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NAVIGATING EARNINGS MANAGEMENT AND CAPITAL MARKETS: A SYSTEMATIC LITERATURE REVIEW

Ni Nyoman Nikunja Vasini[1*], Dewi Susilowati[2]
[1]Master of Accounting Science Program, Faculty of Economics and Business, Jenderal Soedirman University/ Indonesia
[2]Accounting/ Faculty of Economics and Business, Jenderal Soedirman University, Indonesia

[*]Email corresponding author: ni.vasini@mhs.unsoed.ac.id

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Abstract

This study is a systematic literature review (SLR) on earnings management, earnings quality, and market reaction in emerging markets during 2022–2025. The reviewed studies highlight the role of market structure, internal corporate pressures, disclosure quality, and sector-specific factors in influencing earnings management practices and investor perceptions. The synthesis reveals that market liberalization, transparency, and liquidity reduce earnings management, whereas internal pressures such as leverage, profitability, and capital needs increase opportunistic incentives. High-quality disclosure and ESG practices moderate investor perception of earnings management, with market reactions varying by sector characteristics. These findings reinforce agency and signaling theories and provide practical implications for regulators, firms, and investors to enhance transparency, financial reporting quality, and market efficiency.

Keywords: Earnings Management, Earnings Quality, Market Reaction, Market Liberalization, ESG, Emerging Markets

INTRODUCTION

Earnings management continues to be a major focus in accounting research as this practice may disrupt the quality of financial information needed by capital markets to function efficiently. In competitive conditions, companies tend to face pressure to demonstrate stable performance, leading some to employ accrual-based or real-activity manipulation to satisfy investor expectations. This phenomenon is not only theoretical but is also reflected in the alleged financial statement manipulation case of eFishery (2025), which demonstrated how growth pressures and funding needs can create opportunistic incentives in financial reporting (detikFinance, 2025). Empirical findings indicate that this practice directly affects the effectiveness of capital allocation and shareholder protection, as confirmed by Vieira et al. (2021), who found that market pressure can trigger earnings manipulation when oversight mechanisms are not functioning optimally.

The capital market itself has two opposing sides: it increases pressure on management to maintain a strong financial image, while also providing external oversight that can limit manipulation. Recent international studies have shown that as capital markets become more open and integrated, the opportunities and incentives for earnings management tend to decrease. For example, research Tahriri (2022) explains that market liberalization helps improve reporting quality by increasing transparency and accessibility of information across borders.

In the context of increasingly liquid markets, earnings management dynamics are also influenced by a company's funding conditions. Several studies in emerging markets have found that companies with high external demands are more susceptible to earnings management than companies with relatively stable financial structures. Research Thi et al. (2023) shows that leverage and funding pressures increase the intensity of discretionary accruals when companies are undergoing expansion or restructuring. This indicates that a company's financial context is a key determinant of the emergence of financial statement manipulation practices.

In addition to external market factors, the quality of corporate governance plays a strategic role in reducing management's incentives to perform manipulations. A study Nguyen et al. (2024) found that companies with strong corporate governance mechanisms, such as independent boards, effective audit committees, and internal transparency, exhibit a lower tendency to engage in earnings management. However, this research also confirms that strong governance may decline in effectiveness when companies aggressively seek external funding.

Nevertheless, empirical research findings from 2020–2025 show significant variation across industries, macroeconomic conditions, and company characteristics. A study Verdiana & Hanif (2024) found that free cash flow and leverage significantly correlated with earnings management in Indonesian companies, while profitability and liquidity showed no consistent effect. This variation in results indicates that earnings management practices are not solely determined by internal company conditions, but also by market dynamics and other, more complex external pressures.

Based on these findings, a systematic study summarizing the latest empirical evidence is needed to provide a more comprehensive picture of the relationship between earnings management and capital markets. This need is crucial because developments in regulations, market structures, and the digitalization of information in recent years have transformed patterns of corporate accountability. Consistent with the arguments of Koeshardjono et al. (2025), a systematic study enables researchers and regulators to understand new patterns of earnings management practices and formulate more effective monitoring strategies for companies in modern capital markets.

LITERATURE REVIEW

Definition of Earnings Management and Earnings Quality

Conceptually, earnings management refers to managers' actions to influence reported earnings through accounting policy choices and operational decisions to achieve specific objectives, such as meeting profit targets, maintaining stock price stability, or obtaining contractual incentives. This definition is reinforced by recent findings Sun & Li (2025), which show that earnings management practices are a strategic response to external pressures, particularly from the capital market. From a financial accounting perspective, earnings management is divided into two main forms: accrual-based earnings management and real activities manipulation. Accrual-based manipulation is carried out through adjustments to estimates, allowances, or accounting methods, while real activities manipulation occurs through operational decisions such as accelerating sales, deferring costs, or reducing production activities, as explained by Kannangara & Buvanendra, (2022).

Earnings quality is an important dimension of financial reporting, reflecting the extent to which earnings reflect true economic performance and predict future cash flows. According to Muis (2025), high earnings quality is characterized by earnings that reflect the company's fundamental condition through earnings persistence and value relevance, as well as low accrual manipulation. When management manipulates earnings, the quality of financial information declines, and investors' ability to assess the company's prospects is impaired. This aligns with the findings of Mansor et al.(2023), who stated that earnings quality serves as an indicator of the reliability of information used by the capital market for investment decision-making.

The theoretical framework underlying earnings management practices is primarily derived from agency theory, which emphasizes the conflict of interest between managers, as agents, and shareholders, as principals. In this context, managers have an incentive to alter financial statements to fulfill personal interests such as bonuses, reputation, or securing their positions. This explanation is supported by Hidayah & Nuthqi (2025), who found that agency conflicts increase the tendency of companies with weak governance to engage in earnings management. However, not all earnings management efforts are considered negative, as signaling theory suggests that managers sometimes use certain reports as positive information signals to the market. Zhang & Zhao (2023) added that some reporting actions are taken to reduce information asymmetry between companies and investors, although these practices must remain within the limits of acceptable accounting principles.

The Relationship between Earnings Management and the Capital Market

The capital market significantly affects the patterns and intensity of earnings management by providing incentives, pressures, and oversight mechanisms inherent in its structure. A company's access to external funding is a crucial factor; pressure to maintain a short-term performance image encourages management to present consistent and attractive earnings figures. According to Kannangara & Buvanendra (2022), companies with high funding needs tend to have a greater motivation to manipulate earnings, especially when actual performance falls short of investor expectations. In this context, the capital market can exert pressure that strengthens incentives for opportunistic reporting.

Market liquidity also plays a crucial role in earnings management dynamics. High liquidity increases pricing efficiency and reduces information costs, while simultaneously strengthening investor monitoring of management behavior. A study Nguyen et al. (2024) showed that markets with high liquidity are better at detecting earnings manipulation because intense trading activity accelerates the dissemination of information. However, excessive liquidity can also increase short-term volatility, encouraging companies to engage in earnings smoothing to stabilize stock prices.

The next factor is capital market liberalization, which is related to information disclosure, global integration, and increased external oversight. Zhang & Zhao (2023) found that when international capital access is opened, such as through market connectivity policies or relaxation of foreign investment restrictions, companies tend to reduce the intensity of earnings management due to increased transparency pressures and the presence of more professional institutional investors in financial statement analysis. Research Sun & Li (2025) also confirms that market liberalization improves market discipline because foreign investors bring higher analytical standards and governance expectations than domestic investors.

The consistency of findings from 2020–2025 indicates that modern capital markets are not only a venue for securities trading but also an important control mechanism for suppressing opportunistic practices. Muis (2025) concluded that an integrated and closely monitored capital market environment increases transparency, strengthens a company's reputation, and forces management to be more cautious about report manipulation. Thus, the relationship between capital markets and earnings management is dualistic: capital markets can be a source of pressure that triggers manipulation, but they can also serve as a monitoring mechanism that suppresses such behavior.

RESEARCH METHODS

The literature review was conducted systematically using several scientific databases, including Google Scholar, ScienceDirect, Emerald Insight, and indexed national journals, to ensure coverage of relevant, up-to-date studies. The keyword combination used included "earnings management," "earnings quality," "capital market," "market liquidity," "stock market liberalization," and "access to capital," with a publication period limitation of 2020–2025 to ensure that the reviewed research reflected the latest developments in earnings management and capital markets. From the initial identification stage, 99 articles were obtained, and a screening process was conducted based on titles and abstracts to assess theoretical relevance and suitability for the objectives of the systematic review. The inclusion criteria applied included that the study must:

address the correlation between earnings management and capital market aspects or market reactions; use empirical methods, whether quantitative, qualitative, or mixed methods; be published in an indexed scientific journal between 2020 and 2025; and be written in English or Indonesian. Studies that did not address capital market implications, were only editorials, or were working papers that had not undergone peer review, were excluded from the analysis. This stage resulted in a more focused and relevant sample of articles for analysis in the SLR.

The summary of the selection process follows a simplified PRISMA approach to demonstrate transparency and structure. In the initial identification stage, 99 articles were identified that matched the search keywords. After removing duplicates and screening titles and abstracts, the number of articles was reduced to 55, which were deemed to potentially meet the criteria. Next, an eligibility assessment was conducted by reading the full texts of 22 articles to assess the depth of analysis and methodological suitability for the study's focus on earnings management and capital markets. Based on the final evaluation, only 10 articles met all inclusion criteria and were selected as primary sources in this SLR due to their direct relevance and significant empirical contribution to the relationship between earnings management and capital market mechanisms. The figures in this flow representatively illustrate the systematic selection process and are consistent with systematic review writing standards.

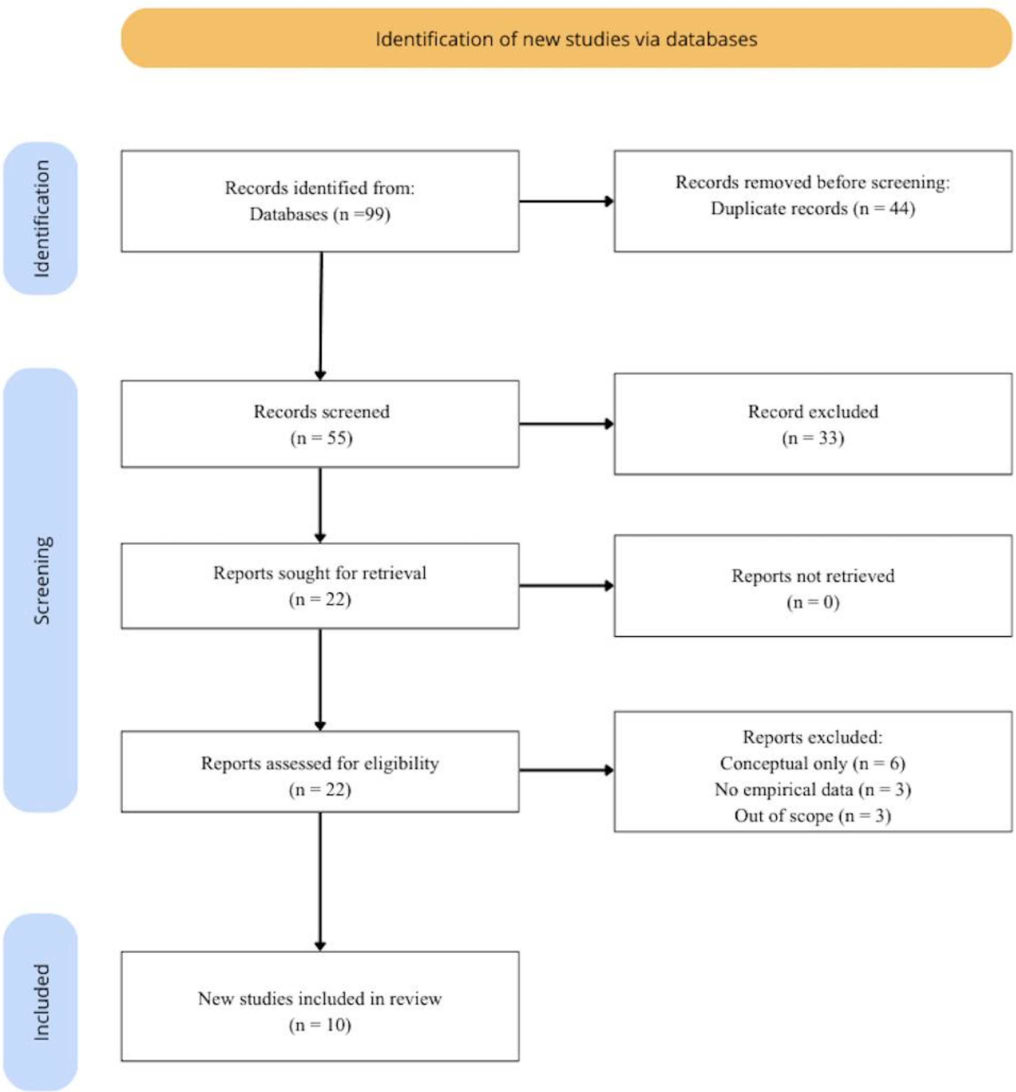

Figure 1. PRISMA 2020 Flow Diagram of Study Selection Process

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RESULTS AND DISCUSSION

RESULT

To provide an empirical overview, this study summarizes prior research on earnings management and its implications for market reactions. This summary includes research methods, variables used, and key findings to identify patterns and differences in results across studies.

Table 1. Summary of Empirical Studies on Earnings Management and Market Reaction

No	Author	Method	Variable	Key findings
1	Song & Song (2023)	Quantitative (DID & PSM-DID)	DA; TREAT, POST, interaction; controls: SIZE, LEV, ROE	The interaction between TREAT and POST has a significant negative effect, indicating a decrease in earnings management practices.
2	Ramadan et al. (2022)	Panel regression, ERC, abnormal returns	REM, CAR, ERC	Real earnings management reduces abnormal returns and weakens ERC, making earnings less informative.
3	Ashour & Atik (2025)	FE Panel, Driscoll–Kraay	AEM, REM; SEO periods; ROA, LEV, SIZE	Earnings management was not found before the SEO, but appeared during and after the offering, primarily through AEM and operating cash flow.
4	Soraya & Arieftiara (2024)	Modified Jones, Quantitative	EM, financial distress; control	Profitability has a significant positive effect on earnings management, leverage has a negative effect, while other variables are not significant.
5	Lestari et al. (2025)	Linear regression (SPSS)	Income smoothing, earnings quality, return	Income smoothing increases earnings response, while earnings quality actually decreases it.
6	Erawati et al. (2023)	Regression & MRA	ROA, CR, IOS, GCG	Liquidity has a significant positive effect on earnings quality, while other variables are not significant and GCG only partially moderates the relationship.
7	Hasanuddin et al. (2025)	Regression, SEM, panel	Disclosure, market response	Disclosure quality increases trading volume and reduces spreads and volatility, with a stronger impact on institutional investors.
8	Lestari & Muthmainnah (2025)	GMM two-step	EM, ERC, ESG	Earnings management is perceived to increase informativeness and trigger investor reactions, especially in high ESG conditions.

No	Author	Method	Variable	Key findings
9	Dombeu & Nomlala (2023)	Literature review	Fair value, accrual quality	The impact of fair value on earnings quality is diverse and there is no consensus on the most appropriate measurement model.
10	Ishak (2024)	Path analysis	EM, leverage, EQ, firm value	Leverage reduces earnings quality and company value, while earnings management has no significant effect.

Source: Author's compilation (2026)

As shown in Table 1, prior studies generally indicate that earnings management influences market reactions, although the direction and magnitude of the effect vary by measurement approach and research context. However, in addition to empirical findings, it is important to critically evaluate each study's contributions and limitations.

Therefore, Table 2 presents a critical review of previous studies, highlighting their research objectives, contributions, weaknesses, and relevance to the systematic literature review.

Table 2. Critical Review of Prior Studies and Research Gap

NO	Author	Objectives	Study contributions	Study weakness	Relevance to the SLR
1	Song & Song (2023)	To provide causal evidence that market integration suppresses earnings management practices.	Provides causal evidence that market integration suppresses earnings management practices.	Limited to the Chinese context so generalizability is low	Supports that market integration improves reporting quality
2	Ramadan et al. (2022)	To analyze the impact of REM on market reactions	Shows that the market responds negatively to the practice of manipulating real activity.	The observation period was short and did not compare with accrual earnings management.	Becomes the empirical basis for the relationship between earnings management and market reaction.
3	Ashour & Atik (2025)	To test earnings management practices during SEO	Provides EM evidence during the stock offering period in emerging markets	The sample was limited and only focused on rights issues.	Relevant to the understanding of EM in the context of corporate financing
4	Soraya & Arieftiara (2024)	Testing the effect of financial distress on EM	Provides evidence of the role of profitability and leverage on EM in Indonesia	Did not take into account governance and macroeconomic factors	Adding evidence to EM determinants in emerging markets

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NO	Author	Objectives	Study contributions	Study weakness	Relevance to the SLR
5	Lestari et al. (2025)	To test the effect of EM on earnings response	Shows that income smoothing increases market reaction compared to earnings quality.	Limited to property subsector and limited variable control	Important for understanding the differences in investor perceptions of EM.
6	Erawati et al. (2023)	To test the determinants of earnings quality and the role of GCG	Shows the role of liquidity and GCG moderation on earnings quality	Small sample and limited variable measurement	Supports studies of earnings quality and the role of governance
7	Hasanuddin et al. (2025)	To test the influence of disclosure on investment decisions	Provides cross-country evidence on the importance of disclosure quality	Potential endogeneity and regulatory differences between markets	Relevant to the correlation between disclosure and market efficiency
8	Lestari & Muthmainnah (2025)	To test investor perceptions of EM with ESG moderation	Shows that ESG strengthens investor reactions to earnings management	Limited sample and Indonesian context only	Important for EM, ESG and market reaction studies
9	Dombeu & Nomlala (2023)	To review developments in earnings quality research	Presents a synthesis of concepts and research gaps related to accrual quality.	Did not utilize systematic review method	Becomes a conceptual basis and identifies research gaps
10	Ishak (2024)	To test the effect of EM and leverage on company value	Shows the role of earnings quality as a mediator in the correlation between leverage and company value.	Limited sample and earnings quality proxy was simple.	Relevant to the correlation between EM, earnings quality, and company value

Source: Author's compilation (2026)

Based on Table 2, several research gaps remain, particularly regarding measurement inconsistencies, limited coverage of emerging-market contexts, and the need for more comprehensive integration of moderating variables. This highlights the importance of further research to deepen the understanding of the correlation between earnings management and market reactions.

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DISCUSSION

A synthetic analysis of the collected studies reveals several consistent findings related to earnings management (EM) practices and earnings quality. First, the influence of market structure and conditions is significant. Song & Song (2023) found that market liberalization in China reduced EM practices, suggesting that market integration and transparency reduce managers' incentives to manipulate financial statements. Similar findings were reported by Hasanuddin et al. (2025), who found that the quality, scope, and timeliness of disclosures increase transaction volume and reduce market volatility, suggesting that more efficient markets can monitor and respond to EM practices. This confirms that markets serve as effective external oversight mechanisms, particularly in emerging markets undergoing regulatory and governance improvements.

Second, internal corporate pressures have also been shown to influence EM practices. Soraya & Arieftiara (2024) highlight that profitability has a positive effect on EM, while leverage has a negative effect. This suggests that more profitable companies may be encouraged to engage in EM as a strategy to maintain a high-performance image, whereas highly leveraged firms face financial constraints that discourage earnings manipulation. Ishak (2024) reinforces this finding, emphasizing that leverage negatively affects earnings quality and company value, whereas EM does not always significantly affect company value, suggesting that certain internal pressures can lead to opportunistic behavior but do not always translate directly into market value.

Third, companies' need for short-term access to capital temporarily drives EM practices. Ashour & Atik (2025) found that EM emerged during and after rights issues, while no significant manipulation was observed prior to the offering. This finding suggests that companies use EM to increase market appeal when seeking additional capital. The findings of Ramadan et al. (2022) are also relevant since real EM reduces cumulative abnormal returns and weakens the earnings response coefficient, indicating that the market is fairly sensitive to indications of earnings manipulation. Therefore, EM can be a double-edged sword: improving short-term image but reducing earnings informativeness for investors.

Fourth, disclosure quality and market reputation moderate the impact of EM on investor reactions. Lestari & Muthmainnah (2025) show that ESG strengthens investors' assessments of EM, particularly for income-decreasing EM. This suggests that EM practices, combined with corporate social responsibility and high-quality disclosure, tend to be more favorably received by the market, confirming the moderating role of external factors and reputation in shaping investor perceptions. Erawati et al. (2023) show that institutional ownership moderates the internal influence on earnings quality, indicating that institutional ownership can act as an additional monitor that reduces opportunistic management behavior.

Fifth, the sector and industry context provide additional nuances to EM practices. Lestari et al. (2025) highlighted the property and real estate subsector in Indonesia, where income smoothing positively affected market reactions, whereas earnings quality negatively affected them. This suggests that investors may value earnings stability over pure accounting quality, particularly in volatile sectors. This phenomenon emphasizes the importance of considering industry context when assessing EM practices and interpreting market reactions.

Theoretically, these findings reinforce the agency and signaling perspectives. More transparent and liquid capital markets mitigate agency problems by increasing external oversight, while internal pressures such as leverage, capital needs, or financial distress encourage opportunistic behavior in managers. These results are also consistent with signaling theory, in which disclosure quality and ESG reputation serve as signals to investors about the credibility of a company's financial statements. From a policy perspective, these findings suggest that market reforms that improve transparency, governance, and disclosure quality can curb earnings manipulation and boost investor confidence, particularly in emerging markets such as Indonesia and China.

Overall, this synthesis demonstrates that EM practices are a multidimensional phenomenon influenced by a combination of external pressures (market structure, disclosure quality, institutional oversight), internal pressures (profitability, leverage, capital needs), and industry context. The interaction among these factors determines the extent of EM practices, the shape of earnings quality, and market responses. The cross-study findings also indicate that investors and regulators need to consider a variety of external and internal indicators to assess the credibility of financial statements and mitigate the risk of investment decisions based on distorted information.

Practical Implications

Market regulators: Strengthening disclosure regulations, cross-exchange transparency, and stricter reporting standards can reduce the frequency of EM, as evidenced by Song & Song (2023) and Hasanuddin et al. (2025).

Companies & boards of commissioners: Governance strengthening (e.g., board independence, audit committees) and information disclosure practices will improve earnings quality and lower the cost of capital, as found by Erawati et al. (2023) and Lestari et al. (2025).

Investors & analysts: In assessing earnings quality, investors should consider liquidity indicators, funding pressure, voluntary disclosure, and ESG as moderating factors for EM, as evidenced by Lestari & Muthmainnah (2025).

Limitations of the Study & Recommendations for Further Research

The main limitations of this study include:

1. The focus is on publications from 2022 to 2025 with a limited scope of quantitative studies in emerging markets. Therefore, relevant studies from other countries or multi-sector contexts may not be covered.
2. Methodological heterogeneity across studies (different EM proxies, different analytical approaches, cross-market samples) renders quantitative generalization difficult.
3. Many studies are still observational or cross-sectional; therefore, limitations in establishing causality for EM practices remain.

Further research recommendations include multi-country longitudinal research to map EM dynamics; quasi-experimental or natural experiments to assess the effects of market reforms and disclosure policies; and mixed-methods research combining quantitative analysis and managerial interviews to understand the motivations behind EM practices in greater depth.

CONCLUSION

Based on a synthesis of findings from recent studies (2022–2025), several key conclusions can be drawn regarding earnings management, earnings quality, and market reactions in the context of emerging markets:

1. Market influence and external structure: Market liberalization, transparency, and liquidity serve as external monitors that suppress earnings management. Studies by Song & Song (2023) and Hasanuddin et al. (2025) confirm that market integration and high-quality disclosure improve market oversight and reduce managers' opportunistic incentives.
2. Internal corporate pressures: Profitability, leverage, and the need for access to capital are important determinants of EM practices. Companies with high profitability tend to engage in EM to maintain their performance image, while companies with high leverage face restrictions that discourage earnings manipulation. Ashour & Atik (2025) and Soraya & Arieftiara (2024) emphasize that internal pressures often drive temporary EM, particularly in the context of rights issues or financial distress.
3. Disclosure quality and ESG: Clear and timely disclosure, as well as the presence of ESG practices, moderate investor perceptions of EM. Lestari & Muthmainnah (2025) show that ESG increases investors' confidence in managed earnings, especially in EM that exhibit

lower earnings. This suggests that corporate reputation and governance can influence how effectively EM is received or detected by the market.

4. Industry and sector context: EM practices and market reactions vary across sectors. Lestari et al. (2025) highlight that in the property subsector, investors tend to value earnings stability (income smoothing) more highly than pure accounting quality, indicating the need to consider industry characteristics when assessing EM.
5. Theoretical and practical implications: The findings strengthen agency theory, and more efficient market signaling reduces agency problems through external monitoring, while internal pressures can trigger opportunistic managerial behavior. Practically, market reforms, improved disclosure quality, and strengthened corporate governance can curb EM practices and boost investor confidence.

The overall conclusion suggests that earnings management is a multidimensional phenomenon influenced by external, internal, and contextual factors. Understanding the interaction of these factors is crucial for regulators, companies, and investors to improve transparency, financial reporting quality, and market effectiveness in developing countries such as Indonesia and China.

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