The Practice of Earnings Management in the Middle East Emerging Stock Markets: Why and How is it Done? A Case Study of Egypt

Sherif M. Manzalawy

Arab Academy for Science, Technology,

Management, and Maritime Transport

School of Management, Cairo, Egypt

E-mail: smanzalawy@yahoo.com

Kami Rwegasira

Professor and Chair, Department of Accounting,

Finance and Economics

Maastricht School of Management, the Netherlands

E-mail: rwegasira@msm.nl

Abstract

The main objective of doing this paper was to explore the general trends and directions in the Egyptian Stock exchange (as a leading stock exchange in the Middle East), regarding earnings management. The paper investigates some of the main factors and identifies the main items that could be used by the management of different firms in several sectors, to manage earnings in order to achieve various goals and could at the same time mislead many stakeholders who are affected by such decisions.

This was a qualitative research study. A large scale survey was carried to help achieve the main objective of this paper. Data analysis was done by responses tabulation and frequency rate analysis and partially represented by diagrams. The main findings of the survey could be summarized as follows. First, the respondents broadly consider the financial statements provided by the firms operating within the Egyptian Stock Exchange context to be of considerable reliability. Second, the respondents, in general, believe that many firms operating in the Egyptian Stock Exchange adopt a variety of earnings management practices for various reasons, amongst which are to affect stock prices upwards. The third survey finding was that, in general the respondents believe that the management of some firms could and do use some accounting items in their earnings management practices. Finally, in order to reduce the probability of earnings management, a general consensus that the government and the concerned authorities should exercise a more tight supervision (e.g., through enforcing corporate governance regulations, and resolving corporate agency problems on a more fair basis, though without stifling the initiatives by responsible market players) over public companies in order to protect the general public from probable technical manipulations that could result in earnings management along with other practices that could mislead the public or endanger a firm's investors position, wealth, or potential profits.

Keywords*: earnings management, corporate governance, corporate agency problems, Egypt, stock market, Middle East.*

1. Introduction

Does an earnings management environment exist? And if so, is it possible for financial manipulation to occur in a highly regulated financial environment that is characterized by a wide range of information dissemination. Earnings management has been an important topic for researchers in financial economics, finance, and accounting. With varying perspectives from an academic standpoint to a more practical/ market oriented viewpoint.

The primary objective of this paper is to examine in an exploratory study whether there is evidence that Egyptian publicly listed firms use earnings management to affect their stock prices upwards and to achieve other purposes (amongst which are job security, abiding by debt covenants … etc.).

Public companies feel pressure to report earnings that meet or exceed analysts' expectations – after all, failure to meet those expectations can hurt companies' stock prices and future image. This pressure can lead to practices that sometimes include fraudulent overstatement of revenues. Any of the improper and unusual revenue-transaction methods used to misstate revenues also can be used to change annual earnings results.

The evidence from previous studies is consistent with firms managing earnings to; window dress financial statements prior to public security offerings, to increase corporate managers' compensation and job security, to avoid violating lending contracts, to reduce regulatory costs, and/or to increase regulatory benefits.

Moreover, Zaluki et al. (2009) has mentioned that managers may engage in earnings management due to the information asymmetry between the issuer and outside investors pertaining to the value of initial public offerings (IPOs). In general, earnings management is accomplished when income is shifted from future periods to the present or vice versa.

One of the potential problems inherent in the corporate form is that managers may focus on short-term personal incentives rather than the long-term economic success of the firm. Managers may attempt to maximize salaries, bonuses, and other short-term compensations. This can be accomplished through improvised business strategy and successful operations. It can also be accomplished, at least in the short run, through aggressive earnings management.

2. Research Questions

The main research questions to be addressed in this paper oscillate around four main questions; *whether* there is a relation between a firm's announced earnings and its stock prices in the Egyptian Stock Exchange?; *do* some of the publicly listed companies in the Egyptian Stock Exchange use earnings management practices?; *which* items are being used to achieve earnings management practices?; and *what* are the possible remedial actions, to mitigate the earnings management practices if found, that could be applied?

3. Literature Review

Earnings were found to be useful in various capital market contexts; such as in the prediction of stocks' systematic risk, corporate bankruptcy, and bond ratings (Foster, 1986). Further, earnings are used in various contexts beyond capital markets, such as for contracting purposes within the firms (e.g., management compensation), and between the firm and its creditors and suppliers (Lev, 1989).

The dramatic increase in the number of restatements filed over the past years has been attributed to numerous causes, including the complexity of the accounting standards, internal control reviews, changes in materiality thresholds, the overly conservative nature of auditors, ***earnings management***, increased transaction complexity, and the second-guessing of management judgments by a variety of interested parties (Plumlee and Yohn, 2010). In addition, other factors could be added as the lack of strenuous corporate governance, absence of vigilant risk management plans, and lenient government supervision.

Mulford and Comisky, (2002), defined earnings management as "The active manipulation of earnings towards a predetermined target. That target may be one set by management, a forecast made by analysts, or an amount that is consistent with a smoother, more sustainable earnings stream."

If financial reports are to convey managers' information about their firms' performance, standards must permit managers to exercise judgment in financial reporting. Management can then use their knowledge about the business and its opportunities to select reporting methods, estimates, and disclosures that match the firm's business economics, potentially increasing the value of accounting as a form of communication.

However, because auditing is imperfect, management's use of judgment also creates opportunities for "earnings management", in which managers choose reporting methods and estimates that do not accurately reflect their firm's underlying economics (Healy and Wahlen, 1999).

Several studies of earnings management for capital market reasons have shown that earnings are managed to meet the expectations of the financial analysts or management (represented by public forecasts of earnings). Kasznik (1999) finds evidence that is consistent with firms in danger of falling short a management earnings forecast using unexpected accruals to manage earnings upwards (Healy and Whalen, 1999).

Consequently, it can be noted that, many of the studies to date use *unexpected accruals* as a proxy for earnings management. Standard setters are very likely to be interested in evidence on which specific accruals or accounting methods are used to achieve earnings management.

Teoh, Wong, and Rao (1998) examine depreciation estimates and bad debt provisions surrounding initial public offerings. They find that, relative to a matched sample of non-IPO firms, sample firms are more likely to have income increasing depreciation policies and bad debt allowances in the initial public offering year and for several subsequent years.

Another unexpected accrual that could be used as a proxy for earnings management is the bank loan loss provisions. Studies of bank loan loss provisions include Beaver et al (1989), Moyer (1990), Liu and Ryan (1995), Liu et al (1997), and others. Overall these studies find compelling evidence of earnings management among banks, presumably (in part) for stock market purposes.

Also, to emphasize a point made earlier, management's use of judgment in financial reporting has both costs and benefits. *The costs* are the potential misallocation of resources that arise from earnings management. *Benefits* include potential improvements in management's credible communication of private information to external stakeholders, leading to an improvement in resource allocation decisions.

Stimulants that could motivate managers to engage in earnings management activities could also be found from another international perspective. The empirical evidence by Charoenwong and Jiraporn (2009) shows that the earnings patterns of non-financial companies in Singapore display earnings management behavior to meet thresholds, namely "to avoid reporting losses" and/or "to avoid reporting negative earnings growth", whereas both financial and non-financial companies in Thailand exhibit earnings management behavior.

The pre- and post-analyses of the 1997 Asian financial crisis indicate that in Thailand non-financial companies stopped managing their earnings reports after the crisis. On the contrary, in Singapore, the evidence of earnings management exists both in the pre- and post-crisis periods. For companies in Singapore, the crisis does not change their earnings report behavior.

The study by Charoenwong and Jiraporn (2009) also finds that corporate governance exerts some influence on the behavior of earnings management among companies in Singapore. By assuming that companies partly owned by the government, generally called government linked corporations (GLCs), are associated with good governance, the results show that GLCs do not avoid reporting losses, but non-GLCs do. However, GLCs are reluctant to report negative earnings growths.

Zaluki et al. (2009) provides general evidence of income increasing earnings management in Malaysian IPOs but this occurs primarily during a period of severe economic stress (the East Asian Crisis). The requirement to provide a profit guarantee appears to reduce rather than encourage earnings management. Within this high ownership concentration market, ownership concerns also appear to constrain, rather than encourage, IPO earnings management.

In Egypt, however, the results by Kamel and Elbana (2009) indicated that the main incentives for manipulating earnings in Egypt were to enhance the chances of obtaining a bank loan; to sustain last year's profit performance; to report profits and to avoid reporting losses; and to achieve high-share valuation. The results also demonstrated that making inadequate provisions; capitalising rather than expensing expenditures; and overestimating the inventory value were the most frequently used techniques in earnings manipulation.

Considering the Egyptian context, currently, the Egyptian accounting setting can be characterized by moderate financial accounting conformity, moderate use of accruals, high importance of the capital market and moderate compliance with corporate governance regulations. Egypt has witnessed a rapid development phase since 1991 and became a market-based economy which requires development of accounting standards as well to help investors in financial performance analysis as it provides relevant information based on maintained reliable financial reporting (HassabElnaby et al., 2003).

Moreover, since an increased number of foreign direct investments is arriving to Egypt, after the increased privatization trends, accounting information is playing a more important and crucial role in the economy. Egyptian companies are moving towards the adoption of International Accounting Standards (Abdelsalam and Weetman, 2003).

A previous World Bank (2002) study warns against the mediocre state of Egyptian preparers' compliance with Egyptian Accounting Standards. It states that, "legal provisions are still vague about the civil or criminal liabilities of parties responsible for supplying misleading or incorrect information in audited financial statements". However, to be fair, since then a lot of changes have been made to modify and enhance the Egyptian financial environment (including the banking, non-banking, and capital markets sectors). Where, the Egyptian Financial Supervisory Authority has been established to oversee that public companies, in addition to other key companies, are complying with the Egyptian accounting standards, along with other proper disclosure requirements. Many lawsuits were raised against non compliant companies.

The research study at hand is intended to update and expand the earnings management study and evidence into the Egyptian capital market – as one of the emerging financial markets in the Middle East and Africa.

4. Methodology

This was a qualitative research study in which a large scale structured survey was distributed among related (and interested) parties to the Egyptian Stock Exchange (EGX). A total of 200 questionnaires have been distributed among the related/interested parties in Egypt (including regulators, members of boards of directors, academics, practitioners, and investors). (*The Questionnaire form is mentioned in detail in appendix 1*.)

A total of 110 participants have responded, resulting in 55% response rate (5% regulators, 5% board members, 36% academics, 27% practitioners, 26% investors) The survey includes four sections; the first section includes general background; the second section tracks the causes and motivations of earnings management in EGX; the third section discusses who is responsible for earnings management; and the fourth section inquires about the possible remedial actions to earnings management in Egypt. The response rate for each section is mentioned in the following data and response analysis section.

The main objective this paper was to explore the general trends and directions in the Egyptian Stock exchange (as a leading stock exchange in the Middle East), regarding earnings management. The paper investigates some of the main factors and identifies the main items that could be used by the management of different firms in several sectors, to manage earnings in order to achieve various goals and could at the same time mislead many stakeholders who are affected by such decisions.

5. Data and Detailed Response Analysis

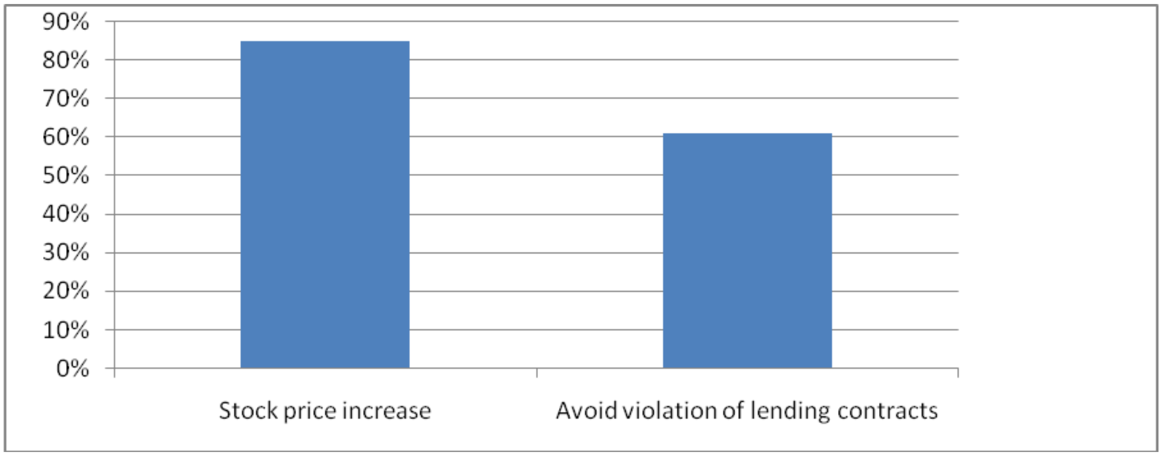
5.1 Data Analysis

Data analysis of the responses was done by tabulation and frequency rates analysis into percentages and partially represented in summary diagrams. This was supplemented by quotations from selected respondents of significant influence and deep knowledge in the financial industry in Egypt. The main findings of the survey are summarized hereunder.

First, the respondents (approximately 90% of the respondents) consider the financial statements provided by the firms operating within the Egyptian Stock Exchange context to be of considerable reliability, and that the earnings figure constitutes the main item to be looked for and awaited as the primary catalyst for a firm's stock price's movement, "*the stock market relies mainly on the firms' financial statement, besides other information from the media, however, the most important piece of information anticipated is the annual earnings figures of the firms" – Mr. HM – financial analyst – Badr Investments*."

Second, the respondents, in general, (approximately 70% of the respondents) believe that many firms operating in the Egyptian Stock Exchange adopt a variety of earnings management practices for various reasons, amongst which are to affect stock prices upwards, (approximately 85% of the respondents) (figure 1) avoiding violations of regulations or violating any loan agreements with the banks (approximately 61% of the respondents) "*Of course some firms resort to earnings management practices* *to increase their stock prices, though they cannot do so for long" – Professor Gad, K. – American University in Cairo, "While doing our securities analyses we need to adjust for the probability of earnings management being adopted by some of the publicly listed firms" – Mr. Hossny, I , Senior Analyst – Forex Direct Dealers.*

Figure 1: Reasons for adopting earnings management (70% response rate)



The *third* survey finding was that, in general the respondents (approximately 85% of the respondents) believe that the management of some firms could and do use some accounting items in their earnings management practices. Such items are mainly the revenues item, (90% of the believing respondents) (figure 2) along with current assets (especially accounts receivables) and current liabilities. (63% of the believing respondents) And to a lesser extent (57% of the believing respondents) fixed assets (property, plant, and equipment) – this last item was mentioned mainly because of the respondents general belief that the firms can affect the valuations and revaluations of the property, plant, and equipment item on their statements [which could be due to the absence of an official body that can provide such valuations]), "*As earnings are of unique importance to the firms and their stakeholders, revenues obviously play a pivotal role in that framework" – Farid, M. – Ex-Vice Chairman of the Egyptian Stock Exchange*.

Finally, in order to reduce the probability of earnings management, a general consensus, approximately 93% of the respondents (figure 3 shows the breakup of suggested remedial actions) that the government and the concerned authorities should exercise a more tight supervision (though without stifling the initiatives by responsible market players) over public companies in order to protect the general public from probable technical manipulations (that could result in earnings management along with other practices that could mislead the public or endanger a firm's investors position, wealth, or potential profits, "*The government's role in ensuring and enforcing the adequate disclosures of the firms' major transactions and events helps safeguard the general public , to some extent, from the misleading acts carried by some publicly listed firms" – Professor Abdeen, T. –Academy for Science, Technology, and Maritime Transport.* The authors think that the application of proper corporate governance standards could help stabilize the market and discourage earnings management practices.

Figure 2: Items used to manage earnings (85% response rate)

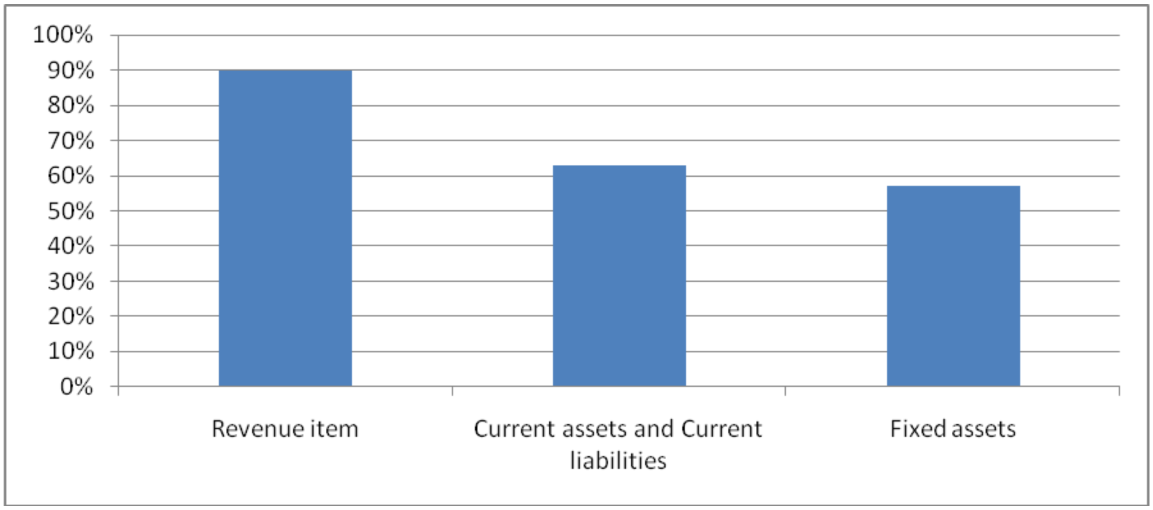
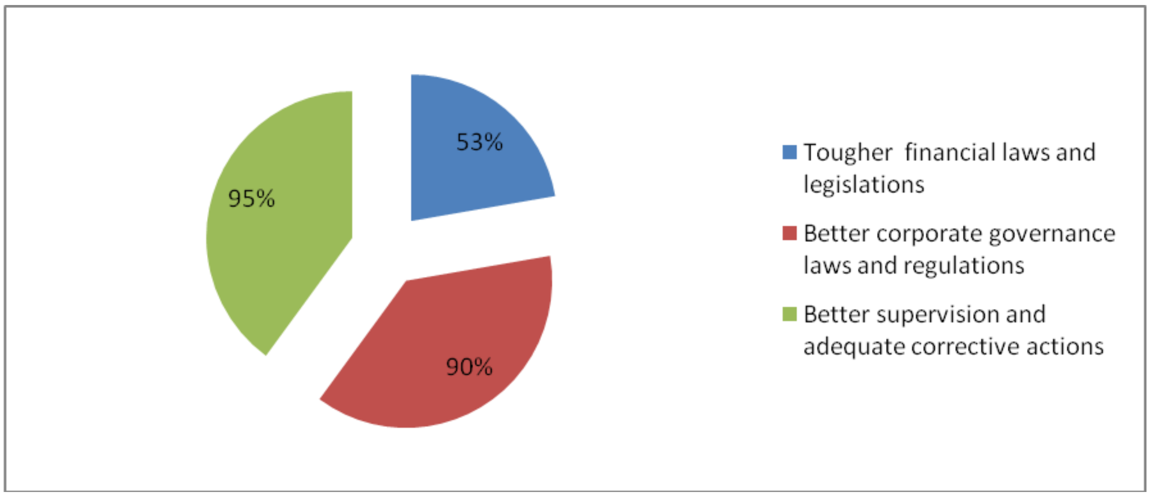


Figure 3: Suggested Remedial Actions



Thus, the main findings of the qualitative analysis at hand corroborates to a large extent the items that were used by the extant quantitative analysis models, and ascertains some of the earnings management motivations that were mentioned in the extant literature.

One of the major insights that could be derived from the current analysis and could contribute to the extant literature is that, it was believed that the best remedial action to combat earnings management in Egypt is to issue new standards, laws and legislations to enforce and punish the firms that adopt earnings management practices. This has lead to a building pressure upon the Egyptian government and other authorities (e.g., the Egyptian Accounting Standards Board) to take corrective actions. However, it was found (as will be shown in the ensuing discussion and analysis) that better supervision (by the government and concerned authorities), and better enforcement and application of corporate governance regulations and measures could offer a better course of remedial actions to deal with current and potential earnings management cases.

5.2 Detailed Response Analysis

A- General:

1. Do you think accounting financial statements are important? Why?

YES	REASONS
90% (of respondents)	1. 95% YES: *Accounting statements comprise the main source of information about the firms* 2. 95% YES: *Accounting statements presents the results of firms operations in orderly and classified manner*
NO	**REASONS**
10% (of respondents)	1. 90% No: *Accounting statements are not reliable* 2. 95% No: *Other sources of information (including non-financial) provides more useful information about the firms*

2. How do you perceive the earnings figure in the income statement?

The main theme perceived generally from the respondents is that the earnings figure is the most important and awaited accounting figure that is being followed and scrutinized by the general public, and thus it has a direct effect on the firms' stock prices and on the firm's image and credibility. "*the stock market relies mainly on the firms' financial statement, besides other information from the media, however, the most important piece of information anticipated is the annual earnings figures of the firms" – Mr. HM – financial analyst.* "*the most important accounting figure is the earnings figure" – Mr Hossny, I. – FXDD.*

3. Is there a relation between a firm's earnings and its stock price?

	YES%	NO%
Regulators 5%	100% of responding regulators	0
Board members 5%	90	10
Academics 36%	85	15
Practitioners 27%	85	15
Investors 26%	90	10

B- Causes and Motivations:

4- Do you think publicly listed companies in the Egyptian stock exchange use earnings management?

	YES	NO
Regulators	60% regulators	40% regulators
Board members	80% Board members	20% Board members
Academics	95%	5%
Practitioners	90%	10%
Investors	90%	10%

5. If you answered yes to the previous question, why do you think they use it?

	YES	Major Reasons
Regulators	60% Regulators	1.100% to increase stock prices 2. 90% to keep a persistent stream of earnings increases.
Board-Members	80% BMs	1.95% to increase stock prices 2.75% to enhance the job security of the management of some firms
Academics	95% Academics	1. 90% to increase stock prices 2. 70% to acquire a good and strong image 3. 80% to evade taxes
Practicioners	90% Practicioners	1. 100% to increase stock prices
Investors	90% Investors	1.100% to increase stock prices

Thus, the previously mentioned reasons for applying earnings management could be summarized as the desire to increase stock prices, maintain increased earnings persistence streams, and enhancing the management's job security.

C- Responsibility:

6. Who do you think is responsible for applying earnings management?

RESPONSIBILTY ON	% ALL RESPONDENTS
Corporate Boards	15%
Management	85%

7. Which items do you think is being used to manage earnings?

ACCOUNTING ITEM(S) USED	% ALL RESPONDENTS
Revenues	90%
Current Assets and Current Liabilities	63%
Fixed Assets	57%

"*As earnings are of unique importance to the firms and their stakeholders, revenues obviously play a pivotal role in that framework" – Farid, M. – Ex-Vice Chairman of the Egyptian Stock Exchange*; *"Obviously, revenues are at the core of management's attention in case of earnings management practices, however, other items could be used as well for such purpose as the current assets and current liabilities" – Professor Ibrahim, M. – Ain Shams University;*

8. Is there a difference across different sectors regarding the probable application of earnings management?

	YES	NO
85% of the sample	90%	10%

"... yes, we have noticed that certain sectors are prone to earnings management rumours and allegations more than others, which could be attributed to several factors as changing market conditions, or new regulations, one of these sectors is the food and beverages sector" – Mr. Badr, S., - Vice Chairman of City Trade Financial Securities; "That's true and plausible enough, as different sectors face different combinations of business and financial risks which could affect the management of firms in different sectors to resort to earnings management practices in order to inflate their earnings and consequently affect their securities prices" – Professor Refaat, M. – Suez Canal University.

D- Remedial actions:

9. What actions do you think should be taken, and by whom, to reduce the probability of earnings management?

% Total respondents	ACTION SUGGESTED	To be taken by
53%	Tougher financial laws and legislations	Parliament/Government
90%	Better corporate governance laws and regulations	Corporate boards/Government
95%	Better supervision and adequate corrective actions	Concerned authorities/ Government/Corporate boards/Management

6. Limitations of the Study and Suggestions for Further Research

One limitation is that this is a qualitative study which largely depended on the analysis of the opinions of experts and individuals in practice in the industry. The bases of their opinions were not always very explicit or mentioned and these opinions and views have a considerable degree of subjectivity and they change over time. It is all along assumed that such views are based largely on reality. The nature of this investigation therefore was essentially exploratory and the results are by and large tentative. This is why a more rigorous quantitative investigation into the same questions about earnings management in Egypt as a follow-up study would highly be recommended.

7- Summary

The main findings of this paper could be summarized as follows; first, the financial statements provided by the firms operating within the Egyptian Stock Exchange context is perceived to be of considerable reliability. Second, the respondents, in general, believe that many firms operating in the Egyptian Stock Exchange adopt a variety of earnings management practices for various reasons, amongst which are to affect stock prices upwards. The third survey finding was that, in general the respondents believe that the management of some firms could and do use some accounting items in their earnings management practices. Finally, in order to reduce the probability of earnings management, a general consensus that the government and the concerned authorities should exercise a more tight supervision (e.g., through enforcing corporate governance regulations, and resolving corporate agency problems on a more fair basis, though without stifling the initiatives by responsible market players) over public companies in order to protect the general public from probable technical manipulations (that could result in earnings management along with other practices that could mislead the public or endanger a firm's investors position, wealth, or potential profits.

References

Abdelsalam, O. H., and Weetman, P. (2003). Introducing International Accounting Standards to an emerging capital market: relative familiarity and language effect in Egypt. *Journal of International Accounting, Auditing and Taxation* 12, 63-84.

Beaver, W., C. Egar, S. Ryan, and H. Wolfson. (1989). Financial reporting, supplemental disclosures, and bank share prices. *Journal of Accounting Research* 27, 157-178.

Burgstahler, D., and Eames, M. (2006). Management of Earnings and Analysts' Forecasts to Achieve Zero and Small Positive Earnings Surprises. Journal Business Finance & Accounting *pp. 633–65*2.

Charoenwong, C. and P. Jiraporn. (2009). Earnings management to exceed thresholds: Evidence from Singapore and Thailand. *Journal of Multinational Financial Management,* 19(3), 221–236.

Cheng, Q., and T. Warfield. (2005). Equity incentives and earnings management. *The Accounting Review* 80, 441-476.

Cohen, D., and P. Zarowin. (2010). Accrual – based and real earnings management around seasoned equity offerings. *Journal of Accounting and Economics* 50, 2 –19.

Foster, G., Olsen, C., and T. Shelvin. (1986). Earnings releases, anomalies, and the behaviour of security returns. *The Accounting Review* 4, 574 – 603.

HassabElnaby, H. R., Epps, R. W., and Said, A. A. (2003). The impact of environmental factors on accounting development: An Egyptian longitudinal study. *Critical Perspectives on Accounting* 14, 273-292.

Healy, P. M., and J. M. Wahlen. (1999). A review of the earnings management literature and its implications for standard setting. *Accounting Horizons* 13, 365-383.

Hoglund, H., (2013). Estimating discretionary accruals using grouping genetic algorithm. *Expert Systems with Applications* 40, 2366 - 2372.

Kamel, H., and S. Elbanna. (2009). Assesing the perceptions of the quality of reported earnings in Egypt. *Managerial Auditing Journal,* Vol. 52.

Kasznik, R. (1999). On the association between voluntary disclosure and earnings management. *Journal of Accounting Research* 37, 57-83.

Kothari, S., A. Leone, and C. Wasley. (2005). Performance matched discretionary accrual measures. *Journal of Accounting and Economics* 39, 163-197.

Lev, B. (1989). On the usefulness of earnings and earnings research: Lessons and directions from two decades of empirical research. *Journal of Accounting Research* 27, 153-192.

Liu, C., and S. G. Ryan. (1995). The effect of bank loan portfolio composition on the market reaction to and anticipation of loan loss provisions. *Journal of Accounting Research* 33, 77-94.

Moyer, S. (1990). Capital adequacy ratio regulations and accounting choices in commercial banks. *Journal of Accounting and Economics* 13, 123-154.

Plumlee, M., and T. M. Yohn. (2010). An Analysis of the Underlying Causes Attributed to Restatements. *Accounting Horizons* 24, 41-64.

Sweeney, A., (1994). Debt covenant violations and managers' accounting responses. Journal of Accounting and Economics 17, 281-308.

Teoh, S., I. Welch, and T. J. Wong. (1998 a). Earnings management and the post issue performance of seasoned equity offerings. *Journal of Financial Economics* 50, 63-99.

Teoh, S., I. Welch, and T. J. Wong. (1998 b). Earnings management and the long term market performance of initial public offerings. *Journal of Finance* 53, 1935-1974.

Zaluki, N., K. Campell, and A. Goodacre (2009). Earnings management in Malaysian IPOs: the East Asian crisis, ownership control and post-IPO performance. Working paper, *(www.papers.ssrn/abstract=963085)*.

Appendix 1: Questionnaire Form

A- General:

1- Do you think accounting financial statements are important? Why?
2- How do you perceive the earnings figure in the income statement?
3- Is there a relation between a firm's earnings and its stock price?

B- Causes and Motivations:

4- Do you think publicly listed companies in the Egyptian stock exchange use earnings management?
5- If you answered yes to the previous question, why do you think they use it?

C- Responsibility:

6- Who do you think is responsible for applying earnings management?
7- Which items do you think is being used to manage earnings?
8- Is there a difference across different sectors regarding the probable application of earnings management?

D- Remedial actions:

9- What actions do you think should be taken, and by whom, to reduce the probability of earnings management?

Response Summary:

Part	**Title**	**Question Number(s)**	**Response Rate (general consensus)**
A	General	1, 2, 3	90%
B	Causes and Motivations	4, 5	70%
C	Responsibility	6, 7, 8	85%
D	Remedial actions	9	93%