EARNINGS MANAGEMENT: A LITERATURE REVIEW ON TRENDS, THEORETICAL DEVELOPMENTS, AND MAJOR FINDINGS

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ABSTRACT

This study aims to map the development of earnings management research over time by reviewing relevant academic literature based on research trends, theoretical developments, and major findings. This study employs a qualitative literature review approach, using published from 1990s to 2025 were selected based on relevance and contribution to the theoretical and empirical development. This review found that earnings management is mainly based on agency theory, and later supported by positive accounting theory, signaling theory, and stakeholder theory. In practice, earnings management is done to meet targets, get bonuses, avoid loan problems, prepare for IPOs, or reduce political pressure. It can be done through changes in accounting (accrual-based) or real business actions (real earnings management). Earnings management can reduce trust in financial reports, cause wrong market decisions, and lead to legal or reputation problems. This study is expected to enrich the body of literature on the development of management accounting research and provide a theoretical foundation for future research.

Keywords: earnings management, accrual-based earnings management, real earnings management, financial reporting, corporate governance

INTRODUCTION

Earnings management has become one of the most important topics in accounting research due to its critical role in influencing the quality of accounting information presented to stakeholders. This issue is highly significant because earnings reporting serves as a key indicator of a company's performance, used by investors, creditors, financial analysts, and regulators in making economic decisions (Bansal, 2024). According to the definition by Healy and Wahlen (1999), earnings management refers to the intentional intervention in the external financial reporting process, aimed at gaining personal advantage—either by misrepresenting information to investors or by influencing contractual outcomes such as managerial bonuses and debt agreements.

Since the early 1990s, academic attention to earnings management has grown significantly, particularly in response to a series of major financial scandals such as Enron and WorldCom, which are now frequently cited as classic cases of large-scale financial manipulation. These events prompted the introduction of stringent regulatory measures, most notably the Sarbanes-Oxley Act of 2002 in the United States, which strengthened oversight of financial reporting and increased managerial accountability (Petra & Loukatos, 2009).

From a theoretical perspective, studies on earnings management have largely adopted the framework of agency theory, which explains the conflict of interest between owners and managers that may lead managers to manipulate financial reports for personal gain (Shoaib & Siddiqui, 2022). In addition, from the perspective of stakeholder theory, earnings management is considered an ethical violation because it undermines the interests and trust of various stakeholders who rely on accurate and transparent financial information for decision-making (Martadinata, 2022; Martadinata & Yasa, 2023; Ali et al., 2024).

Recent studies have also shown a shift in focus from merely identifying earnings management practices to exploring its determinants, impacts, as well as its mechanisms. Accordingly, this study aims to map the development of earnings management research over time by reviewing relevant academic literature that can offer direction for future research.

METHOD, DATA, AND ANALYSIS

This study employs a qualitative literature review approach. Sources were identified using Google Scholar. Articles published from 1990s to 2025 were selected based on relevance and contribution to the theoretical and empirical development of the field. Selected studies were analyzed based on trends over time, theoretical developments, and major findings.

RESULT AND DISCUSSION

Research Trends Over Time

Research on earnings management has developed significantly over the last forty years. In the 1980s and 1990s, many studies based on agency theory (Jensen & Meckling, 1976), focused on how managers used accruals to manipulate earnings, especially during events like IPOs or debt agreements (Healy, 1985; Jones, 1991). These studies led to models such as the Jones Model for detecting earnings management practices (Dechow et al., 1995).

Following major accounting scandals in the early 2000s such as Enron and WorldCom, attention shifted to corporate governance. Researchers explored how boards, audit committees, and ownership structures could reduce earnings management practice (Becker et al., 1998; Klein, 2002). Around this time, real earnings management, which involves altering actual business operations to influence reported earnings, directly impacting cash flow and real business decisions, also gained attention in earnings management research (Roychowdhury, 2006).

Since 2010, the research has expanded internationally, looking at how laws and investor protections affect earnings management (Leuz, Nanda, & Wysocki, 2003). More recent studies also examine earnings management's impact on firm value, capital costs, and investor trust (Cohen & Zarowin, 2010; Eugster, F., & Wagner, A. F., 2021; Sánchez-Ballesta, & Yagüe, 2022). In addition, there's growing interest in how sustainability and ESG reporting may also be subject to earnings management (Christensen, Hail, & Leuz, 2021; Jhunjhunwala & Fatima, 2025). Also, how extraordinary event affects earnings management practice, such as natural disaster and Covid-19 outbreak (Aljughaiman et al., 2023; Boubaker et al., 2025).

Theoretical Developments

The study of earnings management at first has been primarily grounded in Agency Theory, introduced by Jensen and Meckling (1976), which posits a conflict of interest between principals (shareholders) and agents (managers). This misalignment creates incentives for managers to engage in earnings management to maximize personal benefits, such as bonuses or job security, at the expense of shareholders (Zhang et al., 2008; Ali et al., 2020; Akhlaghi & Jouzbarkand, 2024)

In addition to agency theory, Positive Accounting Theory by Watts & Zimmerman (1986) also used to explain the background of earnings management. This theory assumes that managers are rational, self-interested agents who make accounting choices to maximize their personal utility, which often tied to compensation, debt covenants, or political exposure. Based on this theory, managers with compensation tied to reported earnings may engage in earnings management to increase income and receive higher bonuses (Martadinata, 2022). In addition, firms approaching violation of debt covenants may manage earnings upward to avoid breaching financial ratios required in loan agreements (Dyreng et al., 2022). Also, based on Positive Accounting Theory, large, high-profile firms may downplay earnings to avoid regulatory scrutiny or public backlash (Guenther, 1994).

Signaling Theory (Spence, 1973) is also commonly applied to earnings management literature. It explains how one party (the sender) credibly conveys information to another party (the receiver) in situations of information asymmetry (Spence, 1973). In the context of earnings management, managers may manipulate earnings to send favorable signals to the market, particularly during times of asymmetric information, such as IPOs and mergers (Louis, 2004; Fan, 2007). This theory supports the idea that earnings management can be used to influence investor perceptions and enhance firm valuation.

More recent developments incorporate Stakeholder Theory (Freeman, 1984), which broadens the focus from shareholders to all parties affected by managerial decisions. From this perspective, earnings management is not only a breach of fiduciary duty but also an ethical issue that undermines the trust of stakeholders such as employees, customers, and regulators (Martadinata, 2022; Martadinata & Yasa, 2023; Ali et al., 2024). By presenting a manipulated picture of a firm's financial health, managers mislead stakeholders who depend on transparent and reliable information for critical decisions, such as investing, lending, and regulatory oversight (Adejumo & Ogburie, 2025).

Lastly, emerging literature integrates Institutional Theory to explain how organizational behavior, including earnings management, is shaped by external pressures such as norms, regulations, and cultural expectations (DiMaggio & Powell, 1983). This theory highlights how companies adapt earnings practices in response to formal rules and informal expectations within their institutional environment (Aerts et al., 2013; Bao & Lewellyn, 2017; Gokhale & Pillai, 2024).

Major Findings

Research on earnings management has provided various empirical findings. This research categorizes based on motivations, mechanism, and consequences of earnings management. Below are the major findings identified in the literature:

Motivations for Earnings Management

Empirical studies have identified a range of incentives that drive managerial actions in earnings management, including:

1) Meeting or beating earnings benchmarks: Managers frequently manipulate earnings to meet analyst forecasts or prior period earnings, in an effort to maintain market valuation and investor confidence (Dutta & Gigler, 2002; Cormier & Martinez, 2006; Simpson, 2013; Habib, 2024).
2) Bonus and compensation arrangements: Managers whose compensation is tied to accounting performance are more likely to manage earnings upward to maximize bonuses (Martadinata, 2022; Martadinata & Yasa, 2023)
3) Avoidance of debt covenant violations: Firms near breach points often inflate earnings to maintain compliance with loan covenants (Dyreng et al., 2022; Nguyen et al., 2022).
4) Initial Public Offerings (IPOs): Pre-IPO firms often engage in earnings management to present stronger financial performance to attract investors (Louis, 2004).
5) Political cost considerations: Large firms may underreport earnings to reduce political visibility, taxes, or regulatory scrutiny (Watts & Zimmerman, 1986; Guenther, 1994).

Mechanisms of Earnings Management

Empirical studies have identified two major mechanisms of earnings management, such as:

1) Accrual-based earnings management: Involves manipulating accounting entries and estimates within the flexibility of Generally Accepted Accounting Principles (GAAP), without altering actual cash flows (Jones, 1991; Cohen, 2008; Greusard, 2022)
2) Real earnings management: Involves real activities manipulation, including overproduction, sales discounts, and discretionary expense reduction, which distort cash flows rather than accounting entries (Roychowdhury, 2006; Cohen, 2008; Zang 2021)

Consequences of Earnings Management

Empirical studies have identified multiple consequences of earnings management, such as:

1) Reduced financial statement credibility and loss of investor confidence: Users of financial statements (investors, creditors, and analysts) may question the reliability of earnings reports after detection of manipulation, leading to loss of investor confidence (Rezaee, 2005; Alao, 2024).

2) Market mispricing and correction: Earnings management often leads to short-term stock price inflation, followed by price corrections when the manipulation is revealed (Teoh et al., 1998).
3) Legal and reputational risks: Manipulation can expose firms to litigation risk, regulatory penalties, and long-term brand damage (Karpoff, Lee, & Martin, 2008).

CONCLUSION

This literature review has highlighted the evolving nature of earnings management research over time based on research trends, theoretical developments, and major findings. Theoretically, earnings management is primarily grounded in agency theory, then developed by using other theories such as positive accounting theory, signaling theory and stakeholder theory which provides various perspectives on the basis, motivation, and ethical aspects of earnings management. Empirical findings reveal that earnings management is motivated by a variety of incentives such as meeting or beating earnings benchmarks, bonus and compensation arrangements, avoidance of debt covenant violations, IPO, and political cost considerations. Techniques employed include both accrual-based and real earnings management, with various consequences such as reduced financial statement credibility and loss of investor confidence, market mispricing and correction, and also legal and reputational risks.

IMPLICATION, LIMITATION AND SUGGESTIONS

This literature review shows that earnings management can reduce the trust and usefulness of financial reports. It may lead investors and other stakeholders to make wrong decisions. For companies, this highlights the need for stronger controls, honest leadership, and good audit systems. For researchers, it shows the importance of using different theories and better tools to detect and reduce earnings management. Despite offering an overview of earnings management literature, this study has several limitations. First, this literature review focuses on three aspects, namely research trends, theoretical developments, and major findings of earnings managements studies. Other aspects have the potential for further review, such as the methodology used in earnings managements studies, and also the development of earnings managements detection method. Second, this research presents a general overview of earnings management studies. Further research is expected to provide a more specific overview, such as the development of accounting research in certain countries that are under-researched, as well as conducting comparative studies between countries to present aspects of cultural differences in explaining earnings management practice.

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