The effect of political-economic reform on the quality of financial reporting in Egypt

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Abstract

Purpose – This paper aims to study the influence of political-economic reform and especially privatisation on the quality of financial reporting of the Egyptian companies.

Design/methodology/approach – The paper analyses data from official documents and 34 interviews with company executives, financial analysts, external auditors and Stock Exchange regulators to inform our understanding of the relationship between changes in the Egyptian environment and the quality of financial reporting.

Findings – The findings of the research suggest that the recent Egyptian political-economic reform, resulting in privatisation has significant influence on negative accounting practices and hence on lowering the quality of financial reporting through its effect on: departure from uniform accounting system and public accounting regulations; issuing new stock exchange regulative rules; reviving the role of Stock Exchange; and increasing competition within Stock Exchange regarding raising funds.

Originality/value – This paper contributes to the literature by identifying the effect of socio-cultural factors on motivating executives to exercise negative accounting practices and hence producing low-quality financial reports (FRs) and by highlighting the fact that accounting practices cannot be generalised worldwide due to the absence of universal socio-cultural factors which shape these practices. This paper employs new institutional sociology theory and contributes to that theory by acknowledging the active interplay between institutional context and economic environment.

Keywords Egypt, Financial reporting quality, Privatization, Stock exchange, Earnings management motives, New institutional sociology theory, Regulative rules

Paper type Research paper

1. Introduction

The committee on Accounting History of the American Accounting Association’s description of accounting history as “[. . .] the study of the evolution in accounting thought, practices [such as earnings management], and institutions in response to changes in the [economic and regulative] environment, and societal needs [. . .]” (cited in Farag, 2009, p. 404).

Egypt represents a typical case of political and economic reforms. The economy of Egypt, like many other Arabic and developing countries, has rapidly moved away from the inward-looking-based economy in favour of the free-market economy and privatisation, thus becoming the “darling” of the reforming Arab economies in the early 1990s.

Studies have been carried out on the consequences of the movement of the developing countries towards more liberalised economy and privatisation programme on the performance of newly privatised enterprises and concluded that, in Egypt, there is a positive
effect of privatisation on economic growth (Bolbol et al., 2005); productivity of privatised banks (Fethi et al., 2011), performance, competitiveness profitability of newly privatised enterprises (Kenawy, 2009), operating efficiency, capital expenditures and dividends (Omran, 2003). Similarly, Lee et al. (2017) found that the privatisation results in higher consumer welfare and hence great social welfare. By contrast, other research has indicated that there are no differences in the efficiency of delivering services between privatised water and sanitation enterprises and their peers in the public sector (Prasad, 2006). Similarly, Omran (2004) found no substantive improvement in the performance of Egyptian newly privatised firms compared with the performance of the state-owned enterprises. Uddin and Hopper (2003) indicated that in Bangladesh, there was a decline in the contributions of the privatised companies to the state revenues. Bowman (2014) found that privatising British rail industry has gone wrong because train operators are able to achieve fictitious profitability and produce unreal net gain only in case of receiving extensive subsidies and increased direct state support.

Other studies examined the effect of economic-political environment and privatisation on accounting and financial disclosure in the developing countries. Al-Akra et al. (2010) found that in Jordan, privatisation programme significantly affected the disclosure regulations, governance reforms and companies’ ownership and that, in turn, the mandatory disclosure of Jordanian-listed companies complies with IFRs. Dahawy et al. (2002) pointed out that the disclosure level of the newly privatised companies is negatively affected by Egyptian socioeconomic factors; more precisely, it is affected by the secrecy embedded in the Egyptian culture. Al-Akra et al. (2009) found that privatisation had significant influence on reforming the disclosure regulations of Jordan enterprises. Elsayed and Hoque (2010) explored the effect of international environmental factors on firms’ disclosure and found the voluntary disclosure level of Egyptian non-financial listed companies is fundamentally influenced by a set of international environmental factors including global competition, international socio-political institutions, international accounting standards and international financial institutions. Larson and Kenny (1995) found that the adoption of IASs in developing countries is a selective process because of the effect of cultural factors of these nations that differ from those of the developed countries. Abdelsalam and Weetman (2007) similarly concluded that, in Egypt, the socio-economic changes of 1991-1992 affect accounting and that accordingly the implementation of IFRs requires changes in not only laws and regulations but also cultural factors. Nurunnabi (2015) pointed out that in Bangladesh, the high level of corruption as an outcome of socioeconomic environment has a negative influence on the implementation of global accounting standards (IFRs). Winkle et al. (1994) pointed out a close relationship between the success of privatisation and China’s economic reforms, and the development of accounting regulations and reporting standards. However, HassabElhaby et al. (2003) found that, in Egypt, there is no relation between the privatisation of state-owned corporations and accounting development. Uddin and Hopper (2003) concluded that in Bangladesh, newly privatised enterprises did not succeed in achieving the level of transparency of external financial reporting required by accounting regulations. Adhikari et al. (2013) found that public sector accounting reforms in Nepal and Sri Lanka have been much affected by reform contexts, including the level of awareness among stakeholders and their participation in the reform process; these contexts differ due to the specific historical roots of the countries.

Literature has investigated other external factors that can negatively affect accounting and the quality of financial reporting, implying outside factors that motivate firms to manage profits upward including:
- attracting skilled employees and beating an earnings target (Makhaiel and Sherer, 2017);
- meeting the industrial norms (Makhaiel, 2016);
- credit markets and debt covenants (Bartov, 1993; Beneish et al., 2001; Burgstahler and Dichev, 1997; Dechow et al., 1996; DeFond and Jiambalvo, 1994; Dhaliwal et al., 1994; Graham et al., 2005; Makhaiel, 2015; Roychowdhury, 2006; Trueman and Titman, 1988; Watts and Zimmerman, 1990); and
- stock markets which overprices the stock of firms, succeeding in managing the reported earnings when they intend to sell their stock to the public during certain corporate events, i.e. initial public offers (IPO) or seasoned equity offers (SEO), or firms, succeeding in beating financial analysts’ expectations (Cohen et al., 2010; Darrough and Rangan, 2005; DuCharme et al., 2004; Kamel, 2006; Makhaiel, 2015; Marquardt and Wiedman, 2004; Rangan, 1998; Teoh et al., 1998a, 1998b).

In this regard, Bowen et al. (1995), Degeorge et al. (1999), Graham et al. (2005) and McKee (2005) argue that not only shareholders and lenders, but also a number of other stakeholders, for example regulators, all rely primarily on the financial reports (FRs) to assess firms’ performance. Therefore, regulative environment might have an effect on executives desire to manage profits figures. This is in agreement with Rezaee’s (2005) claim that “national stock exchange listing status or meeting minimum exchange listing requirements to prevent being delisted” is an incentive for managing earnings figures; firms, in turn, “should not have blinkers, seeing only one type of stakeholder” (McKee, 2005, p. 39) and neglecting others.

Recently, in Egypt, there are fundamental changes in the regulatory environment in terms of issuing new Egyptian stock exchange (EGX) regulatory rules and new accounting regulations, resulting from the transition of the political and economic systems and privatisation programme. Most prior studies that were conducted in developing countries, including Egypt, concentrated on examining the consequences of political-economic transition and privatisation programme on the performance of privatised state-owned enterprises and their accounting practices. Others explored the influence of certain environmental factors such as credit and stock markets on the negative accounting practices and hence the quality of financial reporting. None of them investigates the effect of the changes in the regulative environment (accounting and EGX regulations), resulting from the political-economic transition on the negative accounting practices and hence the quality of financial reporting. These areas surprisingly remain understudied in spite of McKee’s (2005, p. 83) argument that “the [economic], institutional and regulatory environment [...] currently permits and encourages earnings management”, which is practiced in a “permissive environment” (Giroux, 2004).

This paper, therefore, fills a gap in prior research. It explores key political and economic factors and links them to the development of regulatory environment in Egypt as additional external factors – other than the capital market – that can result in negative accounting practices, e.g. earnings management (EM) practices, and hence negative influence on the quality of financial reporting. This research discusses the recent political-economic and accounting reforms in detail, with a specific reference to privatisation that, in turn, led to significant changes in the regulative Egyptian environment including changes in accounting regulations; regulative rules of EGX; activating EGX’s roles and activities; and increased competition regarding obtaining capitals within EGX.

This paper offers four novel contributions. First, in terms of theoretical contribution, this paper incorporates economic pressure with the coercive pressure of institutional regulatory
bodies to provide an extension to New Institutional Sociology (NIS) theory – that can be named as “Economic-Institutional Theory”– for gaining deeper understanding of the powerful effect of the accounting’s context on shaping accounting practices. Second, it focuses on the effect of socio-cultural factors on the financial reporting quality in Egypt; this paper reports evidence about the effect of the firms’ institutional, regulative and economic environments on encouraging the negative accounting practices (as an EM motive) and hence the quality of FRs. Third, this research is a response for calls to investigate and understand the influence of socioeconomic factors on accounting and reporting processes in developing countries: Egypt (see for example; Hopwood, 1987 and Dahawy et al., 2002). Fourth, the empirical evidence highlights that there are no “one-size-fits-all” approaches to accounting practices and behaviour which can be generalised worldwide because the firms’ contexts differ from one country to another by adopting various political and economic systems and different stock markets that shape accounting behaviour, activities and actions.

An important aspect in this study is selecting Egypt to investigate the relation between accounting and its environment. The dynamic Egyptian environment has evolved through different economic and political systems over the past few decades, which, presumably, affected the accounting regulations and practices, hence the quality of financial reporting.

Three main rationales reflect our choice of Egypt as the selected country for study. First, Egypt provides a unique opportunity for empirical research to gain insights into the implications the relationship between the development of accounting and environment in which they operate. Second, the Egyptian business environment experienced a dramatic reform as a consequence of political and economic transitions, leading to a rapid growth in foreign investment potentials. This, therefore, requires checking the quality of the Egyptian firms’ FRs on which investors focus and base their investment decisions. Third, there has been little financial accounting research which focuses on the emerging economics such as Egypt.

The paper is organised into six sections: Section 2 outlines the political, economic and accountancy developments in Egypt; Section 3 suggests a theoretical economic-regulative framework; Section 4 discusses research method and methodology; Section 5 analyses data and reports the results; and Section 6 provides a summary and conclusion.

2. The political, economic and accountancy developments in Egypt
As argued by Radebaugh and Grey, 1997 (cited in Farag, 2009), economic, political and social factors significantly influence the accounting profession and its practices (cited in Farag, 2009). This leads Farag (2009) to claim that the political and economic circumstances in Egypt are the most influential factors that play a key role in shaping and developing the Egyptian accounting profession. Changes in the political-economic conditions necessitate changes in accounting regulations to meet the demand for financial information (Hassan, 2008a, 2008b), accompanying this transition. Therefore, it is essential to explore the political, social and economic context from which the accounting regulations emerged to explain the changes or developments that have occurred in response to such regulations, especially in less developed countries undergoing economic transition (Hassan, 2008b), such as Egypt.

Egypt, as a developing country, has passed through three stages of political-economic transition: the first was the capitalist-oriented economy during the time when Egypt was a British colony; the second stage was the socialist and state-planned, controlled economy initiated by President Abd-El Nasser; and the last economic stage was marked by the return to a capitalist and more liberalised economy under President Sadat’s “Open Door Strategy” (Hassan, 2008b), which was extended to include the privatisation economic reform in 1990s.
Each political-economic stage, especially the last two stages, had an effect on accounting regulations and the EGX.

2.1 Socialist economy era

After the Egyptian revolution of 1952, the British colonialism came to an end when Abd El-Nasser became the President of Egypt (Farag, 2009; Hassan, 2008b). This political change led to an economic shift from a capitalist to a socialist regime, enforced by President Nasser. He aimed to establish a state-controlled and planned economy, which was based on the central domination of the government who exercised control over the process of using Egyptian economic resources (Hassan, 2008a, 2008b), to discredit the capitalist regime which had exploited Egyptian economic resources and liberate major projects from the domination of foreign investors (Hassan, 2008a). Hence, as part of the socialist regime, in 1961, President Nasser nationalized and seized the Suez Canal as well as 95 per cent of all foreign companies and Egyptian private economic ventures, including banks, industrial firms and insurance companies (Farag, 2009; Hassan, 2008a, 2008b; Zohny, 2000). All of these were transferred to the ownership of the Egyptian Government, which led to the formation of a huge number of public organisations (Hassan, 2008b; Zohny, 2000), and hence to the emergence of a large public sector as the dominant sector within the Egyptian economy (Farag, 2009; Hassan, 2008b). In other words, during the 1960s, Egypt had undergone critical political and economic transformations, including abandoning the capitalist system in favour of adopting a state-planned, centrally controlled economy (Farag, 2009; Hassan, 2008b); nationalisation; and hence an expansion of the public sector (Rahman et al., 2002; Wahdan et al., 2005), which had a critical effect on the role of the EGX and on accounting regulations.

2.1.1 Egyptian stock exchange during the socialist regime. After the creation of a socialist economic regime, the activities of the EGX were frozen and an era of stagnation followed which lasted for nearly 30 years (Abd-Elsalam and Weetman, 2003; Wahdan et al., 2005). Under the socialist regime, the government was responsible for funding all economic activities (Hassan, 2008b); this resulted in a dramatic decline in the stock exchange’s activities to the extent that they served “only nine corporations” (Zohny, 2000). As a consequence of the stagnation of the stock exchange, both national and international investors lost confidence in the Egyptian economy and gradually the meaning of the stock exchange as an organized market for trading shares and as a vital financial tool for creating liquidity “was completely forgotten” to the extent that a whole “Egyptian generation did not hear” or know about its existence (Zohny, 2000).

2.1.2 Accounting regulations under the socialist regime. In 1961, the intensive process of nationalisation led to the creation of the public sector as the most dominant sector of the Egyptian economy, necessitating the modification of accounting Acts and regulations to bring them in line with the needs of the socialist regime (Hassan, 2008a). This resulted in the introduction of the uniform accounting system (Farag, 2009), as a response to the government’s philosophy of domination and to act as a “supporter” to the state’s need for financial information to plan, control and inspect national economic activities (Hassan, 2008a, 2008b). Thus, the main aim of adopting the Uniform Accounting System and its regulations was to monitor how public funds and resources were spent and hence to calculate the national income (Hassan, 2008b). In 1966, the Uniform System was finally created; in the following year, it became mandatory for all public-sector firms to adopt the system when preparing their FRs (Dahawy et al., 2002; Farag, 2009; Hassan, 2008b).
2.2 Market-based economy

Being under the jurisdiction of the socialist regime for many years caused public-sector firms to become inefficient, which led to a “worsening balance of payments problem” (Farag, 2009). Therefore, in the mid-1970s, the Egyptian government launched an initiative that attempted to redirect the economy towards the West (Zohny, 2000), to liberalise it, and hence to return to a capitalist and free-market oriented economy (Farag, 2009; Hassan, 2008a, 2008b; Rahman et al., 2002). More precisely, this attempt started in 1974 when Law 93, known as the “Open Door Economic Policy” was passed by the government to encourage private, foreign, Arabic or joint stock investment projects (Farag, 2009; Hassan, 2008b; Rahman et al., 2002; Wahdan et al., 2005) and, in turn, revitalise public-sector firms by creating competition between public firms and foreign-owned enterprises or by joining them together (Farag, 2009). This leads Farag (2009) to assert that, after 1973, the economic shift to the Open Door Policy resulted in reducing the role of the public sector in favour of encouraging the private sector to flourish.

To serve the aims of this policy, in 1977, the Egyptian Government issued Free Zones Law no (32) which provided taxation and custom exemptions designed to encourage the private sector through prompting “joint-ventures” with Arabic, national and international capital (Hassan, 2008b). Moreover, Company Law No. 159 (1981) was passed, which established and organized limited liability firms and joint stock firms, respectively (Hassan, 2008a, 2008b). However, regardless of the adoption of the open door policy, state domination continued and the public sector was still the dominant sector within the Egyptian economy (Hassan, 2008a, 2008b). This leads Hassan (2008b) to claim that, during the period 1973 to 1991, Egypt had moved slightly towards a market-oriented economy because during this time, the private sector was still unable to play a key role in the Egyptian economy in terms of bringing about more sustainable and rapid economic growth. This led to the emergence of severe problems in terms of “macroeconomic imbalances” and an increase in unemployment and poverty rates (Farag, 2009).

Therefore, one consequence of the “inward-looking growth strategy” and hence of the lack of private investment in the economy is that Egypt still had to rely on foreign financial subsidies (Farag, 2009, Hassan, 2008a, 2008b). In 1987, Egypt signed an agreement with the International Monetary Fund and World Bank to the effect that they would continuously supply the country with the necessary economic resources (Hassan, 2008a, 2008b). As a result, Egypt came under external pressure from its international donors, World Bank and the International Monetary Fund, to start re-structuring its economy (Dahawy et al., 2002 and Kholeif et al., 2007). In 1998, the World Bank published a report containing some recommendations for the Egyptian government including:

- urgent reform of public-sector firms by adopting a privatisation programme, thereby transferring ownership to the private sector;
- reactivating and strengthening the Egyptian Capital Market and the stock exchanges;
- creating a strong association between the Egyptian Capital Market and international markets to raise more economic resources and make savings (Hassan, 2008a, 2008b; Zohny, 2000).

In response to these measures by the World Bank and the international community, the Egyptian Government began to make significant efforts towards re-structuring the economy and introducing comprehensive economic reform (Kholeif et al., 2007; Rahman et al., 2002; Wahdan et al., 2005), by moving away from the inward-looking-based economy
in favour of an export-based economy that prioritised the private sector (Farag, 2009; Kholeif et al., 2007), to liberalise the economy and minimise government intervention in the business sector (Hassan, 2008a, 2008b). Accordingly, in 1991, the Egyptian Government started to implement the privatisation programme by passing Public Enterprise Law 203 and its accompanying regulations (Hassan, 2008a, 2008b; Kholeif et al., 2007; Rahman et al., 2002; Wahdan et al., 2005). This law was designed to establish a legal framework to privatise and sell most of the state-owned and public enterprises, which totalled 314 in all (Kholeif et al., 2007). By mandating a privatisation programme, Egypt began the process of transforming the Egyptian economy into a market-oriented economy, involving a “comprehensive movement towards capitalism, promotion of economic democracy and widespread stock ownership throughout the world” (Dahawy et al., 2002, p. 205), with the aim of restoring economic growth and stabilizing the Egyptian economy (Farag, 2009).

Consequently, as part of the privatisation programme, a number of laws including Company Law No. 159 (1981) and other regulations were adopted by newly privatised firms similar to private-sector firms.

2.2.1 Egyptian stock exchange under free-market-based economy. After nearly 15 years of governmental “hegemony” on Egyptian economy, the death of the President Nasser in 1970 signalled the end of both socialist regime and hence government’s domination over the capital market, which, in turn led to the revival of the capital market as a “healthy” indicator of the successful adoption of the open door policy (Zohny, 2000). This initial reactivation was achieved by passing Presidential Decree No. 520 in 1979 which aimed to hand back responsibility for controlling and organising the market’s operations and activities to the capital market (Hassan, 2008a, 2008b). During the 1990s, a further important step towards strengthening the capital market was taken. This involved a move towards a more liberalised economy when the Egyptian government applied a comprehensive privatisation programme as a way of reforming the Egyptian economy [Egyptian Financial Supervisory Authority (EFSA), 2014]. This programme had a significant impact on boosting the capital market as a vital means of raising economic resources both domestic and international capitals (Zohny, 2000), which was necessary in Egypt for a successful economic transition and privatisation programme to succeed (Dahawy et al., 2002). Therefore, “revitalising Egyptian Capital Markets seemed to Egyptian policymakers during this period an opportunity for raising long-term resources and channelling them into projects of economic and social development” (Zohny, 2000, p. 11).

Thus, an essential part of the privatisation programme was the Egyptian Government’s attempt to reactivate the capital market and the stock exchange’s activities and its regulatory rules (e.g. listing/delisting rules) and hence restore investors’ trust and confidence in its activities (Abd-Elsalam and Weetman, 2003). This is consistent with World Bank’s assumption that “the development of efficient capital markets in Egypt and the privatisation of the public sector are reinforcing each other” (Zohny, 2000, p. 8). In 1992, the Capital Market Law (95) was issued, besides subsequent regulations, resulting “in opened the door again for revitalization of the Egyptian Exchange”.

In the ensuing years, new activities and several institutions working in different fields in the capital market were introduced until the Egyptian capital market and the EGX’s activities became among the strongest and deepest activities of the market in the region. Capital market has a very thorough legislative system, which complies extremely well with the legislative principles governing international markets [Egyptian Financial Supervisory Authority (EFSA), 2014]. More precisely, this economic reform was coupled with a critical change made in the EGX after a new board of directors, headed by Chairman Sherif Raafat, took steps to modernise it, including installing a new trading, clearing and settlement
system which complies with the international standards and developing listing, delisting and trading rules.

2.2.1.1 Egyptian Stock Exchange’s regulatory listing/delisting requirements. According to Article (9) of the Egyptian Securities Listing of the Egyptian Financial Supervisory Authority’s (EFSA) 2009 Board Decision No. 50 for the year 2009[1]: “shares that are compliant with the following condition as at the time of submission of listing application shall be listed”:

F) Net profit percentage before deduction of taxes at last fiscal year preceding listing application shall not be less than 5% of the paid capital to be listed, [which is] originating from the company’s practice of its business, which achieves the main purpose of the company [. . .].

As exception from the above [. . .] Shares of the company not fulfilling the condition (F) may be listed [. . .] conditions [. . .] that average annual net profits of the company [. . .] for the last three years preceding listing application [. . .] shall not be less than 5%, and provided that no losses are incurred during any of the three fiscal years preceding listing application.

Moreover, in accordance with Article 34 of the Capital Market Authority (CMA) 2008 Board of Directors Decision No. (94) of 2008[2]:

[. . .] listing Committee shall delist the shares of a company if the company does not meet the requirements of the minimum net profit [5% of the paid capital] and shareholders’ rights for two fiscal years after the listing [. . .].

2.2.2 Accounting regulations during free-market-based economy. The adoption of the privatisation programme in the 1990s had a significant impact on the Egyptian accounting profession in terms of change, not only in relation to its objective of transforming from meeting the needs of the state-controlled economy to serving the needs of the market-based-economy but also in the accounting system adopted (Farag, 2009).

After privatisation, the Egyptian Government obliged the newly privatised companies to stop using the unified standardised accounting system with immediate effect and switch to the international standard-based system instead (Dahawy et al., 2002; Farag, 2009), to eliminate the differences between public and private companies in terms of accounting treatment and practices (Kholeif et al., 2007). This, in turn, meant that accounting practices had to be changed from not using generally accepted accounting principles or GAASs to the compulsory adoption of international accounting and auditing standards (Farag, 2009). This is because adopting international standards makes it easy for foreign investors to understand and analyse Egyptian firms’ FRs and hence trust these firms and their financial performance (Hassan, 2008b). Hence, these firms are viewed as attractive investment opportunities in the eyes of foreigners, which in turn has led to an increase in the foreign capital flows into Egypt (Dahawy et al., 2002; Hassan, 2008b) required for the desired economic transition to succeed.

To that effect, Capital Market Law 95 of 1992 was passed and initially compelled all listed firms to prepare their FRs in accordance with IASs (Abd-Elsalam and Weetman, 2003; Hassan, 2008b; Rahman et al., 2002); however, later, this law required firms to comply with the Egyptian Accounting Standards (EASs) (Rahman et al., 2002; Wahdan et al., 2005). Therefore, during the period 1997 to 2006, the governmental and accounting professional bodies took significant steps towards establishing the Egyptian Professional Standards in line with the international standards. It is worth pointing out that after 1997, under Company Law No. 159 (1981) and Capital Market Law No. 95 of 1992, all Egyptian firms, regardless of their legal form (i.e. joint-stock, limited liability, or partnership limited by shares) and regardless of whether or not they are listed on the EGX, were obliged to prepare
their FRs in accordance with the EASs, and these FRs had to be audited in accordance with the Egyptian Auditing Standards (Deloitte, 2014). It also became mandatory for privatised firms to adhere to these standards, starting from 1 July 2007, leading to an acceleration in the demise of the unified accounting system (Farag, 2009).

Overall, the market-based economy era, and especially the privatisation programme, has had a major impact on the following:

- increasing the number of listed firms and hence increasing the competition among them while attracting funds;
- activating the stock exchange’ activities and its listing rules; and
- adopting international standard-based accounting system and applying private sector company laws Company Law No. 159 (1981) and other accounting regulations by newly privatised firms similar to private-sector enterprises.

These developments have brought about significant effects on firms’ accounting practices, including the use of EM to raise reported profits.

3. Theoretical framework: economic-institutional theory

This paper adopts NIS and incorporates the economic environment into the NIS analytical framework to provide useful insights into the effect of both institutional-coercive-regulative and economic pressures on firms to use negative accounting practices to achieve upward revisions in reported profits.

Institutional coercive pressure refers to the external pressure which is exerted on a firm from its environment to force it to adopt certain procedures or requirements (DiMaggio and Powell, 1983; Moll et al., 2006). It is considered as a motive for the firm to comply with other external organizations’ requirements, such as governmental and regulatory bodies, which provide it with the necessary support and resources for continued existence, operation and success (DiMaggio and Powell, 1983; Pfeffer and Salancik, 2003).

As suggested by the institutional theory, a kind of coercive pressure is reflective of regulative and enforcing features of particular controlling, powerful and regulatory organizations, e.g. EGX, which aims to control and have an impact on the future performance, actions, and behaviour of firms (DiMaggio and Powell, 1983, 1991), by enforcing them to follow certain regulative procedures and rules (Hussain and Hoque, 2002; Rowan, 1982). In particular, regulatory organizations establish explicit regulative activities, involving setting regulative rules, e.g. listing/delisting regulative rules, monitor firms’ conformity to such rules and rewards/sanctions for firms’ conformity with or departure from such rules (Wickramasinghe and Alawattage, 2007), such as rejection to list firms on stock exchange or delist listed firms.

In addition, Dacin (1997, p. 47, emphasis added) argues:

In fact, a more complete view of organizational action reinforces the notion that organizations are inextricably embedded in a dynamic system of interrelated economic [and] institutional [...] processes.

Thus, DiMaggio and Powell (1983) maintain that “institutional” and “competitive” are two types of sources of pressure exerted on firms; however, NIS theorists stress only on the institutional isomorphism (Moll et al., 2006). This results in exposing the initial analysis of NIS as being faulty because of its lack of emphasis on the role of the economic and competitive forces in affecting firms’ activities and practices (Kholeif et al., 2007; Tsamenyi et al., 2006). To that effect, Dacin (1997, p. 47) argues that “institutional
pressures operate in concert with other forces such as [economic], competitive or market pressures [. . .].

Thus, Oliver (1992) pays significant attention to the importance of incorporating economic considerations with institutional pressure as a way helping in precisely explaining organisational behaviour when deciding whether or not an institutionalised activity or practice, e.g. accounting practice such as EM, is persistent, leading to an adequate and convincing view of organisations’ behaviour in the modern world. Greenwood and Hinings (1996) assert that an interplay between economic and institutional contexts can generate pressure exerted on firms to adopt certain practices or follow certain behaviour, e.g. managing profits, to comply with their requirements, e.g. publishing favourable financial results. As a result, Powell (1991) and Scott (1991) argue that institutional and economic pressures should not be considered as “dichotomous”; both of these types of pressures are exerted on firms which then seek to respond to and comply with them to secure their survival (Powell, 1991; Tsamenyi et al., 2006).

Accordingly, this paper considers the combined effect of both institutional regulative pressure and economic pressure on firms’ behaviour and practice. The EGX is an institutional regulatory agent which exerts a regulative coercive pressure on firms to meet its listing/delisting rules, entailing reporting profits. This institutional-regulative-coercive pressure can be regarded as a motive for adjusting firms’ earnings figures to remain listed on the stock exchange and avoid becoming delisted. This institutional pressure is incorporated within economic pressure, i.e. adoption of Egyptian privatisation programme, as another powerful environmental motive for managing the reported profits of firms. This addition is due to the effect of the Egyptian political-economic reform on:

- accounting system and regulations such as: adopting IASs and company’s laws by newly privatised enterprises;
- activating the stock exchange’s roles and its regulative regulations; and
- increasing the number of listed firms on stock exchange.

All have significant influences on firms’ accounting practices and especially the use of earnings management techniques that have a remarkable impact on the quality of Egyptian financial reporting.

4. Methodology and method

This research adopted an interpretive approach to better understand the effect of institutional and economic contexts, wherein accounting practices operate on FSs’ quality. Consequently, data collection process involved interviewing a total of 34 participants, who were divided into four categories namely firms’ executives, investors, auditors and EGX’s regulators. This diversity was an attempt to maximise the difference within the sample (Glaser and Strauss, 1968 cited in Lewis and Ritchie, 2003), and hence create a representative and inclusive sample relative to the parent population for the sake of enhancing the validity of the study (Lewis and Ritchie, 2003). Using a diverse sample also facilitated the collection of rich data and helped identify the themes shared between different participants regarding the phenomenon under study (Patton, 2002 and Ritchie et al., 2003). This diversity also helped the researchers to improve the construct validity of the interviews using “triangulation” in which all interviewee answers are cross-checked against other interviewee answers and against documentary evidence (such as memos, minutes and published accounts). In this way, the researchers can be confident that the interviews correctly measure what they are intended to measure. The “preparers” category, executives from...
privatised and private firms, make up 32.4 per cent of the interviewed participants. It consists of executives from five different companies, including three industrial companies (45.4 per cent) and two service companies (54.6 per cent). Industrial companies comprise textile, pharmaceutical and motor industry companies. Meanwhile, service companies include restaurant and hospitality and securities brokerage companies. The financial report users’ category (investors or financial analysts) makes up 32.4 per cent of the total interviewees; this consists of large companies and medium-sized companies. The auditor category makes up 26.4 per cent of the total interviewees and includes both large and small audit firms, the later ranged from small-sized to medium-sized firms, depending on the number of its staff. Finally, the EGX regulator group makes up 8.8 per cent of the total interviewed sample (inserts Table I: Percentages of the Categories of Respondents).

Researchers interviewed a small number of regulators (only 8.8 per cent of the total sample) and managers from only two different sectors because of five reasons. First, as reported by Patton (2002, p. 244 – emphasis added), in qualitative research, there are no set rules for determining the appropriate size of the sample or subsample. Instead, selecting or determining the research sample relies on “what you want to know, the purpose of the inquiry, [and] what will be useful”; all are necessary to achieve the research aim (s). Therefore, interviewing a small number of regulators and managers from only two different sectors satisfied the research’s aim because it helped the researchers measure the constructs designed and, in turn, achieve the research objectives. Second, in light of Patton’s (2002) suggestion, the researchers continued carrying out interviews with managers and regulators until the point at which no new useful information was emerging. Third, Patton (2002, p. 246) suggests, “maximizing to the full the advantages of in-depth [data], purposeful sampling will do much to alleviate concerns about […] sample size”. Therefore, participants were selected using a purposive (criterion-based) sampling technique to enhance the research validity, whereby respondents were chosen based on having certain features including their knowledge and experience; roles and professional positions; attitudes, beliefs

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<th>No. of interviewees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auditors Large firms</td>
</tr>
<tr>
<td>Auditors Small and medium firms</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Financial report users (Financial analysts) Securities Brokerage firm: Large</td>
</tr>
<tr>
<td>Financial report users (Financial analysts) Securities Brokerage firm: Medium</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Firms’ Executives Industrial Companies: Textile industrial co.</td>
</tr>
<tr>
<td>Firms’ Executives Industrial Companies: Pharmaceutical industrial co.</td>
</tr>
<tr>
<td>Firms’ Executives Industrial Companies: Motor industrial co.</td>
</tr>
<tr>
<td>Firms’ Executives Service Companies: Restaurant and Hospitality co.</td>
</tr>
<tr>
<td>Firms’ Executives Service Companies: Securities Brokerage co.</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Regulators Egyptian Exchange (EGX)</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Total interviewees</td>
</tr>
</tbody>
</table>

Table I. Numbers and percentages of the four categories of respondents included in interviews.
and perceptions (Ritchie et al., 2003); and ability to shed light on phenomenon under study (Tables II, III, IV and V: the demography of research’s respondents). Fourth, data collection in Arabic countries needs obtaining much permission to gain access to a “bureaucracy” that was difficult; in spite of granting this permission, it was still difficult to interview some of the participants who proved more difficult to gain access to than other participants (Form, 1976). This problem is faced by the researchers, in particular, while interviewing EGX’s regulators. Fifth, in Egypt, the data collection process is very time consuming because obtaining multiple personal contacts was important; hence, the researchers interviewed executives from only five different companies with whom they could establish contact.

To enhance the validity of interviews, the researchers relied on not only purposeful sampling, but also taking into account the following arguments when choosing the sampled participants. The first argument is for Levitt (1998), Chairman of SEC, who considers managing FRs to be “a game among market participants”. More precisely, Degeorge et al. (1999) identify that the information disclosure game is played between executives and outsiders such as investors and financial analysts. Thus, the sample used in the present research consists of company managers and investors (i.e. financial analysts as a surrogate for investors). The second is the argument of Ritchie et al. (2003) who mention that including additional members of the population, who have attitudes towards and experience of the phenomenon being studied necessary to arrive at an important understanding of this phenomenon. In this regard, Dechow et al. (1996, p. 31 – emphasis added) suggest that “by better understanding the determinants of disclosure policy, investors, analysts, and other parties evaluating firms’ accounting information will be more prepared to anticipate earnings manipulations”. Thus, this research intends to include external auditors and EGX regulators as two other groups that evaluate firms’ FRs, which may be able to provide additional or contradictory views about the phenomenon.

<table>
<thead>
<tr>
<th>Regulator</th>
<th>Position</th>
<th>Age</th>
<th>Years of experience</th>
<th>Certificate</th>
<th>Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>REG1</td>
<td></td>
<td>49</td>
<td>10</td>
<td>PhD, UK</td>
<td>The Egyptian Exchange</td>
</tr>
<tr>
<td>REG2</td>
<td></td>
<td>39</td>
<td>6</td>
<td>MBA, Durham, UK</td>
<td>The Egyptian Exchange</td>
</tr>
<tr>
<td>REG3</td>
<td></td>
<td>43</td>
<td>8</td>
<td>MBA</td>
<td>The Egyptian Exchange</td>
</tr>
</tbody>
</table>

**Note:** It is not appropriate to describe their job positions as they will be well know

<table>
<thead>
<tr>
<th>Auditor</th>
<th>Age</th>
<th>Experience</th>
<th>Firm size</th>
<th>Certificates</th>
<th>Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUD 1</td>
<td>26</td>
<td>4</td>
<td>Big</td>
<td>Master in auditing</td>
<td>Auditor</td>
</tr>
<tr>
<td>AUD 2</td>
<td>28</td>
<td>6</td>
<td>Big</td>
<td>Master in auditing</td>
<td>Auditor</td>
</tr>
<tr>
<td>AUD 3</td>
<td>26</td>
<td>5</td>
<td>Big</td>
<td>Master in auditing and tax diploma</td>
<td>Auditor or Manager</td>
</tr>
<tr>
<td>AUD 4</td>
<td>25</td>
<td>4</td>
<td>Big</td>
<td>Diploma in Auditing</td>
<td>Deputy Director (direct auditor)</td>
</tr>
<tr>
<td>AUD 5</td>
<td>45</td>
<td>12</td>
<td>Big</td>
<td>PhD in accounting and auditing</td>
<td>Senior</td>
</tr>
<tr>
<td>AUD 6</td>
<td>45</td>
<td>18</td>
<td>Small</td>
<td>PhD in accounting and auditing</td>
<td>Partner</td>
</tr>
<tr>
<td>AUD 7</td>
<td>46</td>
<td>19</td>
<td>Small</td>
<td>PhD in accounting and auditing</td>
<td>Owner, partner</td>
</tr>
<tr>
<td>AUD 8</td>
<td>30</td>
<td>7</td>
<td>Small</td>
<td>Diploma in auditing</td>
<td>Owner, partner</td>
</tr>
<tr>
<td>AUD 9</td>
<td>30</td>
<td>6</td>
<td>Small</td>
<td>Master in auditing</td>
<td>Auditor</td>
</tr>
</tbody>
</table>

**Table II.** Demography of EGX regulators

**Table III.** Demography of external auditors

JFRA 16,1 256
<table>
<thead>
<tr>
<th>Manager</th>
<th>Position</th>
<th>Age</th>
<th>Years of experience</th>
<th>Certificate</th>
<th>Field/company</th>
</tr>
</thead>
<tbody>
<tr>
<td>MAN 1</td>
<td>Financial manager</td>
<td>42</td>
<td>12</td>
<td>Diploma in accounting and audit</td>
<td>Pharmaceutical industrial company</td>
</tr>
<tr>
<td>MAN 2</td>
<td>Accounting manager</td>
<td>37</td>
<td>9</td>
<td>Diploma in accounting and audit</td>
<td>Pharmaceutical industrial company</td>
</tr>
<tr>
<td>MAN 3</td>
<td>Financial controller</td>
<td>38</td>
<td>16</td>
<td>Master business administration (MBA)</td>
<td>Car industrial company</td>
</tr>
<tr>
<td>MAN 4</td>
<td>Financial manager</td>
<td>33</td>
<td>10</td>
<td>MBA</td>
<td>Car industrial company</td>
</tr>
<tr>
<td>MAN 5</td>
<td>Financial manager</td>
<td>50</td>
<td>25</td>
<td>MBA</td>
<td>Textile company</td>
</tr>
<tr>
<td>MAN 6</td>
<td>Financial manager</td>
<td>42</td>
<td>20</td>
<td>Diploma in accounting and audit</td>
<td>Restaurant and hospitality</td>
</tr>
<tr>
<td>MAN 7</td>
<td>Financial manager</td>
<td>28</td>
<td>6</td>
<td>MBA</td>
<td>Brokerage company</td>
</tr>
<tr>
<td>MAN 8</td>
<td>CEO or Managing Director</td>
<td>60</td>
<td>41 in general</td>
<td>MBA</td>
<td>Brokerage</td>
</tr>
<tr>
<td>MAN 9</td>
<td>Chairman of the Board of Directors</td>
<td>55</td>
<td>27</td>
<td>PhD in accounting</td>
<td>Brokerage</td>
</tr>
<tr>
<td>MAN 10</td>
<td>Financial manager</td>
<td>56</td>
<td>35</td>
<td>Master business administration (MBA)</td>
<td>Brokerage</td>
</tr>
<tr>
<td>MAN 11</td>
<td>Chief executive officer (CEO), Managing director</td>
<td>59</td>
<td>27</td>
<td>PhD in financial and economics</td>
<td>Brokerage</td>
</tr>
</tbody>
</table>

Table IV. Demography of corporate executives.
<table>
<thead>
<tr>
<th>Financial analysts</th>
<th>Age</th>
<th>Year of experience</th>
<th>Position</th>
<th>Certificate(s)</th>
<th>Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td>FAN1</td>
<td>42</td>
<td>16</td>
<td>Vice president/researcher department</td>
<td>Certified portfolio management</td>
<td>Large</td>
</tr>
<tr>
<td>FAN 2</td>
<td>28</td>
<td>6</td>
<td>Financial analyst</td>
<td>MBA, Master in Business Administration</td>
<td>Medium</td>
</tr>
<tr>
<td>FAN 3</td>
<td>31</td>
<td>7</td>
<td>Technical Analyst</td>
<td>Master in economics</td>
<td>Medium</td>
</tr>
<tr>
<td>FAN 4</td>
<td>35</td>
<td>12</td>
<td>Head of research/financial and technical analyst</td>
<td>Diploma in investment management/ Master in investment management</td>
<td>Medium</td>
</tr>
<tr>
<td>FAN 5</td>
<td>35</td>
<td>15</td>
<td>Managing director (CEO)</td>
<td>Diploma in analysis stock markets/ Diploma in Fundamental Islamic Finance</td>
<td>Medium</td>
</tr>
<tr>
<td>FAN 6</td>
<td>60</td>
<td>25</td>
<td>Financial analysis</td>
<td>PhD in finance</td>
<td>Medium</td>
</tr>
<tr>
<td>FAN 7</td>
<td>38</td>
<td>16</td>
<td>Managing director</td>
<td>MBA in financial analysis/ Diploma in financial analysis</td>
<td>Large</td>
</tr>
<tr>
<td>FAN 8</td>
<td>26</td>
<td>4</td>
<td>financial analyst</td>
<td>Diploma in stock market studies/ MBA in markets stock studies</td>
<td>Large</td>
</tr>
<tr>
<td>FAN 9</td>
<td>30</td>
<td>10</td>
<td>Financial analyst/ Manager of Research and of investment</td>
<td>Certified Management Accounting (CMA)/Certificated financial managers (CFM)/Charted Market Techniques (CMT)/Certificated Portfolio Managers (CPM)</td>
<td>Medium</td>
</tr>
<tr>
<td>FAN 10</td>
<td>27</td>
<td>8</td>
<td>Financial analyst</td>
<td>MBA and PhD in finance</td>
<td>Medium</td>
</tr>
<tr>
<td>FAN 11</td>
<td>49</td>
<td>18</td>
<td>Financial analyst/ writer in the financial and economic press</td>
<td>MBA and PhD in finance</td>
<td>Large</td>
</tr>
</tbody>
</table>

Table V. Demography of financial analysts

JFRA 16,1
Therefore, the sample of this research collectively comprises four different categories of interviewees namely managers (EM practitioners), financial analysts (users of FRs), auditors and EGX regulators (outside reviewers of firms’ FRs and observers of EM practice). These participants are chosen from the working population or sample frame which refers to the full range of relevant participants and groups available to serve the research purposes (Ritchie et al., 2003), which may be practically used as units of analysis, i.e. the sample units (Zikmund et al., 2010). The most convenient source for the sample frame is the lists published on websites useful for creating a sample of organizations or professionals (Ritchie et al., 2003 and Zikmund et al., 2010). In light of this guidance, the researcher depended on the EGX and Egyptian Financial Supervisory Authority’s (EFSA) websites for choosing securities brokerage firms, EGX-listed companies and licensed auditors, in addition to personal relationships and friendships that were used to recruit other participants, e.g. some of the participants from large audit firms, non-listed companies and especially, EGX regulators.

The research method used was semi-structured interviews (insert: Interview Guide):

**Interview Guide:**
Introduction and background questions.
Regulative Context and Economic System Motivational Effect:

1. *Opening question:* In your opinion, does the privatisation programme have an effect on your (a firm manager’s) willingness to adjust the profit numbers?
2. *Probing questions:* Could you tell me more about the effect of this programme on:
   - the competition among firms for attracting both local and foreign capital;
   - the accounting system and practice; and
   - the EGX’s activities and role.
3. *Opening question:* In your opinion, does the regulative listing/delisting rules of stock exchange play a role in motivating you (a firm’s manager) to adjust or manage the firm’s financial image?
4. *Opening question:* In your opinion, what are the reactions of the regulators of EGX when your firm (a firm) reports losses? (Words in italic and between brackets indicate the part of the question which was changed to rephrase the whole question to make it suitable for interviewing groups other than the firms’ management group).

Unlike the questionnaires, interviewing approach enables the researcher to elicit individuals’ experiences, beliefs, perceptions, attitudes and behaviours in relation to aspects of practices that impact the quality of financial reporting. Thus, the semi-structured interview is highly advantageous and hence adopted as a suitable data collection method for serving the research objectives including:

- allowing a predetermined schedule of interview questions covering all aspects of the phenomenon under investigation to be implemented in advance (Arthur and Nazroq, 2003; Berg, 1995; Patton, 2002);
- the possibility of drawing comparisons between the responses of the various individuals involved in the phenomenon, with the use of a predetermined list of interview questions that are typically asked to all the research participants in a systematic and comprehensive order (Arthur and Nazroq, 2003; Berg, 1995; Patton, 2002);
the opportunity to emphasise on certain topics and address specific aspects of the phenomenon being studied; thus, it helps consider what has occurred and why (Zikmund et al., 2010); and

- enabling the researcher to acquire in-depth information and explanations about the phenomenon, because it allows the interviewer to ask unscheduled probing questions about new and useful issues that might emerge during the interaction between interviewer and interviewees; it also provides the opportunity to ask probing questions which are responsive to the differences in the experiences and thoughts of the various participants (Arthur and Nazroq, 2003; Berg, 1995).

To that effect, the interview guide is designed comprising two different styles of questions to elicit the most coherent and complete picture possible about the phenomenon namely: “essential” or “opening” questions and “probing” questions (Berg, 1995).

Furthermore, to ensure a high level of external validity, the interviewer endeavoured to be as neutral as possible to avoid leading the interviewees towards particular answers (Charmaz, 2001) and being unbiased during the analysis of the data collected (Lewis and Ritchie, 2003). Being unbiased entails researchers to providing explanations for the phenomenon, not only by incorporating, analysing all the data collected (Mehan, 1979; Silverman, 2010) but also by avoiding the use of brief “conversations, snippets” from interviews or just “a few well-chosen examples” (Bryman, 1988; Silverman, 2000). Accordingly, Ritchie and Spencer’s (2002) thematic approach was used to comprehensively analyse the data, starting from constructing a thematic framework or index based on the research questions and interviewing questions. Indexing was the next step, in which the researcher systematically applied the thematic framework to the gathered information in its textual form. Thereafter, charting step was achieved, entailing transferring the data from its original contexts to be rearranged in accordance with the headings and subheadings drawn from the thematic framework, i.e. according to each interview question, by employing a “cut and paste approach” to chunks of text and verbatim responses of the interviewees. Using direct quotations from participants’ answers and excerpts from what the participants actually said enhanced the validity of research in terms of providing accurate and correct interpreting and representing the effect of regulative and economic factors on EM, in ways that they are perceived by the participants and the research population. The researcher then focussed on the final step, mapping and interpretation, wherein data were interpreted and answers were provided to the research questions. During this process, the analyst defined concepts; searched for patterns and connections; reviewed comparisons and contrast the participants’ perceptions, beliefs, or experiences and developed strategies and map the nature of phenomena.

The reliability of research was further enhanced by interviewing not only senior executives with a lot of integrity but also other groups of interviewees, such as auditors, who had no incentive to be untruthful. Also, interviewing different groups helped the researchers compare the answers, beliefs and attitudes of each interviewed group with others, leading to ensure that all interviewees, especially managers, told the truth and reflected their own beliefs and attitudes regarding EM incentives.

5. Data analysis and results
This section analysed the data collected from interviews and official documents, e.g. Company Law No. 159 (1981) and EGX rules, by referring to the theoretical framework of Economic Institutional Theory.
5.1 The impact of political-economic reforms on the quality of financial reporting

Egypt represents a typical case of an economy in transition whose system moved towards a more liberalised political-economic system, resulting in adopting privatisation programme. This programme, in turn, led to significant effects on regulations of both accounting and EGX, reviving the role of EGX and increasing competition within EGX regarding raising capitals. All have vital impact on executives’ propensity to manage FRs and hence the quality of FRs.

5.1.1 The impact of the political-economic reform on accounting regulations.

Privatisation programme affected accounting regulations in terms of applying IASs and company’s laws by newly privatised enterprises similar to private sector firms, consequently on the quality of enterprises’ FRs.

Moving away from the inward-looking-based economy in favour of the free-market economy and privatisation resulted in abandoning a uniform accounting system to adopt international standard-based accounting system, which is comparatively more flexible than the former with regard to the preparation of the privatised enterprises’ FRs; this flexibility enabled management to shape a firm’s FRs to achieve a certain interest regardless of thinking about the goodness and credibility of the published FRs:

Under state-controlled economic system, adopting the Uniform Accounting System, requiring adopting uniform accounting standards, restricts the ability of executives to manage FRs. However, after reforming the political-economic regime in 1990s, it became mandatory for all privatized public-sector firms to adopt accounting system based on AISs; these AISs are more flexibility in their application, as a result preparing FRs become discretionary method, leading to open chance toward management to format FRs as they wish the FRs to be […] at the end of the day, the quality of FRs is dramatically declined (MAN9, a CBD).

A similar view was expressed by one of the regulators:

In 1960s, Uniform Accounting System and its regulations was commonly used for providing national government with financial information needed in planning, and inspecting national activities […] after adopting privatisation programme in the beginning of 1990s Uniform Accounting System was replaced with an accounting system-based on international accounting standards, this system gives management chance to choose among different alternatives accounting principles, accounting treatments and practices; meaning this system gives management a golden opportunity to manage profit upward or downward as they wish and hence influence the quality of the financial reporting (REG1).

Because of the adoption of the privatisation programme, newly privatised companies were mandated to adopt an international standard-based accounting system and thus subjected to private company laws such as Company Law No. 159 (1981). According to Chapter One (shareholder companies) of Law No.159/1981 on Joint Stock Companies, Partnerships Limited By Shares and Limited liability Companies, employees including managers of a shareholder company have the right to receive not less than 10 per cent of the distributed profits and not more than their annual salaries, as specified in Article 41 of the Law:

Workers – and employees including managers- in the Company shall have a share in the distributable profits to be fixed by the General Assembly […] at not less than 10% of these profits and not surpassing the total of the annual wages of workers in the company (emphasis added).

This profit percentage is reflected in managers’ salaries of the privatised companies, instead of receiving fixed salaries, as they used to under the state-controlled economic system.
Thus, the four interviewed groups agreed that, after the privatisation programme was introduced, it became necessary to manage the published profit figures upwards, as remarked by senior executive:

The privatisation programme has played a very important role in motivating management’s willingness to manage the company profits, resulting in lowing the quality of the financial reporting […] [because] after privatisation, managers receive a percentage of the company’s profits, which makes them not only want to report profits but also report increases in such profits from one year to the next (MAN1, a financial manager).

However:

[…] before the implementation of this programme, employees received their salaries regardless of whether they achieved or reported a profit or a loss, and thus they were rewarded for nothing […] (REG2).

An auditor adds that:

[…] from the employees’ perspective, in public companies there are no differences between reporting or achieving profits or losses, because they receive their salaries and bonuses anyway (AUD8, small firm, senior).

Analysing the executives’ and auditors’ views therefore revealed a general agreement that:

[…] when managers succeed to report increases in a firms’ profits and they must therefore get and share a distribution percentage from such profits […] this constitutes a motive for managing these figures upward and then the quality of financial reporting has become subject under suspicion and questioning (MAN10, a financial manager).

Analysts shared the view that the managers’ partnership in the reported profits motivates them to modify the FRs for publishing increases in the profit figures to increase their bonus i.e. profit share.

5.1.2 The impact of political-economic reform on the regulations of EGX. The most important influence of the privatisation programme on managing profits and, in turn, the financial reporting is reflected in its key role in “reviving” the EGX’s role and its regulations.

Regulators made this point clear by stating that:

Starting from 1994-1995, the privatisation programme has boosted the EGX. It boosted the percentage of trading, because privatizing companies was done through the stock market to sell 10%-20% of state-owned (public) firms to the public through the Stock Exchange; thus, this was the first driver for reviving the EGX by increasing its activities and creating and activating new rules (REG1).

Reviving the role of EGX and its regulative listing/delisting regulations shapes additional external environmental factors that influence the financial reporting of companies.

In Egypt, the official documents regarding regulative listing/delisting rules of the firms’ securities on EGX require firms to report profits. Regulators referred to these rules and stated that when firms seek to be listed for issuing stocks for the first time, they must meet certain requirements[3] of the EGX’s listing department, including providing profitable financial statements. The listing committee makes the final decision about whether or not the firm will be listed, based on its ability to:

[…] achieve profits of at least 5% of the firm in paid capital resulting from its basic activities for the last three years preceding listing application or registration and not reporting losses during such years.

(REG3), as a regulator details:
Any firm wanting to make an initial public offering [IPO] comes to the stock market to be listed. Referring to listing rules, the firm should meet the listing department requirements. Some of these are related to the firm’s profitability, and then the listing committee decides whether the firm can be listed or not. Once this firm makes a certain percentage of profits, it will get listed (REG1).

Similarly, analysts and auditors supported the regulators’ view by stating that reporting profits in the period preceding the listing registration is a core requirement of the EGX for listing a company and that “EGX will not help a company that achieves losses to obtain capital” (AUD7, small firm, partner).

A financial manager details below a real-life situation experienced by his company which had pressure exerted on it by EGX’s regulative rules to manage the FRs upwards to become listed when it wanted to raise additional money to expand its activities:

I faced a real situation when our company decided to apply for listing on EGX in order to attract new capital for extending our activities. Deciding to trade our stocks on EGX put pressure on managers to provide the EGX with good financial reports […] We then decided to positively adjust our FRs in order to meet listing requirements, at that time we did not think in the credibility and quality of our FRs at all […] (MAN6, a financial manager).

However, one of the regulators (REG1) mentioned that “a firm that reports losses can be given an exemption to be listed on EGX in condition having rational justifications for reporting such losses, e.g. political or economic issues that have negatively influenced its profits. This exemption is only granted for a short time, after which the firm’s situation will be reviewed again by the listing committee”.

Moreover, the EGX’s regulators emphasise on the importance of continuous reporting profits by stating that:

[…] referring to delisting rules, in the case of reporting losses or achieving profits of less than 5% of the firm’s paid capital for two consecutive years, the listing committee can delist this firm from EGX. We delist firms which are low quality and which achieve a high percentage of losses to protect investors (REG3).

Regulators stress their role in protecting the EGX’s dealers by acknowledging that:

As a regulator, I protect investors through following the EGX’s rules to delist low quality securities […] to bring the investors a perfect menu with good dishes i.e. offering quality stocks […] accordingly they make their investment decisions (REG2).

The analysts’ group shares the view that:

The EGX review and re-evaluate the firm’s listing situation. If it reports losses for 2 consecutive years it delists the firm for the sake of protecting investors (FAN8).

Therefore, executives, auditors and analysts agreed that the listed companies come under pressure to report profits to remain listed on EGX, because reporting losses for 2 years after being listed carries the penalty of being delisted.

However, regulators made an important point that reporting losses do not necessarily mean delisting the firm, stating that:

[…] with justified losses which might result from restructuring of the firm, the nature of its activities or the international crisis of 2008, which negatively affected most firms’ performance, I cannot delist them as failing companies (REG3).

Auditors supported the regulators’ argument about exemption from the delisting rules by claiming that “[…] if I made a loss for one year, there is no problem, but rational reasons and proofs for such losses are required […]” (AUD1, big firm, auditor).
Interestingly, a chairman of the board of directors of a brokerage company highlights the fact that:

\[\ldots\] strict application of the EGX’s listing/delisting rules, especially regarding reporting profits, resulted in decreasing the number of listed companies from 744 to 306 companies in 2005 and 2009 respectively \[\ldots\] (MAN9, a CBD).

Therefore, all the interviewed groups indicated a clear-cut consensus that the EGX’s regulative rules exert coercive pressure on firms to necessarily report certain level of profits for being listed on stock exchange and avoiding delisting situation, leading to provide a significant motive for executives to manage the FRs upward; as a consequence, the quality and reliability of published FRs are negatively influenced. Moreover, executives continue saying that \[\ldots\] the firm’s propensity to manage the FRs upward either to meet the EGX’s listing requirements or to avoid delisting after becoming listed is enhanced after reactivation of the Stock Exchange and its listing/delisting rules by privatisation \[\ldots\] “(MAN9, a CBD). One auditor (AUD5, big firm, partner) summarizes such views by stating that “EGX’s rules exert pressure on firms to manage their FRs in order to report profits and avoid losses”.

\[5.1.3\] The impact of political-economic reform on the market for raising funds. The third motivational influence exerted by the privatisation programme to manage the FRs can be observed through its effect on selling the public-sector firms in EGX, thereby increasing the number of listed companies trading on the stock exchange and creating greater competition between these firms to attract capitals.

All the interviewed groups generally agreed on this issue and indicated that, after the privatisation programme, in particular:

\[\ldots\] after 2000, the number of privatised firms dealing in EGX has increased more than the private firms. The percentages of privatised and private firms’ participation in EGX and in investment activity in Egypt are almost 70% to 30% respectively (AUD3, big firm, auditor).

This resulted in increased competition between those companies to attract capital. Thus, from the interviewees’ perspective, this programme is viewed as a significant source of pressure exerted on management to adjust the profitability picture of the firm upward to be able to compete for attracting domestic and foreign funds, without thinking about the FRs’ quality, as summarized by the following analyst:

Yes, it is 100% right that the privatisation programme has increased the pressure on company managers to adjust the FRs upward to attract capital, either foreign or local, due to the increasing number of listed firms and hence increasing competition between them to attract such funding (FAN1).

This consensus is grounded in the following beliefs. Analysts and regulators interpret the world of privatisation as a function of highly competitive markets. They see the privatisation programme as a “[\ldots] tool to create competition between firms on financial and non-financial levels” (REG1). Companies compete not only in the product market through the product’s quality and price which encourages customers to buy the product, but also in the stock market through their favourable financial statements that encourage investors to buy their stocks. “Like customers who seek a good quality product with a competitive price, investors search for profitable and strong stock in the stock market” (REG2). Similarly, the executives assert that “[\ldots] I consider my firm’s stock as a physical product on the Egyptian Stock Exchange \[\ldots\]” (MAN3, a financial controller), which must be of high quality to increase customers’ demands. “Each company listed on the Egyptian Stock Exchange tries hard to brighten its stock image to make it attractive for investors” (AUD8, small firm, senior). Hence:
after the privatisation programme [...] it has become necessary to enhance my stock’s ability to compete and to attract customers (i.e. investors). This drives me to manage my financial results upward in order to compete on the Egyptian Stock Exchange [...] We left the issue of the financial reporting’s reliability and credibility a side (MAN3, a financial controller).

In light of the aforementioned views about the positive relationship between publishing favourable FRs, i.e. profits and attracting new capital, executives believe that:

[...] such a programme puts pressure on the firm to compete in attracting new capital, especially in the case of the initial public offering (IPO) on the stock market. In this case, it becomes necessary for firms to pay due concern to the published reports. I must give good indicators to the stock market by conveying a positive message and good financial information [i.e. reporting profits][...] Without considering the quality of financial statements (MAN9, a CBD).

6. Summary and conclusion
The main findings of our research are based on the analysis of the 34 interviews conducted with executives, investors, auditors and EGX’s regulators and also the official documents; these indicate that Egyptian political-economic reforms have a negative influence on the quality of financial reporting through its effect on accounting regulations, the regulations of EGX, reviving the role of EGX and increased competition within EGX regarding raising funds.

This study contributes to the literature in a number of ways. First, the research has contributed theoretically; it incorporates economic pressure within the coercive pressure of institutional regulatory bodies to provide an extension to NIS theory for gaining deeper understanding of the strong effects of accounting on shaping accounting practices. Second, it validates the effect of the Egyptian political-economic environment and privatisation on creating negative accounting activities, practices and behaviours. Third, the influence of the socioeconomic factors on accounting and reporting processes in developing countries e.g. Egypt have been investigated and understood; their impact at this time of change and growth is documented. Fourth, the empirical evidence highlights that there are no universal accounting practices and actions which can be generalised worldwide because of the variety of political and economic systems affecting these practices and actions.

This research has a number of limitations: First, the results were based on responses from a small number of interviewees; thus, they should be interpreted with caution, given the limitation of the employed purposive sampling technique. Second, this study adopted the NIS theory and interpretive approach which helped identify the motivating effect of regulative and economic factors in the particular setting, i.e. Egypt. This implies that the primary limitation of this study is in the application of the results to other settings. This calls for future research investigating this phenomenon in other settings which have so far been under-researched in this area either using the same theory and research philosophy or by adopting others. The third limitation is that the research participants were limited to four groups: managers; financial analysts, auditors and regulators. Although their views were very useful in serving the thesis aims, during the data analysis, it emerged that it would be beneficial to include some other participants who are interested in quality FRs such as creditors, employees and suppliers. It would also be beneficial to conduct further research interviewing these interested parties in FRs besides academics and accountants. The fourth limitation of this study is its focus on certain kinds of industrial sectors: pharmaceutical, motor and textile and on two service sectors: restaurant and hospitality and brokerage. Thus, further research on investigation by including other sectors is necessary. The fifth limitation is that this study is an explanatory research that explores many issues. Thus, further research is required using an in-depth or case study designed to investigate the consequences of publishing low-quality FRs on the Egyptian
economy. Another limitation is that factors affecting the quality of FRs of the Egyptian companies are shaped and significantly influenced by economic and political factors. These aspects continuously change over time, implying further investigation.

Our conclusions could be of interest to other countries, particularly developing countries, who want to improve the quality of their accounting practices and financial reporting. They also could be of interest to regulators who care about attracting both international and national investors interested in the emerging capital markets; they should find the results of this study beneficial. In fact, the focus on Egypt, an emerging and Arab country, and the use of recent data, informing accounting and EGX regulators about the effect of recent economic and political reforms, resulting in privatization on motivating negative accounting practices and hence reducing the quality of financial reporting might provide a better understanding of accounting and its business environment in Egypt and other similar countries experiencing booming economies with a bundle of investment opportunities. Hence, this study should provide international investors and researchers with a better understanding of the environmental factors that affect accounting in the emerging markets.

Notes
1. It mandated the Article 9 of the Decree of the Capital Market Authority’s Board of Directors No. 30 – Dated 18 June 2002.
3. “Before going to the listing department there is a necessary step that must be taken: the firm must get approval for its financial statements to be listed before it comes to the EGX listing department [...] The Egyptian Financial Supervisory Authority (EFSA) makes a list of auditors available and offers a licence for these elite external auditors to review and approve the listed companies’ FRs [...]” (REG1).

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Further reading

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