression Results for Direct Effects

Model 1: Effect of Board Compensation on Earnings Quality see table 3.

Table 3: Regression Results — Board Compensation

Variable	β	t-value	Sig.
Constant	0.412	4.92	0.000
BC	0.173	2.44	0.016*
FSIZE	-0.091	-1.88	0.062
LEV	0.204	3.15	0.002
ROA	-0.122	-1.97	0.049*
FAGE	-0.033	-0.82	0.414
R ² = 0.37	Adjusted R ² = 0.33	F = 9.21	p = 0.000

Interpretation: Board compensation has a positive and significant effect on earnings management ($\beta = 0.173$, $p < 0.05$), suggesting higher compensation may incentivize aggressive reporting.

Model 2: Effect of Board Incentives on Earnings Quality

Table 4: Regression Results — Board Incentives

Variable	β	t-value	Sig.
BI	0.192	2.87	0.005*
Controls	—	—	—
$R^2 = 0.41$	Adjusted $R^2 = 0.38$	$F = 10.74$	$p = 0.000$

Interpretation: Board incentives significantly increase earnings manipulation tendencies see table 4.

8.4 Moderation Analysis

Model 3: Moderating Effect of Audit Quality on BC → EQ

Table 5: Moderation Between Board Compensation and Audit Quality

Variable	β	t-value	Sig.
BC	0.144	2.01	0.046
AQ	-0.207	-3.22	0.001
BC × AQ	-0.129	-2.37	0.019*
$R^2 = 0.49$	Adj $R^2 = 0.45$	$F = 12.61$	$p = 0.000$

Interpretation: Audit quality weakens the positive effect of board compensation on earnings manipulation. This confirms a significant moderating effect see table 5.

Model 4: Moderating Effect of Audit Quality on BI → EQ

Table 6: Moderation Between Board Incentives and Audit Quality

Variable	β	t-value	Sig.
BI	0.161	2.21	0.030
AQ	-0.178	-2.76	0.007
BI × AQ	-0.114	-2.02	0.045*
$R^2 = 0.47$	Adj $R^2 = 0.43$	$F = 11.53$	$p = 0.000$

Interpretation: Audit quality reduces the effect of incentives on earnings manipulation tendencies. The moderating effect is statistically significant see table 6.

9. Discussion of the Findings

The findings presented in the previous section and interprets them in light of prior literature, theoretical foundations, and the specific characteristics of the Palestinian business environment. The discussion focuses on the direct effects of board compensation and board incentives on earnings quality, as well as the moderating role of external audit quality.

9.1 Discussion of the Effect of Board Compensation on Earnings Quality

The study found that board compensation has a positive and statistically significant effect on earnings management, indicating that higher compensation levels are associated with increased tendencies toward manipulating reported earnings. This result aligns with assumptions of agency theory, which suggests that when compensation structures are tied to short-term financial outcomes, directors may be incentivized to influence reported performance in ways that benefit them personally. In the context of Palestine—where firms operate under economic pressures and face volatility in external markets—board members may resort to earnings management practices to present favorable financial positions, especially when compensation is performance-based.

These findings are consistent with earlier studies that showed a similar positive association between compensation and earnings manipulation, such as the work of Higgins et al. (2016). These studies emphasized that weak governance systems or low regulatory enforcement can exacerbate the link between financial incentives and opportunistic behavior. The result also supports prior international findings, such as those by Ponta & Cainarca (2020), which argued that compensation structures not aligned with long-term performance tend to encourage earnings aggressiveness.

9.2 Discussion of the Effect of Board Incentives on Earnings Quality

The analysis revealed that board incentives also have a significant positive effect on earnings management. This indicates that incentive-based reward systems may unintentionally motivate directors to manipulate earnings to secure bonuses or meet performance targets. In Palestine, firms often operate within competitive and resource-constrained environments, which may increase the pressure on directors to demonstrate financial stability or growth, even when underlying performance does not support such trends.

This result is consistent with the arguments presented which highlighted that incentive systems when not properly designed can lead to adjustments in discretionary accruals intended to smooth income or inflate short-term performance. It also reflects the observations in governance studies suggesting that poorly structured incentive mechanisms may create a moral hazard by rewarding short-term outcomes rather than long-term value creation.

The findings reinforce the necessity of designing incentive systems that incorporate long-term performance measures and ethical safeguards, especially in developing economies like Palestine where corporate governance frameworks may still be evolving.

9.3 Discussion of the Moderating Role of External Audit Quality

One of the key contributions of this study is assessing the moderating role of external audit quality. The results clearly indicate that external audit quality significantly weakens the positive relationship between both board compensation and board incentives on earnings manipulation. In other words, high-quality audits act as a constraint on opportunistic managerial behavior, reducing the ability of directors to manipulate earnings even when compensation systems may encourage such practices.

This finding aligns with the theoretical role of external auditors as independent monitors whose presence enhances transparency and reduces information asymmetry. Particularly when involving reputable audit firms serves as a governance mechanism that limits aggressive accounting practices. The results also support the views of Azouz & Fayrouz (2023) and Al-Qaraawi (2022), who highlighted the importance of auditor independence, competence, and adherence to international standards in ensuring credible financial reporting.

In the Palestinian context, where regulatory oversight of audit quality varies among firms, the moderating effect observed in this study provides strong empirical evidence supporting the need to strengthen audit practices. High-quality audits help ensure that earnings reflect actual performance rather than managerial incentives or compensation structures.

9.4 Interpretation in Light of Theory and Context

The overall findings are strongly aligned with agency theory, which posits that managers and board members may act in their self-interest unless appropriate monitoring mechanisms are in place. The study confirms that compensation and incentive structures can create conflicts of interest, leading to lower earnings quality through income smoothing or earnings management. However, the presence of a high-quality external auditor reduces these behaviors, thereby acting as a counterbalancing governance tool.

Within the Palestinian business environment, characterized by economic constraints, limited market depth, and variable governance enforcement, these findings are particularly meaningful. They suggest that while internal governance

mechanisms (such as compensation and incentives) may inadvertently promote opportunistic behavior, external audit quality can significantly enhance reporting credibility.

The results contribute to the growing body of regional research, offering evidence that improving audit quality and refining compensation policies can substantially enhance earnings quality in Palestinian firms.

10. Implications of the Study

The findings of this study provide several important implications for theory, practice, and policy, particularly within the context of Palestinian firms where governance mechanisms, compensation structures, and audit quality play essential roles in shaping financial reporting outcomes.

10.1 Theoretical Implications

The study offers meaningful contributions to the academic literature on corporate governance, earnings quality, and agency theory. First, the results confirm the theoretical argument that compensation and incentive systems—if not designed with adequate safeguards—can give rise to opportunistic behavior among decision-makers. This reinforces agency theory's central premise that personal benefits may be prioritized over organizational interests when monitoring systems are insufficient. Moreover, by demonstrating that external audit quality significantly moderates the relationship between compensation structures and earnings management, the study adds empirical evidence to the theoretical linkage between internal governance mechanisms and external assurance processes.

The multidimensional measurement of earnings quality—through earnings management, persistence, and income smoothing—enhances theoretical clarity about how compensation and incentives affect different facets of financial reporting. This nuanced approach contributes to the literature by recognizing that earnings quality is not a single construct but a composite of behavioral and reporting outcomes. Finally, the study expands the body of knowledge concerning developing economies by providing evidence from Palestine, where institutional environments differ substantially from those in developed markets. This contextual contribution underscores the importance of considering local governance settings when applying global theories.

10.2 Practical Implications for Firms and Managers

The findings have important implications for the managerial and operational practices of firms in Palestine. The positive relationship between board compensation and earnings manipulation suggests that companies need to redesign their compensation packages to reduce overemphasis on short-term financial performance. Firms are encouraged to shift toward compensation models that reward long-term strategic achievements, sustainability indicators, and ethical behavior to reduce the likelihood of opportunistic reporting.

Similarly, incentive systems should be carefully reviewed to ensure they promote responsible financial decision-making rather than earnings-based goal attainment alone. Training programs for board members should highlight the ethical expectations and long-term responsibilities associated with their roles. Internal audit departments may also benefit from enhancing their monitoring procedures to detect early signs of income smoothing or discretionary accrual manipulation.

The study also demonstrates the critical importance of selecting high-quality external auditors. Firms that engage reputable, independent, and technically competent audit firms benefit from a reduced risk of earnings manipulation. Therefore, companies are advised to integrate audit quality considerations into their governance frameworks, recognizing it as an investment in credibility rather than an administrative cost.

10.3 Policy and Regulatory Implications

The findings of the study carry significant implications for regulators and policymakers, particularly in the Palestinian Capital Market Authority, the Ministry of National Economy, and professional audit oversight bodies. The demonstrated impact of compensation and incentives on earnings quality suggests that clearer governance guidelines are needed to regulate the structure and disclosure of board compensation systems. Regulators may consider issuing codes of best practice that delineate acceptable forms of financial rewards and require firms to incorporate long-term performance metrics into compensation contracts.

The strong moderating effect of audit quality highlights the need for regulatory emphasis on auditing standards and auditor oversight. Policymakers should enhance audit firm accreditation processes, ensure compliance with international auditing standards, and periodically evaluate the performance of external auditors. Strengthening penalties for audit negligence or lack of independence may further improve reporting integrity across the Palestinian market.

Moreover, mandatory disclosure policies regarding compensation, incentive structures, and audit characteristics can enhance transparency, enabling investors to make informed decisions. Encouraging firms to adopt integrated reporting or sustainability reporting practices may also contribute to improved governance and accountability.

10.4 Broader Implications for Investors and Stakeholders

The study offers valuable insights for investors, creditors, and other stakeholders who rely on financial statements to assess firm performance and risk. By demonstrating that board compensation and incentives can negatively influence earnings quality—unless moderated by high audit quality—the study provides stakeholders with a clearer understanding of the indicators that may affect the reliability of financial information. Investors should consider audit quality and governance disclosures as part of their evaluation criteria when assessing investment opportunities in Palestinian firms.

11. Conclusion

This study examined the effect of board compensation and board incentives on the quality of reported earnings among firms operating in Palestine, while also assessing the moderating role of external audit quality. Using a descriptive–analytical approach and multiple regression models, the study provided empirical evidence that both compensation and incentive systems exert significant influence on earnings quality, particularly through their impact on earnings management practices. The results revealed that higher levels of board compensation and performance-based incentives were associated with an increased likelihood of discretionary accrual manipulation and income smoothing, suggesting that current compensation structures may unintentionally encourage short-term financial reporting behavior.

The study also found that external audit quality plays a critical moderating role in this relationship. High-quality audits—characterized by independence, reputation, and professional expertise—significantly weakened the positive relationship between compensation mechanisms and earnings management. This demonstrates that strong external monitoring can effectively constrain opportunistic behavior and enhance the credibility of financial reporting. These findings align with agency theory, which emphasizes the importance of monitoring mechanisms to mitigate conflicts of interest between decision-makers and stakeholders.

In the context of Palestine, where firms operate amid economic uncertainty, evolving regulatory frameworks, and varying governance effectiveness, the study contributes valuable insights into the interaction between governance mechanisms and financial reporting outcomes. The results highlight the need for enhancing board compensation structures, strengthening audit quality practices, and promoting transparent governance systems to improve earnings quality and restore stakeholder confidence. Overall, the study advances theoretical understanding, informs corporate practice, and provides empirical evidence that can guide policy development in Palestine’s corporate sector.

11.1 Recommendations

Based on the findings and implications of this study, the following recommendations are proposed for firms, regulators, and stakeholders in Palestine:

1. Recommendations for Firms and Boards of Directors

Redesign Compensation Structures:

Firms should revise their board compensation schemes to reduce emphasis on short-term financial performance and incorporate long-term strategic indicators, ethical behavior metrics, and performance sustainability.

Reevaluate Incentive Systems:

Incentive plans must be calibrated to discourage earnings manipulation by linking rewards to long-term outcomes rather than annual earnings targets.

Strengthen Internal Controls:

Companies should enhance internal audit functions to monitor earnings quality indicators and detect early signs of accrual manipulation or income smoothing.

Increase Transparency in Governance Disclosures:

Firms should provide more detailed and standardized disclosures concerning compensation, incentives, and audit engagements to improve investor trust.

2. Recommendations for External Auditors

Enhance Audit Quality Practices:

Audit firms must ensure strict adherence to international auditing standards, strengthen staff training, and adopt advanced analytical tools to detect earnings manipulation.

Promote Auditor Independence:

To maintain credibility, audit firms should enforce rotation policies and avoid conflicts of interest that compromise independence.

3. Recommendations for Policymakers and Regulators

Issue Clear Governance Guidelines:

Regulatory bodies such as the Palestinian Capital Market Authority should establish frameworks governing compensation and incentives, ensuring alignment with long-term corporate performance.

Develop Audit Quality Oversight Mechanisms:

Create or strengthen an audit oversight board to regularly evaluate audit firm performance, enforce compliance, and sanction misconduct.

Mandate Enhanced Financial Disclosures:

Introduce stricter disclosure requirements regarding board compensation, incentives, and audit arrangements to increase transparency and comparability across firms.

Encourage Adoption of Corporate Governance Codes:

Promote corporate governance standards that emphasize accountability, integrity, and improved monitoring practices.

4. Recommendations for Investors and Stakeholders

Incorporate Governance Indicators in Investment Decisions:

Investors should consider compensation structures, audit quality, and earnings quality indicators as core elements of financial risk assessment.

Engage Actively in Governance Reform:

Institutional investors can influence firms by advocating for stronger governance, better financial reporting, and improved monitoring practices.

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