



Literature Review on The Effect Of Leverage, Profitability, And Firm Size On Earnings Management

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ABSTRACT

Earnings management remains a crucial issue in corporate financial reporting in Indonesia, driven by the pressure to maintain a positive image and the trust of investors and creditors. This study aims to examine the influence of leverage, profitability, and firm size on earnings management practices. The method used is a literature review with a qualitative approach, collecting and analyzing previous research findings from journals indexed in Sinta and Google Scholar. The results of the review indicate that high leverage encourages management to present stable financial performance, profitability affects income adjustments to maintain a positive image, and firm size plays a role in the likelihood of earnings management, where larger companies tend to have stricter supervision. The diversity of findings among studies suggests the need for further research by adding other variables such as Good Corporate Governance and Corporate Social Responsibility to broaden the understanding of the factors influencing earnings management.

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INTRODUCTION

The rapid development in the business sector today has forced companies, especially those listed on the Indonesia Stock Exchange, to build competitive advantages in order to obtain the external funds necessary for their continued operations. Information about profits contained in financial reports is usually a major concern for investors and potential investors. This situation encourages company managers to implement certain strategies to push them to generate profits that meet investor expectations. This pressure often leads to the misuse of financial statements in various ways, such as smoothing, inflating, or deflating profits to influence the reported profit value, which is known as earnings management. (Meiden 2022)

According to Felicia (2022), earnings management is an effort or action taken by company management with the aim of managing profits in accordance with management's interests. Generally, companies want large profits in order to attract investors to invest in the company and convince stakeholders and shareholders of the company's performance.

One factor that is thought to influence earnings management is leverage. A high level of leverage indicates the company's dependence on external funds, which can put pressure on management to present stable financial

performance. In recent years, the issue of earnings management has gained widespread attention because it can mislead users of financial statements and reduce the level of confidence in the reliability of a company's financial information. One example that attracted public attention in Indonesia is PT Indofarma Tbk (INAF), a state-owned pharmaceutical company that experienced a 99.65% decline in profits but still received an unqualified audit opinion. According to a report by CNBC Indonesia (2024), this situation indicates a discrepancy between actual financial performance and the reported figures, suggesting the possibility of the existence of practices management earnings aimed at maintaining the company's image as well as maintain a positive perception from the public and shareholders (CNBC Indonesia, 2024).

Additionally, the Supreme Audit Agency (BPK) found irregularities and potential state losses amounting to Rp371.8 billion related to the operational activities and financial reporting of PT Indofarma. These findings reinforce indications of accounting fraud, such as inflated inventory values, improper revenue recognition, and fictitious accounts receivable (BPK, 2024).

The Indofarma case shows that profit management practices occur not only in private companies, but also in state-owned enterprises (SOEs). Pressure to maintain financial performance and retain a fair audit opinion can encourage management to manipulate financial statements. This phenomenon reflects the weak implementation of transparency and accountability principles, and shows that internal and external oversight has not been optimal in preventing financial reporting distortions. (cnbcindonesia.com)

This phenomenon shows that profit management practices are still an important issue in corporate financial reporting. Several factors are thought to influence managers' tendency to engage in these practices, including leverage, profitability, and firm size. In such conditions, managers tend to manipulate profits so that creditors maintain confidence in the company's ability to meet its obligations. However, previous research has shown differing findings. Astriah et al. (2021) reported that leverage has no effect on earnings management, while Rianita and Pramesti (2021) found that leverage has a significant effect on these practices. Different results were also seen in the research by Khoirunnisa et al. (2023), which stated that leverage has a negative but insignificant effect on earnings management.

In addition to leverage, profitability is also an important factor that is often studied in relation to earnings management. Companies with high profitability generally strive to maintain a good reputation in the eyes of investors and the public, so managers are motivated to adjust earnings to appear consistent over time. However, various studies have produced mixed results. Astriah et al. (2021) found that profitability has a positive effect on earnings management, while Laili et al. (2024) showed that profitability has no effect on this practice. These differing results indicate that the relationship between profitability and earnings management requires further study to reach a more definitive conclusion.

Another factor that is often considered is firm size. Large companies tend to have better monitoring systems and greater public attention, so the

opportunity to manipulate financial statements is smaller than in small companies. However, previous studies have also shown inconsistencies. Astriah et al. (2021) state that firm size has no effect on earnings management, while Rianita and Pramesti (2021) and Setiowati et al. (2023) find that firm size has a significant effect on this practice.

Based on the previous description, it can be seen that there are still differences in research results regarding the influence of leverage, profitability, and firm size on profit management practices. Some studies found a significant influence, while other studies showed inconsistent results. These differences in findings indicate a research gap that is interesting to explore further.

Therefore, this study was conducted using a literature review approach to examine and compare various relevant previous research results. Through this study, it is hoped that a more comprehensive understanding of the relationship between these three variables and earnings management can be obtained, while also contributing to the development of theory and further research in the field of accounting, particularly in the context of financial reporting and corporate managerial behavior.

LITERATURE REVIEW

Agency Theory

According to Jensen and Meckling (1976), an agency relationship is an agreement whereby the principal appoints an agent to carry out tasks and grants the agent the right to make decisions

The agency theory is used by the author as the main basis for explaining the relationship between various factors that can influence earnings management. Conflicts of interest and gaps arise between the principal and the agent to present information that is not entirely accurate to shareholders, especially activities related to management performance assessments, which cause managers to have a tendency to hide certain information unknown to shareholders for their personal gain. (Maria Theresia Cinthya A.D Luh Gde Novitasari Ni Luh Putu Sandrya Dewi)

Earnings Management

Profit is an important indicator in financial reports that reflects a company's financial information and performance, both in the short and long term, and serves as a basis for investors in making investment decisions. Profit management is an action taken by management with the aim of managing income, which includes the use of certain accounting methods, changes in accounting policies, adjustments to the timing of expense and income recognition, or other means that affect the amount of profit in a given period. (Felicia 2022)

Negative earnings management occurs when management alters financial statements to make them appear stable and in line with the expectations of external parties. This practice contradicts the purpose of financial reporting,

which is to provide accurate financial statements. Earnings smoothing is done deliberately with the aim of attracting investors who tend to pay more attention to the stability of financial performance than to the methods used by management to generate profits. (Lutfiyah et al., 2023).

Leverage

Leverage is a ratio used to measure the amount of debt a company must bear and the company's ability to pay off its obligations (Purnama et al., 2021). According to Suharna (2021), leverage or the solvency ratio is a ratio used to assess the extent to which a company's assets are financed by debt compared to its own equity. The higher a company's leverage ratio, the greater the risk it must face. This situation drives companies to increase profits to mitigate the impact of risk (Astria et al., 2021).

Profitability

The profitability ratio is an indicator that shows a company's ability to generate profits during a certain period. According to Suharna (2021), the profitability ratio is used to assess a company's ability to generate profits as a reflection of its overall financial performance. The higher the profitability ratio, the better the company's ability to make a profit. This can encourage companies to engage in profit management by reducing reported income to reduce their tax burden (Astria et al., 2021).

Firm Size

Firm size is a scale that classifies the size of a company based on various measures, such as Law No. 20 of 2008, which classifies companies into four categories, namely (1) Micro Enterprises, (2) Small Enterprises, (3) Medium Enterprises, and (4) Large Enterprises (Setiowati et al., 2023). Firm size reflects the size of assets and average sales, which indicate the size of an industry. The larger the size of the industry, the greater the obligations that must be fulfilled, making it difficult for management to implement profit management. Conversely, small industries tend to have greater opportunities to implement profit management (Ani & Hardiyanti, 2022).

RESEARCH METHODS

This study uses a qualitative approach with a literature review method. This method is carried out by collecting and reviewing various previous research results related to the influence of leverage, profitability, and firm size on profit management practices in companies.

The research data was obtained from secondary sources, which included national scientific journals and research reports available on databases such as Google Scholar and SINTA.

RESEARCH RESULTS AND DISCUSSION

Based on a review of relevant theories and previous studies, the discussion of this literature review in the field of Earnings Management is as follows:

The Role of Leverage in Earnings Management

This discussion examines the effect of leverage on earnings management. Leverage is used in 15 articles and is considered to have a positive effect in 7 articles (46.67%), while the other 8 articles show a negative effect. This is in line with 7 studies conducted by Aldona L & Listari S (2020); Rianita N.M & Pramesti N.M.D, (2021); Charolin C et al., (2022); Maria Theresia Cinthya A.D et al., (2022); Setiowati D.P et al., (2023); Adityaningsih A & Hidayat 1 (2024); Laili N et al., (2024), which prove that leverage as an effort to increase company profits can be used as an indicator to assess managers' behavior in conducting earnings management.

This finding can be explained through Agency Theory, which states that the relationship between capital owners (Principles) and managers (Agents) has the potential to cause conflicts of interest. High levels of corporate debt can encourage managers to manipulate profits so that the company's financial condition appears favorable with the aim of maintaining the trust of creditors and investors.

According to Aldona L & Listari S (2020), high corporate debt levels can encourage managers to adjust profits to appear stable and in line with the targets expected by external parties. Recent research by Adityaningsih A & Hidayat 1 (2024) states that companies with high leverage tend not to use loans as a source of funding, but instead switch to using equity.

The Role of Profitability in Earnings Management

This discussion examines the influence of profitability on earnings management. Profitability was used in 10 of the 15 articles considered to have a positive influence of 66.7%. These findings are in line with 10 studies conducted by Astriah S.W, et al (2021); Rianita

N.M & Pramesti N.M.D. (2021); Adyastuti N. A & Khaif M (2022); Charolin Cet al. (2022); Felicia & Natalylova K (2022); Maria Theresia Cinthya A.D et al., (2022); Lutfiyah A et al., (2023); Setiowati D.P et al., (2023); Wardana D. N et al., (2023); Saputri S.K & Dewi M.K (2024) which prove that profitability is also an effort to increase company profits. which can be used as an indicator to assess managers' behavior in conducting profit management.

This is in line with agency theory, which states that there is a relationship between capital owners and management, whereby high company

profitability can maintain a positive image and earn rewards from capital owners. Profitability reflects a company's ability to generate profits and is one of the main measures of a company's performance.

According to Saputri S.K & Dewi M.K (2024), companies with low profitability are required to manage their profits well in order to gain the trust of investors to maintain their capital. This influences management to present more stable profits. Low profitability can cause concern for companies regarding their financial condition and investor confidence.

The Role of Firm Size on Profit Management

In addition to examining the influence of leverage and profitability, this study also discusses the influence of firm size on earnings management, in accordance with 4 of 15 articles that are considered to have a positive influence of 26.7%. Based on research conducted by Rianita N.M & Pramesti N.M.D, (2021); Charolin C et al., (2022); Setiowati D.P et al., (2023); Laili N et al., (2024) which prove that firm size plays an important role for investors and creditors because it is related to the level of investment risk faced. Larger companies generally have broader access to various sources of funding. Therefore, large companies tend to have a higher incentive to engage in earnings management compared to small companies, given that large companies receive more scrutiny and oversight from investors.

The results of research by Laili N et al. (2024) reveal that the larger the size of a company, the lower the chances of success in implementing earnings management compared to small companies. This is due to the ease of access to financing enjoyed by large companies, as well as their confidence in generating sufficient profits, thereby reducing the need for earnings management.

CONCLUSION

Based on the Literature Review that has been conducted, it was found that leverage, profitability, and firm size are associated with earnings management. High leverage places companies under greater financial pressure to maintain the trust of creditors and investors, thereby encouraging management to present financial statements that appear stable and favorable. This pressure may motivate managers to adopt accounting policies or reporting strategies that support the appearance of consistent financial performance.

Profitability also influences management decisions in adjusting profits in financial statements, both when profits are high and low, in order to maintain a positive image in the eyes of investors. Companies with high profitability tend to smooth earnings to demonstrate performance stability, while companies experiencing low profitability are more likely to manage earnings to avoid negative perceptions from the market. This finding indicates that profitability does not merely reflect operational success but also functions as a managerial incentive in financial reporting behavior.

Meanwhile, firm size produces different outcomes across companies. Smaller companies often face greater difficulties in obtaining external financing and generally operate under weaker monitoring mechanisms. As a result, smaller companies tend to have a higher propensity to engage in earnings management compared to larger companies. On the other hand, larger companies are typically subject to stricter supervision from investors, auditors, and regulators, which limits managerial discretion in manipulating reported earnings, although it does not entirely eliminate such practices.

However, the findings across previous studies are not entirely consistent, indicating that leverage, profitability, and firm size do not always have a direct or significant influence on earnings management practices. These inconsistencies suggest that earnings management is a complex and multifaceted phenomenon that cannot be explained by a single factor alone. Other organizational, governance, and environmental factors may also play a role in influencing managerial decisions related to financial reporting. This study has limitations related to the amount of literature data, which only covers Sinta-indexed articles during the observation period and may not fully represent conditions in the field. Therefore, future research is encouraged to expand the range of references and incorporate additional variables such as Good Corporate Governance, Corporate Social Responsibility, liquidity, ownership structure, and audit quality to provide a more comprehensive and in-depth understanding of earnings management practices. With broader perspectives and more diverse research designs, future studies are expected to offer stronger empirical evidence and clearer conclusions regarding the determinants of earnings management.

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