

## **EARNINGS MANAGEMENT AND ISLAM**

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### **ABSTRACT**

This article, by applying five Islamic concepts (*Fitrah, Akhlaq, Niyah, Ijtihad* and *Maslahah*), seeks for a solution of the problem of earnings management conducted by the managers. By analyzing several definitions of earnings management it can be found that managers' wrong/unethical intention is the main cause behind this problem. The article suggests that if the intention (*Niyah*) of the managers can be purified through ethical training (*Akhlaq*), then it can be expected that they will apply their highest possible effort and knowledge (*Ijtihad*) in order to ensure the interests of the stakeholders (*Maslahah*). This can be a possible solution for the problem of earnings management.

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**Keywords:** Earnings management, Islam, Ethics.

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## **Introduction**

The issues like creative accounting and earnings management are not new in accounting literature anymore. Over the last decade, the problems related to these issues remained as burning questions for the accounting profession almost all over the world. Some major corporate scandals like Enron, Worldcom, Tyco and others are highly responsible for the growing interests on these issues from the part of the professional and the researchers. The accounting profession remained concerned about developing standards and regulations in order to control earnings management. Researchers were also focusing on this issue with enough importance. As a result a huge amount of literature on earnings management came into existence over the last decade. The researchers focused on issues like the motivations behind earnings management, the techniques applied in earnings management and the effects of earnings management. The ethical issues related to earnings management also got highlighted.

The issue of earnings management came into existence because in general, according to the Generally Accepted Accounting Principles (GAAP), accountants have the permission to practice a certain level of discretion while taking decisions on some measurement and reporting issues (Saringat, Haron and Tahir, 2013). In many cases, these measurement and reporting practices are driven by unethical and self-interest oriented motives that help the managers to reach to certain goal. This opportunistic behavior of the managers can harm the stakeholders in many ways. That is why this issue needs to be addressed with enough emphasis.

In general, earnings management can be defined as ‘the choice by a manager of accounting policies so as to achieve some specific objectives’ (Scott, 2000; 351). There is no doubt that financial reports are considered as important documents by most of the stakeholders. In the financial statements, ‘earnings’ is a component that has a significant effect on the decisions of various stakeholders (especially shareholders and bondholders). The earning figure can have an impact on the behavior of the stakeholders. Their impression about the company can be changed as a result of any change in earnings. The investment decisions of the shareholders can get affected. Government and other regulatory agencies may also get affected by this. In simple words, the earnings can be considered as a significant factor for the survival of the company. That is why managers can show opportunistic behavior and attempt to manage earnings.

The agency theory considers the management of a company as the agents of the stakeholders (the principal) of that company. In general, it is expected that the shareholders and the debt-holders will provide with the funds necessary for the efficient operation of the company. The managers should act as the agents of these principals (debt-holders and shareholders) and operate the company in an efficient manner by using these funds. The theory highlights that these two parties (i.e., the agent and the principal) may have conflict of interest. When this conflict of interest arises, the managers (who are in charge of the use of the principals’ funds to manage the company) can become manipulative and opportunistic. They might concentrate only on self-interest and not on the interest of the shareholders and debt-holders. This behavior or act can be harmful for the providers of the funds. In order to discharge accountability, the managers report on the performance and the state of the organization in the financial statements of the company. Financial statements are the documents that are highly

based on the accounting numbers. Managers(including accountants) can apply several discretions in preparing the accounting based reports. If these discretions are applied in preparing the financial statements in order to fulfill management's self-interest, sometimes it can be harmful for the shareholders and debt-holders.

Positive accounting theory proposed by Watts and Zimmerman (1986) also highlights that management can behave opportunistically in order to maximize their self-interest. Managers can manipulate earning in order to increase their bonus, to build up the confidence of the debt-holders and to manage many other political issues.

So, it can be said that earnings management guided by some unethical intention of the management can be harmful for the management. This article is based on this issue. In order to maintain the interests of the shareholders and debt-holders, the decisions of management must be ethical and not guided by self-interest. The intention of the management is crucial here. This article, from an Islamic perspective, explains the importance of good intention in reporting the earnings. The article, through a model (based on the Islamic concepts) also highlights how good intention can lead to better decision that ensures stakeholders' interests.

### **Earnings Management and the Intention of the Managers**

Accounting as a discipline is sometimes blamed as 'not scientific enough'. This is the reason why there exists less scope for deriving something which can be considered as absolute accounting truth (Bayou, Reinstein and Williams, 2011). The reason for this is that the accounting information can be presented with the help of different methods and principles. As mentioned earlier, in many cases, the choice of different methods, estimates and principles depends on the discretion of the accountants. Though in the discipline of accounting we find the discourses like 'true and fair', 'representational faithfulness', 'objective', 'reliable' and others, many issues involve a good degree of subjectivity.

The issue of earnings management came into existence because of this reason. If the intention of the managers (including accountants) is not good, the financial reporting may not be true and fair. Managers will behave opportunistically while applying the power of discretion. According to Schipper (1989: 92), earnings management is "a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain". A similar definition was given by Yunanda and Majid (2011: 134):

"The earnings management decision takes place when the accountant chooses the reporting methods and the estimates that do not accurately reflect their actual performance".

It can be identified from these definitions that the issue of the 'intention' of the accountants is important to identify whether some earnings management practices took place or not. It can be understood from the discussion so far that accounting measurement cannot reach to an absolute truth because as a discipline accounting allows the accountants to use different methods of measurement. By saying accounting measure is 'verifiable' we in fact mean that the information can be verified if only the same method is used for verification. Therefore, the earning figures can be different when different accountants choose to apply different accounting methods even on the same

data. Earnings management will take place only when the intention of the accountant will be to reach to a certain figure in order to fulfill some hidden objectives.

Mulford and Comiskey (2002) identified several motives for earnings management by the management. The management of the company may have an intention to raise the share price and thus manipulate corporate valuation. They may try to lower the cost of capital. They can also go for managing earnings in order to increase profit-based bonuses and decrease tax. Some of these motives can be harmful for the stakeholders.

Accounting scandals like Enron, Worldcom, Tyco, Satyam Computers and others took place because of managers' opportunistic behavior in terms of reporting the earnings. For example, the incorporation of 'mark-to-market' accounting by Enron resulted in the greatest accounting scandal the world has ever encountered. Many people think that Enron was not just an organizational crisis but it was a crisis of humanity. People like accountants, auditors and even politicians worked together in a force to manipulate accounts and fulfill the self-interest. All of them had unethical intentions. As a result, the shareholders lost huge amount of money and the employees lost jobs all on a sudden. Big audit firm like Arthur Andersen had to surrender their license as auditors.

Over the years, the literature on earnings management has grown enormously. Authors have highlighted different aspects of earnings management in different countries. These studies highlighted the opportunistic behavior of the management. Gaver, Gaver and Austin (1995) found that accountants manage accruals in order to manipulate the bonus. According to Burgstahler and Dichev (1997), in order to not report on losses or earning decline, management exercise earnings management. It was also found from the studies that managers get engaged in earnings management in order to meet the short-term earnings objectives (Schipper, 1989; Healy and Wahlen, 1999). Balsam (1998) found a relationship between discretionary accruals and cash compensation of the CEOs. Wu (1997) found that earnings were managed downwards just before the leveraged management buyouts (Wolk, Tearney and Dodd, 2001). Obid and Demikha (2012: 54), by mentioning some previous research argues that 'the flexibility of Generally Accepted Accounting Principles (GAAP) promotes the engagement' in earnings management.

It can be said that because of this less scientific nature of accounting, there will always be a possibility that the accountants will try to manipulate information in their own ways to fulfill some desired objectives. Though after the Enron crisis many codes of corporate governance were introduced and accounting standards were also made well equipped to control earnings management, the possibility of the practice of earnings management still exists. Even now if the accountants want to manipulate the accounts, they can do it in many ways. Only good intentions of the accountants can solve this problem. If the intention of the accountant is not ethical, earnings management will take place.

For many centuries, religion is considered as one of the major sources of ethics. In many ways religion guides our behaviors and activities. That is why many researchers wanted to find out the solutions regarding earnings management in religion. In recent years, Islamic values and ethics got immense importance from the researchers working on earnings management (see Obid and Demikha, 2012; Hamdi and Zarai, 2013; Yunanda and Majid, 2011; Saringat, Haron and Tahir, 2013). Yunanda and Majid (2011: 134) highlight earnings management as an unfair dealing and mentions that it is forbidden in Islam.

This article also highlights the issue of earnings management from the Islamic perspective. In Islam, the issue of proper intention (*Niyyah*) gets huge importance. This article, through emphasizing on some Islamic concepts (like *Fitrah*, *Akhlaq*, *Niyyah*, *Maslahah* and *Ijtihad*) gives a model for purifying the intention of the people in management and dealing with the problem of earnings management.

### **Earnings Management and Islam**

It was mentioned earlier that in order to control the earnings management practices several authorities have suggested several laws, rules and guidelines. There is no doubt that these rules, regulations and laws are important but the behavioral aspects (especially the intention of the management) should also be taken under consideration. This section of the article presents with a model on how by using several Islamic guidelines the intention (*Niyyah*) of the accountants can be modified so that they take good decisions to ensure the best interest of the stakeholders.

Most of the discussions on earnings management by the Western scholars are presented from the perspectives of agency theory and positive accounting theory. Both of these theories emphasize on the self-interest driven characteristic of human being. These theories highlight that as human beings are self-interest driven, in most of the cases they behave in an opportunistic manner. These theories are mainly based on an idea that as everybody is self-interest oriented, there can be a conflict of interest between different parties. As a result, there will always be a lack of trust among the parties involved. The dark side of the human behavior is highlighted by these theories. But Islam believes that fundamentally the nature of human being is good. Here comes the concept of *Fitrah* and *Akhlaq*. Both of these concepts highlight the issue of human nature, disposition and behavior.

### ***Fitrah***

Though there are different interpretations of the concept of *Fitrah*, scholars like IbnTaymiyyah and Shah Wali Allah supported the idea that (El-Mesawi, 2003):

“Like Ibn Taymiyyah and others, the sense of oneness of God and love of Him and submission to His will is, according to Wali Allah, rooted in human nature and conscience”.

It means that human beings have a normal disposition toward good deeds and virtue and a natural disliking towards vice (El-Mesawi, 2003). This is the inherent characteristic of man. Al-Faruqi (1992: 67) also mentions:

“Islam holds that man is created innocent..... No matter who his parents were, who his uncles and ancestors, his brothers and sisters, his neighbor or his society were, man is born innocent”.

So, Islam highlights that man, by nature is not evil.

Though the concept of *Fitrah* highlights that human beings are inherently good, it is also true that this nature can get corrupted because of the surroundings and environment. Moreover, man has free will. That is why a proper nurturing of *Fitrah* is needed. Here comes the concept of *Akhlaq*.

### ***Akhlaq***

The concept of *Akhlaq* is also related to the nature and character of man. The concept of *Akhlaq* calls for a good connection and relationship between the creator and His

creatures and also between the creatures (Rahim, 2013). According to Kamri (2009), as the concept of *Akhlaq* is related to Islamic ethics that is why Islamic ethics should consider the following four basic elements of *Akhlaq*:

“Firstly, the determination of good, bad, right and wrong of a manner is based on the *Shara*’ prescription and not by following the consideration of human logic per se. Secondly, the behavior is expressed in the relationship among human beings and also between the man and Allah S.W.T. Thirdly, the behavior is purposely for hoping Allah S.W.T. blessing in this world and hereafter. Fourthly, its implementation combines the internal and external components of a human being, which starts off from the knowing by heart and expressing by physical parts of body easily without force”. (Kamri, 2009: 174).

According to the famous Muslim scholar Al-Ghazali, human beings consist of both physical and spiritual form (Rahim, 2013). Among these, mainly the spiritual form is related to *Akhlaq*. Ismail, Othman and Dakir (2011: 107) described the concept of *Akhlaq* in the following manner:

“Human behaviour in Islam is also known in Arabic as *Akhlaq*, referring to the practice of virtue, morality and manners in Islamic theology and philosophy. The Quran has stated clearly in great details about how humans are to behave to one another, about the immense reward waiting the virtuous and about the eternal sanctions to befall those who fail to conform.”

*Akhlaq* ensures ethical behavioral relationship among people. According to Kamri (2009), *Akhlaq* can be nurtured through education, training and practice. According to the author a man can maintain *Akhlaq* by striving, training, observation, socialization, prayer, introspection and advice. Kamri (2009), through a case study of Tabung Haji Malaysia (an organization responsible for conducting the pilgrimage related activities for the clients) showed how the *Akhlaq* related issues can be included in the code of conduct of the employees in order to purify the hearts and do good things.

Kamri (2009) mentions that education on *Akhlaq* can be gained from any good teacher who will help to get both physical and spiritual education. This education will help to differentiate between good and bad. The education and training of *Akhlaq* can be gained from family, educational institutions and organizations. *Akhlaq* can also be developed through introspection by checking self-weaknesses and going for rectification (Kamri, 2009). *Akhlaq* can be developed through observing and socializing. Good behavior of other people can be imitated. Prayer can also help in the purification of heart. In order to perform the tasks in an ethical manner one needs to get oneself purified with the spirit of *Akhlaq*. Rahman (2010: 39) mentions that ‘ethics should be cohesively implanted into accounting practices, because ethics clearly signal and distinguish right from wrong, good from bad, and justice from injustice’.

It can be understood from this discussion that *Akhlaq* ensures the purification of heart, correction of self-weakness and ability to differentiate between good and bad. It can be expected that when *Akhlaq* can be established in a man, ultimately his/her intention (*Niyyah*) will become good. He/she will have an intention to safeguard the interests of the others.

### **Niyyah**

The issue of intention (*Niyyah*) got huge importance in Islam. There is a famous *Hadith* (the sayings and works of the last Prophet in Islam) that says “actions are dependent upon intentions”. Also, in terms of earnings management, if the intention of the accountant is good, their actions will be in favor of the stakeholders’ interest. It can be predicted that if the intention is not self-interest oriented, the accountants will apply prudence and rigor while taking the decisions of earnings reporting. By using Islamic terms it can be said that if the *Niyyah* is good then the accountants will apply *Ijtihad* (the utmost effort that can be applied by human) in the practice in order ensure *Maslahah* (benefit/welfare). The terms *Maslahah* and *Ijtihad* are described in the next two sections.

### **Maslahah**

The word *Maslahah* represents benefits and public interest (Yunanda and Majid, 2011). This is a principle that is applied in dealing with the legal issues in Islam. Yunanda and Majid (2009: 131) define *Maslahah* as:

“*Maslahah* comprises considerations which are in line with objectives to secure a benefit for public and prevent harm”.

According to Rahman (2003), accountants should incorporate this Islamic principle of *Maslahah* in their decision making. It is expected that in this pluralistic society the accountants should perform in a socially responsible manner that will ensure both individual and societal interests (Yunanda and Majid, 2011). According to Rahman (2010: 38) *Maslahah* can work as ‘an ethical filtering mechanism’ that can help to ‘resolve ethical conflicts normally faced by accountants’.

### **Ijtihad**

The accountants should exercise utmost effort and diligence while taking decisions on reporting aspects that involve their own discretion. The principle of this highest level of effort can be derived from the method of *Ijtihad* described and applied by Islamic jurists. The word *Ijtihad* originates from an Arabic word *Jahada*. *Jahada* means attempt. *Ijtihad* means to struggle and strive with the highest possible effort, knowledge and labor. This involves a rigorous, honest and utmost attempt in order to reach to a conclusion. According to Hallaq (1984: 3), *Ijtihad* involves:

“... the exertion of mental energy in the search for a legal opinion to the extent that the faculties of the jurists become incapable of further effort...”

Though this method of solving problems was mainly used by the jurists, accountants can also apply this method in taking their decisions. In case of taking reporting decisions that involve ambiguity they should apply their knowledge (if possible, the cumulative knowledge of all people in the department) so that they can reach to a sound conclusion that can ensure public interest (*Maslahah*). Enough rigor and diligence should be applied in order to reach to the solutions of confusing and novel problems. Rahman (2010: 44) while describing Islamic accounting ethics mentioned that accountants should be diligent in their practice and ‘refrain from agreeing to perform professional duties unless sufficiently competent to perform’. They should prepare reports that are ‘complete, clear and supported by appropriate analyses of relevant and reliable information’ (Rahman, 2010: 44).

The person who performs *Ijtihad* is called *Mujtahid*. In general the person who is capable of performing *Ijtihad* should have huge knowledge about the Islamic laws and other issues. It was mentioned earlier that mainly jurists perform this task.

The accountants can follow the methods and rigor that are followed in performing *Ijtihad*. The spirit of *Ijtihad* is to think and work rigorously until an acceptable and best possible solution is reached. An accountant shall apply his/her knowledge and diligence in the best way to reach to a conclusion or decision.

It was mentioned earlier that in many cases accountants have to apply own discretions in case of reporting. The accountants should apply the spirit of *Ijtihad* in this case and take the decisions.

### **An Islamic Model for Dealing with Earnings Management**

The Islamic concepts discussed here can be linked in dealing with the problem of earnings management. The concept of *Fitrah* highlights that man has a natural inclination towards good. Though man is inclined to good but can get corrupted by the surroundings and his free will. That is why nurturing and maintenance of *Fitrah* is needed. The teaching of *Akhlaq* can ensure that. *Akhlaq* can ensure that man can differentiate between good and bad and thus behave in an ethical manner. This ethical orientation will create good intention (*Niyyah*) in man. Thus a man will apply the highest effort (*Ijtihad*) in taking decisions in order to ensure public interest (*Maslahah*). The model is depicted through figure 1.

**Figure 1: An Islamic Model for Dealing with Earnings Management**

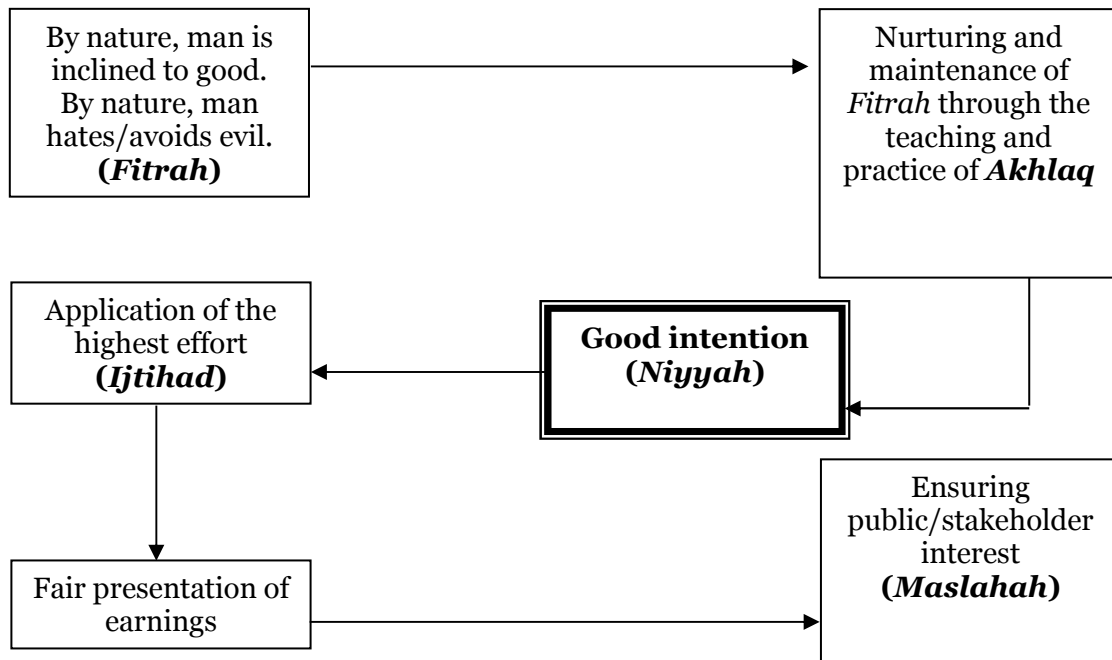




Figure 1 highlights that education and training of *Akhlaq* can maintain the *Fitrah* in a man and thus man's intention becomes pure and good. Education and training of *Akhlaq* can be treated as important to ensure ethical behavior. The training of *Akhlaq* can be conducted in the family level. Besides this, the educational institutions and the organizations should also give enough importance on this.

There are controversies related to whether ethical behavior can be ensured through education and teaching. For example, Ponemon (1993), by conducting an experiment based study on the undergraduate and graduate accounting students concluded that teaching and training of ethics cannot ensure ethical behavior. Even then accounting researchers kept emphasizing on ethics education in accounting (see Lehman, 2013; Mahdavihou and Khotanlou, 2012; Yunanda and Majid, 2011; Bayou, Reinstein and Williams, 2011). If the education on *Akhlaq* can be introduced in accounting education, the future accountants can get an idea on the expected moral behavior. The moral crisis arising from earnings management should be highlighted in these trainings. For example, at present, in most of the cases, when the students learn about the cases of organizations like Enron and Worldcom, the earnings management techniques and procedures of these companies get emphasized. The crisis of humanity is not highlighted in that way. The fact is, these are not only the cases of earnings management rather these cases also expose the dark side of human beings. These crises are the results of greed and manipulation. As a result of the greed of few people many investors lose money. When Enron collapsed, many employees lost their jobs. Also when a top audit firms like Arthur Andersen get closed, there arises a lack of trust between stakeholders and accounting professionals. These crises of humanity need to be emphasized along with the technical issues. The disaster arising from unethical behavior needs to be highlighted.

It can be expected that an ethics based teaching will help students understand the moral crises of the present world. The teaching of *Akhlaq* can inculcate moral values in the future accountants.

Moreover, the teaching, training and practice of *Akhlaq* can also be introduced in the organizations. Kamri (2009), through a case study, describes how *Akhlaq* education can be implemented through code of ethics in the organization. It can be expected that if the employees are continuously reminded about the ethical issues, their intentions may become good. They will try to avoid unethical and illegal acts and work for the best interests of the stakeholders. So, both educational institutions and organizations should play important roles to ensure the ethical practices of the accountants in terms of earnings management.

## **Conclusion**

This article proposes for the use of some Islamic concepts that can be helpful in mitigating the problems arising from earnings management practices. This article emphasizes on the behavioral issues by focusing on the nature of human beings as explained by the religion of Islam. While dealing with several issues of earnings management most of the Western scholars mainly focused on the self-interest oriented behavior of human beings. Because of this self-interest oriented nature, managers intend to practice earnings management. In contrast, Islam emphasizes that by nature human beings are inclined to good deeds and things. If this basic nature of human beings can be nurtured and maintained, they will always intend to do good things that will help in

taking best earnings reporting decisions. These decisions of the accountants will help to uphold stakeholders' interest.

Though this model is based on Islamic concepts, this can be applied anywhere. Purifying intentions through the training of proper ethical behavior is considered important everywhere in this world and thus it can be applied to any organization in any country. The issue of applying diligence and rigor in order to serve public interest is also important for all kinds of organizations and societies.

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