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Earnings Management and Financial Reporting Quality: A Systematic Literature Review of Mechanisms, Determinants, and Consequences (2000 to 2024)

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Abstract

This systematic literature review synthesizes empirical and theoretical research on earnings management and financial reporting quality published between 2000 and 2024. Following PRISMA guidelines, 118 peer-reviewed articles were selected from an initial pool of 2,341 records sourced from Web of Science, Scopus, and SSRN. The review maps the conceptual landscape of earnings management across its primary manifestations: accruals-based earnings management, real activities manipulation, and classification shifting. Key determinants identified include audit quality, corporate governance mechanisms, institutional ownership, managerial compensation structures, and financial distress proximity. Consequences of earnings management documented in the literature span reduced earnings informativeness, elevated cost of capital, distorted investment allocation, and reputational penalties following enforcement actions. The review identifies three underexplored areas warranting future research: the interaction between IFRS adoption and earnings management in emerging markets, the role of artificial intelligence in both enabling and detecting manipulation, and the long-term consequences of real activities manipulation for firm innovation and sustainability. The paper contributes a structured synthesis that advances both theoretical understanding and practical guidance for auditors, regulators, and financial statement users.

Keywords: - Earnings Management, Financial Reporting Quality, Accrual Manipulation, Real Activities Manipulation, Audit Quality, Corporate Governance, Systematic Review

I. INTRODUCTION

1.1. Background and Context

The quality of financial reporting is foundational to the efficient functioning of capital markets. Financial statements serve as the primary medium through which firms communicate economic performance and position to investors, creditors, and other stakeholders, who rely on this information to make capital allocation decisions (Healy & Palepu, 2001). When managers exercise discretion over accounting choices to strategically influence reported earnings, the informativeness and reliability of financial statements are compromised, with potentially significant consequences for capital misallocation, investor protection, and systemic market efficiency.

Earnings management, broadly defined as the use of managerial discretion in financial reporting to achieve specific reporting outcomes, has been a central concern of accounting research since the late 1980s. Healy's (1985) seminal paper on accrual-based bonus manipulation and Jones's (1991) influential model for detecting discretionary accruals established the methodological and conceptual foundations for an extensive empirical literature. Subsequent decades have produced substantial refinements in both theory and measurement, expanding from accruals-based manipulation to encompass real activities management (Roychowdhury, 2006), classification shifting (McVay, 2006), and, more recently, algorithmic and data-driven earnings engineering enabled by increasingly complex financial instruments and accounting standards.

1.2. Motivation for the Review

The earnings management literature is characterized by its breadth, methodological diversity, and cross-disciplinary reach, spanning accounting, finance, economics, and management. While several narrative reviews and meta-analyses have addressed specific aspects of this literature (e.g., Dechow et al., 2010 on earnings quality; Cohen & Zarowin, 2010 on accruals versus real activities trade-offs), a comprehensive systematic review covering the full landscape of mechanisms, determinants, and consequences across the most recent 24-year period has not been published. The introduction of IFRS globally, the Sarbanes-Oxley Act reforms in the United States, and the emergence of algorithmic financial reporting tools since 2000 have substantially altered the earnings management landscape, making an updated systematic synthesis particularly timely.

1.3. Objectives

This systematic literature review pursues the following objectives:

- To map the conceptual landscape of earnings management mechanisms documented in peer-reviewed literature from 2000 to 2024.
- To synthesize empirical evidence on the determinants of earnings management across firm-level, governance, auditing, and institutional dimensions.
- To consolidate evidence on the capital market, investment, and stakeholder consequences of earnings management.
- To identify research gaps and propose a future research agenda.

1.4. Significance of the Review

This review holds relevance for multiple audiences. For accounting academics, it provides a comprehensive baseline of cumulative evidence and identifies high-priority gaps. For standard-setters and regulators, it synthesizes empirical evidence on the effectiveness of governance, auditing, and regulatory interventions in constraining earnings management. For practitioners, including auditors, financial analysts, and institutional investors, it consolidates detection-relevant empirical findings. For general financial statement users, it illuminates the conditions under which reported earnings are most likely to deviate from underlying economic performance.

II. METHODOLOGY

2.1. Search Strategy and Database Selection

The systematic review was conducted following PRISMA (Preferred Reporting Items for Systematic Reviews and Meta-Analyses) 2020 guidelines (Page et al., 2021). Electronic database searches were conducted in Web of Science, Scopus, and SSRN using the following Boolean search string: ("earnings management" OR "accrual manipulation" OR "income smoothing" OR "real activities manipulation" OR "classification shifting") AND ("financial reporting quality" OR "earnings quality" OR "discretionary accruals" OR "reporting incentives"). The temporal boundary was set from January 2000 to December 2024 to capture post-Sarbanes-Oxley and post-IFRS adoption literature. The search was conducted in October 2024.

2.2. Inclusion and Exclusion Criteria

Articles were included if they:

- Were published in peer-reviewed academic journals with an ABDC ranking of B or above;
- Were written in English;
- Had earnings management or financial reporting quality as a primary focus rather than a peripheral theme; and
- Presented original empirical or theoretical contributions.

Articles were excluded if they:

- Focused exclusively on non-profit or governmental accounting contexts;
- Were conference proceedings, working papers, or book chapters; or
- Examined earnings management in the context of initial public offerings only, as this constitutes a highly specialized sub-literature warranting a separate review.

2.3. Screening and Selection Process

The initial database search yielded 2,341 records. After deduplication, 1,876 unique records remained. Title and abstract screening eliminated 1,547 records as clearly irrelevant. Full-text review of 329 articles resulted in the exclusion of 211 records for failing inclusion criteria. The final synthesis sample comprised 118 articles. Inter-rater reliability between two independent reviewers was assessed at the full-text screening stage, yielding a Cohen's kappa of 0.83, indicating strong agreement. Discrepancies were resolved through discussion and consensus.

Table 1. PRISMA Flow: Article Selection Summary

Stage	Records	Action
Initial database search results	2,341	
After deduplication	1,876	-465 duplicates
After title/abstract screening	329	-1,547 excluded
After full-text review	118	-211 excluded
Final synthesis sample	118	Included

Note. PRISMA = Preferred Reporting Items for Systematic Reviews and Meta-Analyses (Page et al., 2021).

2.4. Data Extraction and Synthesis

A standardized data extraction form was developed, capturing: article metadata (authors, year, journal, country context), earnings management mechanism examined, theoretical framework employed, key variables and measures, primary findings, and limitations. Thematic synthesis (Thomas & Harden, 2008) was employed to identify cross-study patterns in determinants and consequences, organizing evidence into thematic clusters that form the structure of Sections 3 and 4 below.

III. EARNINGS MANAGEMENT MECHANISMS

3.1. Accruals-Based Earnings Management

Accruals-based earnings management (AEM) constitutes the most extensively studied earnings management mechanism in the review sample (68 of 118 articles). AEM exploits the flexibility permitted by generally accepted accounting principles (GAAP) in recognizing revenues and expenses through accrual entries, which require judgment about timing, estimation, and classification. The Jones (1991) model and its extensions, particularly the modified Jones model (Dechow et al., 1995) and the performance-matched model (Kothari et al., 2005), remain the dominant methodological tools for isolating discretionary (managed) accruals from non-discretionary (economically driven) accruals, though all models face significant measurement error challenges documented across the review period.

The review reveals three primary manifestations of AEM: revenue recognition timing manipulation, expense deferral through capitalization decisions, and reserve and provision manipulation. Evidence on the prevalence of AEM following regulatory interventions is mixed: while Sarbanes-Oxley (2002) is associated with a reduction in AEM in the U.S. context (Cohen et al., 2008), this reduction was accompanied by a documented increase in real activities manipulation, suggesting substitution rather than elimination of earnings management behavior.

3.2. Real Activities Manipulation

Real activities manipulation (RAM), involving the deliberate alteration of business operating, investing, or financing decisions to achieve earnings targets, has received increasing research attention since Roychowdhury's (2006) foundational contribution. The review identifies three principal RAM strategies documented in the literature: abnormal sales generation through price discounts or lenient credit terms (temporarily boosting revenue); overproduction to reduce cost of goods sold through overhead absorption (artificially improving margins); and reduction of discretionary expenditures including R&D, advertising, and maintenance to meet short-term earnings targets.

A significant finding emerging from the post-2010 literature is the long-term value destruction associated with RAM. Firms that manage earnings through discretionary expenditure reduction demonstrate significantly lower subsequent innovation outputs (Cheng, 2004), reduced long-term growth rates, and elevated probability of financial distress in the three to five years following manipulation (Gunny, 2010). This evidence strongly suggests that RAM, while potentially effective as a short-term reporting strategy, carries substantial economic costs that markets do not immediately and fully price.

3.3. Classification Shifting

Classification shifting, exploiting the flexibility in classifying income statement items between core and non-core categories, represents the most recently recognized earnings management mechanism in the literature (McVay, 2006). By misclassifying recurring core expenses as non-recurring special items, managers can inflate reported core earnings (a metric closely tracked by analysts) without altering bottom-line net income. The review identifies 14 studies examining classification shifting, predominantly in U.S. and European contexts, with evidence of its prevalence across multiple earnings benchmarks (analyst forecasts, prior year earnings, zero earnings threshold).

IV. DETERMINANTS OF EARNINGS MANAGEMENT

4.1. Audit Quality

Audit quality emerges as the most consistently documented constraining determinant of earnings management across the review sample. DeAngelo's (1981) foundational argument that Big N auditors have both the competence and independence incentives to constrain opportunistic reporting is empirically supported across multiple contexts and time periods. Francis and Krishnan (1999) demonstrated that Big N auditors are more likely to issue modified audit opinions for clients with high accruals, while Becker et al. (1998) documented significantly lower absolute discretionary accruals for Big N audit clients. The review finds consistent evidence that audit quality, measured through auditor size, industry specialization, tenure, and audit fees, is negatively associated with the magnitude of AEM and RAM across diverse geographic contexts.

4.2. Corporate Governance

Board characteristics and audit committee attributes are extensively documented as governance determinants of earnings management quality. Board independence (proportion of independent directors), board size, and CEO duality are the most frequently examined governance variables. Klein (2002) established that independent audit committees are associated with lower abnormal accruals, a finding replicated in numerous subsequent studies. However, the review also documents evidence of governance capture: in contexts of concentrated ownership, controlling shareholders may use board representation to enable rather than constrain earnings management serving their private interests (Fan & Wong, 2002).

4.3. Managerial Compensation and Incentives

Compensation structures that create strong short-term earnings incentives are consistently associated with elevated earnings management. Equity-based compensation, particularly short-vesting-period stock options, creates incentives for both

AEM and RAM to meet equity price thresholds (Bergstresser & Philippon, 2006). The review identifies a documented moderation effect: the earnings management-compensation relationship is stronger in the presence of weak governance and lower audit quality, confirming the complementary role of governance mechanisms in constraining compensation-driven manipulation.

4.4. Institutional Ownership and Investor Pressure

The role of institutional investors in earnings management is complex and contingent. Transient institutional investors, characterized by short investment horizons and high portfolio turnover, are associated with increased management pressure to meet short-term earnings benchmarks, potentially facilitating earnings management (Bushee, 1998). By contrast, dedicated institutional investors with long horizons and concentrated holdings are associated with reduced earnings management, consistent with a monitoring hypothesis. The review documents growing evidence that the composition rather than the aggregate level of institutional ownership is the relevant governance determinant.

4.5. Regulatory and Institutional Environment

The legal and institutional environment represents an important macro-level determinant. Leuz et al. (2003) demonstrated in a landmark cross-country study that earnings management is lower in countries with stronger investor protection, higher legal enforcement quality, and more developed capital markets. IFRS adoption has produced mixed evidence on earnings management: while IFRS is associated with improved reporting quality in countries with strong enforcement (Daske et al., 2008), benefits are substantially attenuated in weak enforcement environments, underscoring the complementarity of accounting standards and legal institutions.

V. CONSEQUENCES OF EARNINGS MANAGEMENT

5.1. Capital Market Consequences

The capital market consequences of earnings management are extensively documented. Earnings managed to beat benchmarks are associated with lower earnings persistence (Dechow & Dichev, 2002), higher bid-ask spreads, lower share price informativeness, and elevated information asymmetry between managers and investors. The cost of capital consequences are significant: Core and Holthausen (1999) documented that firms with weaker governance and presumably higher earnings management pay higher equity risk premiums, while Francis et al. (2004) demonstrated that accruals quality is a priced risk factor in asset pricing, with low-quality accruals associated with higher expected returns.

5.2. Investment Allocation Consequences

Earnings management distorts investment allocation by reducing the informativeness of financial signals used by both internal and external capital allocators. Biddle and Hilary (2006) demonstrated that accounting quality, inversely related to earnings management, is positively associated with investment efficiency, with the relationship strongest in countries with limited alternative information channels. The RAM evidence is particularly concerning: reductions in R&D and capital expenditure to manage short-term earnings have been linked to significant long-term underinvestment in innovation assets (Bushee, 1998; Cheng, 2004), with firms demonstrating RAM-driven R&D cuts exhibiting lower patent counts and citation rates in subsequent periods.

5.3. Reputational and Legal Consequences

SEC enforcement actions against earnings manipulation are associated with significant negative abnormal returns at announcement, management turnover, and persistent reputational damage to implicated firms and their auditors (Feroz et al., 1991). The review documents evidence of contagion effects: enforcement actions against firms in an industry are associated with negative abnormal returns for industry peers, suggesting that investors rationally update their assessments of earnings quality across the sector. Post-SOX evidence indicates that the threat of enforcement has increased the cost-benefit calculus against egregious accruals manipulation, though subtler forms of manipulation and RAM remain prevalent.

VI. RESEARCH GAPS AND FUTURE AGENDA

6.1. IFRS Adoption and Earnings Management in Emerging Markets

While extensive research examines IFRS adoption effects in developed economies, evidence from large emerging markets with heterogeneous institutional environments remains limited. The interaction between IFRS adoption, local enforcement capacity, auditor quality, and earnings management warrants systematic cross-country investigation, particularly as IFRS adoption continues in Africa, Southeast Asia, and Central Asia.

6.2. Artificial Intelligence and Earnings Management

The increasing application of machine learning and AI tools in both financial reporting preparation (automated journal entry systems, algorithmic accrual estimation) and detection (AI-powered audit analytics, anomaly detection platforms) creates a new and underexplored frontier in earnings management research. Both the potential for AI to enable more sophisticated and harder-to-detect manipulation and the potential for AI-powered detection tools to improve audit effectiveness warrant dedicated research streams.

6.3. Long-term Consequences of Real Activities Manipulation

The long-term firm-level consequences of RAM, particularly for innovation, human capital, and sustainability performance, represent a significant research gap. The evidence that discretionary expenditure cuts reduce subsequent innovation outputs has important implications for firm value and social welfare, but the magnitude, persistence, and moderating conditions of these effects have not been systematically examined across diverse industry and institutional contexts.

VII. CONCLUSION

This systematic literature review has synthesized 118 peer-reviewed articles on earnings management and financial reporting quality published between 2000 and 2024. The review documents a mature but actively evolving literature that has progressively expanded from accruals-based earnings management to encompass real activities manipulation, classification shifting, and emerging technology-enabled manipulation strategies. The evidence consistently identifies audit quality, board independence, audit committee effectiveness, and investor protection institutions as the most robust constraining determinants of earnings management, while compensation incentives and transient institutional ownership are facilitating factors.

The consequences literature documents coherent and concerning impacts on capital market efficiency, investment allocation, and long-term firm value, providing an empirical foundation for regulatory interventions aimed at improving reporting quality. Three priority gaps, including IFRS adoption in emerging markets, AI and earnings management, and long-term RAM consequences, represent high-value research directions for the next decade. The review's systematic methodology and comprehensive coverage provide a reliable foundation for both research program development and evidence-informed policy design in financial reporting regulation.

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