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In the name of others: an investigation of earnings management motives in Egypt

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Abstract

Purpose – Previous literature on earnings management (EM) indicates that managers are motivated to adjust reported income to serve their own self-interests, and to try and influence capital markets. However, previous research has failed to provide an appropriate theoretical underpinning for EM and has ignored the effect of cultural and environmental factors on shaping managers' motivations. Therefore the purpose of this paper is to draw on interpretive methodology and new institutional sociology (NIS) theory to identify the external factors that motivate managers of Egyptian companies to use EM to modify financial statements.

Design/methodology/approach – The research adopted an interpretative methodology and interview methods. Interviewees were conducted with 34 participants, who were divided into four different categories; executives, financial analysts, auditors and stock exchanges' authorities.

Findings – This paper provides empirical evidence on the range of external factors that motivate Egyptian corporate executives to adjust the earnings number in financial statements. These external factors include the expectations of investors, lenders and employees, the impact of stock exchange listing rules, beating an earnings target, and the privatisation of key state-owned companies.

Research limitations/implications – The authors recognise that the paper has a number of limitations. The research is concerned solely with EM in Egypt and, therefore, it would not be safe to generalise the results to other contexts, even in the Middle East. Further research on the behaviour of managers towards EM in other countries would be useful to test validity of the results reported in this paper.

Originality/value – The principal contribution of this paper is to build on the previous EM literature to include external factors within the Egyptian context which motivate Egyptian managers to manage the earnings of companies in an upward direction. It adds additional EM motives to available literature including: employees, stock exchange's rules, privatisation and meeting industrial norms. Also, the paper provides evidence of the effect of concentrated share ownership on managers' likelihood to engage in EM behaviour. The paper also extends NIS theory to recognise the importance of the interplay between institutional and economic environment by including economic reform, and non-financial providers as factors that can explain the EM behaviour.

Keywords Egypt, Earnings management, Privatisation, Egyptian Stock Exchange, Motivations for earnings management, New institutional sociology

Paper type Research paper

1. Introduction

The motivation for this paper is to fill three gaps in the previous literature concerning managers' incentives to practice earnings management (hereafter EM). First, there is the environmental gap which includes some of the non-finance stakeholders, such as employees, the current Egyptian economic system and rules for stock market listing. Although some managerial motives are shaped by stock and credit markets, and beating an earnings target to adjust the reported profit number have been addressed, some other factors or motives in the environment have not been considered. Those factors are other stakeholders, the economic system, and the stock market regulations. Previous studies ignore the influence of environmental factors on shaping motives for adopting certain accounting practice like adjusting the financial statements but Perera (1989) argues that accounting is not a

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cultural-free practice. In this regards, although Egypt adopted international accounting standards (IASs) from 1996, it chose suitable IASs to the Egyptian context. Egypt translated only 35 of 41 IASs to set up the Egyptian accounting standards and ignored others. For instance, Egypt did not adopt IAS 19: employee benefits; IFRS 13: fair value measurement; or IFRS15: revenue from contracts with customers.

The second gap relates to the research philosophy and methodology adopted for all the previous studies, namely positivism. This methodological approach fails to capture the effect of role of the economic, social and political context in shaping managers' motives. Hopwood (1987) makes this point clear in stating that despite the fact that accounting is practiced within a wider context, much research has studied accounting as a relatively static technical phenomenon and explored it in "ways that are disconnected from the contexts in which it operates". Consequently, he calls for more attention to be devoted to understanding accounting practice by relating it to the wider economic and social setting of the organisation. Therefore, for this research an interpretive approach is adopted as an alternative philosophical and methodological approach to help understanding the managerial motivations in their wider economic and social context.

The absence of a strong theoretical explanation for the phenomenon constitutes the third gap. Drawing upon an appropriate theoretical framework enables the researchers to use more appropriate lenses to see the phenomenon and derive a more powerful and better understanding of the EM practice.

The nature of accounting plays an important role in influencing and shaping executives' incentives. Degeorge *et al.* (1999) claim that the existence of the EM phenomenon is due to the "game of information disclosure" between the firm's management and its stakeholders. The reliance on disclosed information to measure and assess both the firm's performance and management's performance reflects why managers pay attention to the earnings number (Lev, 1989), which in turn creates the managerial incentives to manipulate earnings (Xu *et al.*, 2007) in order to affect decisions makers' perceptions. Similarly, this paper assumes that long-term, "active" and beneficial EM is a legitimate and ethical behaviour that promotes favourable financial statements in order to build and sustain good long-term relationships with external stakeholders, including shareholders and lenders, and hence increase the firm's value over the long term.

Previous literature suggests that EM arises from managers' motives to satisfy the expectations of a variety of external stakeholders, including: shareholders, debt holders, employees, as well as a wish to exceed certain earnings benchmarks. These motives may be divided into two categories. The first is the managerial motivation to adjust reported income to enhance the firm's reputations with outsiders or external stakeholders; these can be characterised as the "firm's interests". The second is the motivation to advance managers' own self-interests; these can be characterised as "managers' self-interests". This paper focusses on the first kind of motivations.

Although previous research has provided some understanding of, and explanation for, managerial motives for EM, they do not provide an appropriate theoretical underpinning for EM and they have adopted a narrow methodological approach. In particular, the positivist methodology that characterises most, if not all, of the previous literature has ignored the effect of cultural and environmental factors on managers' behaviour. Furthermore, there has been very little research in EM in Arabic countries. To address these gaps this paper draws on an interpretive methodology and new institutional sociology (NIS) theory to provide insights into the external factors that motivate managers of Egyptian companies to use EM to improve the financial statements.

The paper contributes to existing EM literature by highlighting the effect that the Egyptian economic and cultural context has in shaping and influencing the executives' intention to modify the financial statements. The findings of the research suggest the

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following managerial motives for EM in Egypt: investors, lenders, employees, Egyptian Stock Exchange's (EGX) rules, beating an earnings target, and the recent privatisation programme. Accordingly, the principal contribution of this paper is to extend the existing EM literature to include an analysis and evaluation of the reasons given by managers for adopting EM practices. Previously the EM literature has paid insufficient attention to such motives especially employees, stock market's rules, and the privatisation programme, and this paper argues that managers cite, or use the name of, these stakeholders to support their decisions to report favourable earnings. Also, this paper provides support for the argument that dominate share ownership affects managers' propensity to adjust the financial earnings upwards. On the theoretical level this paper extends the orthodox institutional perspective to expand the external stakeholders and economic factors that may influence the manager's behaviour to engage in upward EM.

The remainder of this paper is organised as follows: Section 2 discusses the definition and practice of EM; Section 3 reviews the literature on EM; Section 4 focusses on the NIS theoretical framework; Section 6 describes the research methodology and methods; Section 7 reports the empirical findings and the paper concludes with a discussion and conclusion.

2. Definition and practice of EM

Watts and Zimmerman (1978) differentiate between two types of EM based on the purpose of the practice: EM as a device used either to hide the "true" financial performance of the firm in order to deliberately mislead users of the FRs, or to convey private information for signalling the firm's "true" financial performance, and providing indicators about it. The first definition is adopted by many scholars as a result of recent financial scandals and company collapses, e.g. Enron and WorldCom (see e.g. Beneish, 1999; Dechow and Skinner, 2000; Healy and Wahlen, 1999; Schipper, 1989). Hence, the phenomenon of EM has acquired a bad reputation and it has been seen in a "negative light".

However, McKee (2005, p. 38) agrees with the second purpose of EM provided by Watts and Zimmerman and argues that EM can be seen in positive light and used for a more constructive purpose and that EM "is fine as long as" it refrains from damaging the underlying financial and economic image of the firm.

Positive EM is seen as "the use of operating and discretionary accounting methods to adjust earnings to a desired outcome" (Giroux, 2004, p. 2). Hence, McKee (2005) argues that EM is a technique that is responsive to an unpredictable economic environment and that it is better to keep some EM mechanisms, e.g. operational activities, in reserve so as to be able to react to any unpredictable circumstances, e.g. economic events, and hence to be able to achieve the desired earnings figures. In Egypt the unpredictable economic environment represented in the economic reform which had begun in the beginning of the 1990s, reactivated the EGX's listing rules which require reporting operational outcomes. In this context a restaurant and hospitality firm considers the use of a variety of marketing techniques, such as discounting prices or offering credit, as a legitimate upward EM mechanism in response to this unpredictable economic event, because this helps the firm to manage the operational profits upwards and report the desired level of these profits (i.e. 5 per cent of the firm's paid capital), required by EGX.

Bange and De Bondt (1998) state that the greater a company's ability to control its strategic context, the greater its ability to increase its stock price and to decrease its investment risk; hence EM is seen as a mechanism for signalling a firm's quality. McKee (2005) and Dechow and Skinner (2000, pp. 247-248) take the view that "no earnings management" is clearly not an optimal solution. Some EM is expected and should exist in capital markets in order to create a "better capital market". For instance, an executive employed in a brokerage firm highlighted that: raising new capital requires a positive financial image in the capital market by conveying an indication of the firm's strength to

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stock market participants, so that its shares will be in demand by investors. In this company a reduction in the service commission which is used to boost profits upwards can be seen as an EM mechanism that helps the firm to signal its quality. To that effect, Arya *et al.* (2003, p. 111) argue that "[…] In such an environment, a managed earnings stream can convey more information than an unmanaged earnings stream".

Accordingly, McKee (2005, p. 39) defines EM in a positive sense as a "legitimate" management tool and "part of a well-managed business" used for achieving favourable financial outcomes and in turn increasing and "deliver[ing] value to shareholders". In this way EM is a signalling mechanism and is "beneficial" or "white" behaviour when managers use it to signal private information and enhance the information content of reported earnings. In this way EM managers can use to increase the market value of their firms (Arya *et al.*, 2003; Goncharov, 2005; Gunny, 2010; Ronen and Yaari, 2008; Sankar and Subramanyam, 2001).

Maximising the firm's value in order to increase the returns for shareholders may also be achieved by building and sustaining "successful long-term relationships with suppliers, employees and customers" (Giroux, 2004). For example, a financial controller working in a car manufacturing firm stressed this point by saying that: reducing advertising expenses used for managing profits and, hence reporting increases in profits can be seen as a signalling mechanism which signals and increases the firm's value in the labour market, resulting in building a better relationship with its talented and highly valued employees, and thereby retaining them. By signalling financial success EM can play a part in building good relationships with these external stakeholders, which itself can contribute to the overall success of the firm (Giroux, 2004).

3. Previous research on motives for EM

Previous research has shown that managerial attempts to improve the financial statements can be explained by several motives, or incentives including: first, conforming to the terms of debt contracts (Burgstahler and Eames, 2003; Watts and Zimmerman, 1990); second, the need to attract new funds (Bushee, 1998); and third, beating earnings benchmarks (Dechow and Skinner, 2000; Degeorge *et al.*, 1999), and each of these is discussed below.

3.1 Debt contract incentives

Several researchers have identified debt constraints or covenants as incentives for EM behaviour (Bartov, 1993; Burgstahler and Dichev, 1997; Dechow *et al.*, 1996; Watts and Zimmerman, 1990). It is regarded as important to have sufficient headroom in the performance indicators used in covenants. Reducing the likelihood of covenant default or violation also motivates managers to adjust upwards reported income number (Beneish *et al.*, 2001; DeAngelo *et al.*, 1994; DeFond and Jiambalvo, 1994; Graham and Harvey, 2001; Graham *et al.*, 2005; Pergola, 2005; Roychowdhury, 2006; Subramaniam, 2006; Sweeney, 1994).

3.2 Capital market and investor incentives

Earnings are the basic information used by capital market participants to build their beliefs and expectations about a firm's future performance (Cheng and Warfield, 2005; Stein, 1989). Therefore, executives tend to boost earnings upward to encourage shareholder's perception of the firm's value upward as well (Stein, 1989), hoping for a boost to the stock price (Abarbanell and Lehavy, 2003; Cheng and Warfield, 2005). Capturing the role of the capital market in motivating executives to manage earnings makes it necessary to know how it reacts to the published earnings. This reaction can be rewarding, i.e. increasing the stock price, or penalising, i.e. decreasing the stock price of the firms.

The literature supports the idea of the capital market's super premium, i.e. high stock price as incentive for managing earnings. This premium is given to firms which succeed in

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managing the reported earnings upward when intending to issue new stocks during certain organisational events, i.e. initial public offers or seasoned equity offers (Cohen and Zarowin, 2010; Dechow and Skinner, 2000; Kamel, 2006; Rangan, 1998; Teoh *et al.*, 1998a, b). The literature also suggests that the capital market rewards firms which are able to align their reported income with the market's forecasts through manipulating reported profits when compared with firms which fail to do so (Bartov *et al.*, 2002; Bhojra *et al.*, 2003; Gleason and Mills, 2008; Graham and Harvey, 2001; Hribar *et al.*, 2006; Kasznik and McNichols, 2002).

However, the capital market also punishes firms when a large negative stock price is associated with negative earnings surprise (i.e. failure to meet the analysts' earnings expectations) (Gleason and Mills, 2008; Graham *et al.*, 2005; Hribar *et al.*, 2006; Mikhail *et al.*, 2004; Payne and Robb, 2000; Skinner and Sloan, 2002).

Furthermore, several writers observe severe capital market reaction in term of dramatic stock price decline after the announcement of the re-statement of firms' financial reports due to violating GAAPs or committing fraud (Beneish, 1999; Beneish and Vargus, 2002; Dechow *et al.*, 1996; Feroz *et al.*, 1991; Kedia and Philippon, 2009; McNichols and Stubben, 2008; Palmrose *et al.*, 2004).

3.3 Beating earnings targets incentives

Both the accounting literature and the financial press have identified three benchmarks which provide motives for managers to adjust reported earnings number when earnings fall short of targets. Those targets include: avoiding falls in reported earnings, avoiding reporting losses and meeting financial analysts' expectations (Cohen *et al.*, 2010; Dechow and Skinner, 2000; Degeorge *et al.*, 1999).

Prior research supports the avoidance of reporting losses and earnings decreases as important managerial incentives to manipulate earnings upward by using either high level of discretionary accruals or real business activities when earnings fall short of such targets (Burgstahler and Eames, 2003; Bushee, 1998; Dechow *et al.*, 2003; Degeorge *et al.*, 1999; Graham *et al.*, 2005; Gunny, 2009; Marquardt and Wiedman, 2004; Roychowdhury, 2006; Shen and Chih, 2005).

In addition, there is evidence of a corporate culture that seeks to adjust the reported earnings to meet financial analysts' forecasts. This suggests that some firms do try to manage income in order to meet or, perhaps, just slightly exceed, such expectations and that this tendency is increasing (Abarbanell and Lehavy, 2003; Bartov *et al.*, 2002; Brown, 2001; Cheng and Warfield, 2005; Matsumoto, 2002; Payne and Robb, 2000).

Several writers have hierarchically ordered those targets in accordance with their importance as follows: avoiding reporting losses (report positive profits); followed by avoiding reporting profits decreases and then meeting analysts' expectations (Degeorge *et al.*, 1999; Graham *et al.*, 2005). However, others find that meeting analysts' forecasts is the most important target. As they find that firms are facing more intense pressure to manage earnings in order to beat financial analysts' forecasts over meeting other targets because the benefits derived from meeting analysts' expectations are greater than those resulting from avoiding either losses or income decreases (Brown and Caylor, 2005; Caylor, 2010; Graham *et al.*, 2005).

Furthermore, Barth *et al.* (1999) add another benchmark by providing evidence that managers have a strong incentive to manipulate earnings in order to not only report growth in annual earnings but also to maintain such a pattern over the long term.

4. Institutional theory: providing a framework for conceptualising upwards EM

This paper uses NIS theory to provide a theoretical framework for understanding which contextual factors motivate Egyptian corporate executives to adjust their firms' financial image.

NIS has been widely used in accounting research as a helpful analytical framework for understanding why new accounting practice is adopted. For instance, Hussain and Hoque (2002)

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find that many institutional forces including: regulatory control; accounting standards/financial legislation; competition; organisation tendency to copy best practice from others, all are powerful macro pressures exerted on banks to adopt a particular system of performance measurement. Carpenter and Feroz (2001) find that financial dependence is a powerful coercive pressure which promotes four US states to adopt GAAPs, while preparing their FRs, as a symbol of legitimacy. Similarly, Carpenter and Feroz (1992) conduct that the providers of financial resources, i.e. public and credit markets, are institutional-political power which force New York State to adopt GAAPs in order to provide a symbol of legitimacy, and in turn demonstrate that the state's finances were managed well. Similarly, Carpenter and Dirsmith (1993) demonstrate that the institutional environment, i.e. audit clients, influences the goals and practices of the audit profession. For example, the increase in the size of the audit client firms and unwillingness of those clients to pay for 100 per cent verification audits were major factors in persuading the auditing profession to institutionalise statistical sampling in auditing process. In other words, it was institutional factors that led to auditing adopting a more scientific approach to audit work.

Much of this literature has focussed on governmental organisations and, especially, on funds providers as institutional coercive bodies, forcing firms to adopt a certain organisational practice. However these studies have not given more concern for other coercive factors such as: the providers of non-financial resources. In addition, this literature has not considered the shared influence of the institutional pressures, and economic forces on firms' behaviour, procedures, and practices.

Accordingly, this paper contributes to NIS literature by identifying the providers of non-financial resources as an additional coercive pressure financial providers, and regulatory and governmental bodies; and by recognising the interplay between institutional and economic pressures exerted on firms, forcing them to find a way in order to comply with those pressures' requirements, and in turn, to secure their survival. This paper, therefore, identifies five institutional and economic factors exerting pressures on firms to publishing favourable financial results, namely: capital and credit markets; employees, EGX; beating an earnings target; and privatisation economic programme.

4.1 The role of external factors in motivating managers to use EM

NIS assumes that there are factors external to the firm that shape the insider practices and procedures of the firm (Meyer and Rowan, 1977; DiMaggio and Powell, 1983). NIS is able to explain the interplay between firms' practices and its broader social environment; it is a beneficial lens through which to see and understand how a particular practice – such as EM practice – or policy from the firm's environment impinges on or penetrates into the life of the firm (DiMaggio and Powell, 1983, 1991; Moll *et al.*, 2006). NIS suggests that this penetration from the environment occurs because the firm is subject to pressure exerted by the institutional contexts to conform to the practices and procedures which are seen as more legitimate and acceptable. Those legitimated practices are defined by the prevailing rationalised arrangements of the organisational work in society and adopted by successful firms in a given domain (Carpenter and Feroz 2001; Meyer and Rowan, 1977; Mezias and Scarselletta, 1994). Within the general framework of NIS, DiMaggio and Powell (1983), Meyer and Rowan (1977) and Scott (1995) assume that legitimated practices from the firm's institutional environment – e.g. publishing favourable financial performance – invade the firms' structures by coercive, normative and mimetic forces.

4.1.1 Coercive pressure from external organisations. Covaleski and Dirsmith (1988) and Powell (1985) report that "behind every institutionalized expectation lies the threat of active coercion". According to DiMaggio and Powell (1983) and Moll *et al.* (2006), institutional coercive pressure portrays the external pressure – either formal or informal – which is exerted on a firm from its environment to force it to adopt certain practices, structures or

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procedures; i.e. EM practice. As noted by Hussain and Hoque (2002), coercive pressure arises from the need for the firm to be seen as legitimate; it helps to achieve institutional legitimacy and confirms the firm's social and economic fitness for survival (DiMaggio and Powell, 1983). Coercive pressure is the motive for the firm to comply with the requirements of external organisations, which provide it with necessary support and required resources – either financial or non-financial – for operating successfully and its sustainability (DiMaggio and Powell, 1983; Pfeffer and Salancik, 2003). In particular, this pressure comes from other organisations, such as governmental and regulatory bodies and suppliers, upon which a firm depends for its survival (DiMaggio and Powell, 1983).

4.1.1.1 Providers of finance. Thompson (1967) observes that the reliance on set of providers of finance subjects firms to pressure in order to meet those suppliers' whims and requirements (cited in DiMaggio and Powell, 1983). Thus, as Powell (1983) argues "the *stronger party to the transaction [financial suppliers i.e. capital and credit markets] can coerce the weaker party* [firms] to adopt its practices in order to accommodate the *stronger party's needs* [publishing favourable financial results]" (cited in DiMaggio and Powell, 1983, p. 154, emphasis added). Carpenter and Feroz (2001) suggest that firms need financial resources from their environment to enhance their survival; the ability to survive depends on their effectiveness in meeting and managing the interested groups' requirements (Pfeffer and Salancik, 2003). Therefore, capital markets and credit markets are powerful sources of institutional pressure on firms to improve the financial image of the firms (Meyer and Scott, 1982; cited Carpenter and Feroz, 2001), by publishing favourable FRs. This is consistent with Carpenter and Feroz's (2001) argument that the institutional perspective provides a lens to see that the choice of a particular accounting rule or practice is motivated by "economic resource dependency".

4.1.1.2 Other stakeholders. As argued by DiMaggio and Powell (1983, p. 148), each firm is embedded in a broader context consisting of other organisations including: "key suppliers, resource and product consumers, [employees], regulatory agencies, and other organizations"; which the firm must deal with in order to acquire the necessary resources for the organisation's survival (Pfeffer and Salancik, 2003), including not only financial resources but also other essential resources, such as the resources of a non-financial nature. Degeorge *et al.* (1999, p. 2) argue that "earnings reports are important for those people concerned with the firm's viability and profitability because they make firm-specific investments" such as the supply of capital, labour and revenues.

Therefore, DiMaggio and Powell (1983) argue that exchange relationships and dependency are the bases of coercive pressure. Accordingly, in this paper, NIS is extended to include other organisational actors, for example suppliers of goods and services, as additional powerful coercive motives for managers to adjust the FRs upwards in order to comply with their main requirement, i.e. publishing favourable reports in order for it to be supplied with the necessary resources for operation and survival, e.g. skilled employees.

4.1.1.3 Regulatory bodies. Institutional theory suggests that there are powerful institutional agents who can exert coercive pressures on organisations, which are required to follow certain practices, procedures (Hussain and Hoque, 2002) or requirements, e.g. publishing favourable FRs. DiMaggio and Powell (1983, 1991) consider coercive pressure as reflective of regulative and enforcing features of particular regulatory organisations or institutions; which set regulative rules, monitor firms' conformity to such rules, and establish rewards/sanctions for firms' conformity with or departure from such rules (Wickramasinghe and Alawattage, 2007).

The EGX is a regulatory agent that exerts pressure on firms to meet its listing and delisting rules. As shown in the Appendix EGX's regulatory rules require that for Egyptian

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firm's securities to be listed, firms must earn a minimum level of net profit before tax. Either firm must earn profits of at least 5 per cent of capital in the year before the listing application or the company must achieve an average net profit of at least 5 per cent of capital over the last three years preceding and not report any losses during that period. Moreover, those rules require that securities shall be delisted if the company achieves profits less than < 5 per cent of capital for two years after being listed. Meeting EGX's regulatory rules and requirements is a motive to adjust upwards the earnings in the financial statements of firms. Therefore, as argued by Rezaee (2005), "national stock exchange listing status or meeting minimum exchange listing requirements to prevent being delisted" is an incentive to manage the earnings number.

4.2 Beating an earnings target motives: mimetic pressure

DiMaggio and Powell (1983), Carpenter and Feroz (2001) and Moll *et al.* (2006) argue that when firms need to enhance their social and economic fitness and seek to increase their legitimate appearance and, hence, survival, they emulate or mimic practices and rules which are adopted by others perceived to be more legitimate and successful in the firm's domain. In this way, the firm attempts to model itself on its peers by conforming to these legitimated practices which result in meeting the expectations of the important interested "constituencies" about how it is designed, operates and runs (DiMaggio and Powell, 1983; Hussain and Hoque, 2002). Hence, this mimetic pressure or motive can be a source of change for the firm (DiMaggio and Powell, 1983). This argument can be extended to the realm of EM where the mimicking or beating of the "normal" or prevailing level of profit earned by most other firms is a motive for the firm's managers who are below this earnings level to manage their firm's financial image in order to compare favourably with their peer group. This helps to further its social and economic fitness and hence to sustain its legitimacy and reputation with outsiders.

4.3 Economic factor motive

As argued by Dacin (1997, p. 47, emphasis added):

> […] 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*.

This leads DiMaggio and Powell (1983) to maintain that "institutional" and "competitive" are two types of isomorphism and sources of pressure exerted on firms. In this respect, Moll *et al.* (2006) contend that, although there are two kinds of isomorphism or pressures, NIS theorists stress only the institutional isomorphism. This is a limitation of NIS because it may give insufficient emphasis to 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 […]".

Greenwood and Hinings (1996) assert that interplay between economic and institutional contexts can generate pressure to adopt a certain organisational behaviour. Powell (1991) and Scott (1991) assert that both 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 in order to secure their survival (Powell, 1991; Tsamenyi *et al.*, 2006). DiMaggio and Powell (1991) demonstrate that institutional theorists are now more aware of the importance of economic, competition and efficiency mechanisms than was the case previously, leading to considerable attention being recently devoted by academics to the interplay between institutional and economic and market pressures.

المنارة للاستشارات

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Following the previous academic discussion, economic privatisation programme is incorporated within the initial analytical framework of NIS theory as a powerful environmental motive for managing the FRs of firms. This addition is due to the effects which this economic reform has had on accounting practices involved EM.

Since the 1980s there has been a fairly rapid transition in Egyptian economic system, moving from the inward-looking-based economy in favour of an export-based economy that prioritised the private sector (Farag, 2009; Kholeif *et al.*, 2007), in order to liberalise the economy and minimise government intervention in the business sector (Hassan, 2008a, b). Accordingly, in 1991 the Egyptian Government started to implement the privatisation programme by passing Public Enterprise Law 203 and its accompanying regulations (Hassan, 2008a, b; Kholeif *et al.*, 2007; Rahman *et al.*, 2002; Wahdan *et al.*, 2005). This law was designed to establish a legal framework in order to privatise and sell most of the state-owned and public enterprises, which totalled 314 in all (Kholeif *et al.*, 2007). This led to increased number of firms listed in the stock exchange, and hence to increases in the competition between these firms to obtain funds.

Consequently, as part of the privatisation programme, a number of actions and laws were issued including: company Laws. These laws involve company Law No. 159 for 1981, and other regulations which were adopted by newly privatised firms similar to private-sector firms. For Example, article (41) of the Company Law No. 159 (1981)[1] gives workers rights to share the company's profits as specified below, and this provides a justification for managers to adjust the financial results upward:

> Workers in the Company shall have a share in the distributable profits to be fixed by the General Assembly on the proposal of the administrative board, at *not less than 10% of these profits* and not surpassing the total of the annual wages of workers in the company (emphasis added).

In addition, privatisation programme had a significant impact on boosting the capital market as a vital means of raising economic resources (Zohny, 2000; Dahawy *et al.*, 2002). 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 to restore investors' trust and confidence in its activities (Abd-Elsalam and Weetman, 2003). These rules entail that in order to be listed or to avoid delisting firms should report profits.

Overall, it can be seen the effect of privatisation programme as the most recent governmental attempt for reforming the Egyptian economy on accounting practice, in terms of its effect on: increasing the number of listed firms; activating the stock exchange' activities and its listing rules; applying private-sector-company laws, e.g. company law 159 for 1981 on newly privatised firms. All have significant effect of accounting practice and hence on EM phenomenon.

In summary, this application of NIS theory suggests that adjusting the financial statements is a technique that enables the firm's managers to couple or comply with Egyptian environmental and external factors' pressures and whims, i.e. publishing favourable FRs. Complying (coupling) with the expectations of external stakeholders and other factors enables managers to signal that they conducting their duties properly way. This in turn helps to enhance the confidence, good faith, competence, and hence legitimacy, of an organisation (Meyer and Rowan, 1977; Modell, 2002).

Meyer and Rowan (1977) make this point when they argue that organisations seek to become legitimate with the public, the state, capital market and with shareholders. In this way, its credit position would become more favourable resulting in obtaining investments, debts and donations easily. Arthaud-Day *et al.* (2006) assert that key financial resources, such as shareholders, tend to support legitimate and trustful firms. Complying with external expectations, e.g. publishing favourable financial statements is one of the ways to

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strengthen the firm's legitimacy, decrease the firm's turbulence, maintain its stability and hence mobilise support from a broader range of external "constituents" and in turn enhance its success and survival in the long term (Carpenter and Feroz, 2001; DiMaggio and Powell, 1983; DiMaggio, 1988; Meyer and Rowan, 1977; Moll *et al.*, 2006; Oliver, 1992).

The corollary of this is that firms which deviate from normal behaviour (e.g. publishing unfavourable financial results) suffer from weak legitimacy (Meyer and Rowan, 1977; Meyer and Scott, 1983; cited in Deephouse and Carter, 2005). Companies which lack legitimacy may be considered as "negligent, irrational, unnecessary" and unacceptable firms by either the capital market or the state (Meyer and Rowan, 1977). Therefore, firms which are vulnerable to the loss of their legitimacy with the stock market and government bear real costs (Meyer and Rowan, 1977). Karpoff *et al.* (2008) add that deterioration in a firm's legitimacy and reputation with outsiders leads to decline in revenues and higher costs of financing.

Thus, losing legitimacy reduces firms' ability to access both financial and non-financial resources. In contrast, firms which comply with institutional pressures are rewarded in terms of enhancing their legitimacy and reputation with outsiders. This facilitates the firms' mission in the resource allocation process and in acquiring needed societal resources, which buffer the firm from failure and further its success and survival abilities in long run (Carpenter and Feroz, 2001; Meyer and Rowan, 1977; Moll *et al.*, 2006; Scott, 1987; Zucker, 1987).

5. Research method

This study draws on an interpretive approach to get better understanding of why managers use EM to present more favourable financial reports. The interpretive approach advocates that reality is socially constructed, and that individuals are seen as having an active role which enables them to create their environment and reality (Burrell and Morgan, 1979). Accordingly, providing a better understanding of EM motives within the Egyptian context necessitated eliciting the perceptions, beliefs and experiences of individuals involved in EM. For doing so, this study adopted semi-structured interviews (Table I, interview guide). In the beginning of each interview, talking briefly about the EM motives, and inquiring about the interviewee's background and demographic characteristics helped to create a comfortable environment for the interview, enabling interviewees to talk freely (Berg, 1995; Zikmund *et al.*, 2010), and tell their stories about EM incentives with more integrity.

Selecting the research sample was based on purposive (or criterion-based) sample approach to prompt the validity of the study, and collect relevant answers to the research questions. This sampling approach entails selecting the phenomenon population in accordance with the certain purposive criteria, necessary, and relevant features of the research population. The sample's units were chosen in accordance with the participants' knowledge and experience; their roles and professional positions; their attitudes, beliefs and perceptions regarding EM phenomenon, and their ability to shed light on various aspects of EM motives (Ritchie *et al.*, 2003) (Tables II-V; respondents' demography).

Enhancing the validity of this study and providing some assurance that the findings were valid in an Egyptian context necessitated involving a variety of respondents who are central to study the phenomenon in order to "maximise the difference" within the sample, hence to create a representative and inclusive sample relative to the parent population (Glaser and Strauss, 1967; Lewis and Ritchie, 2003). Accordingly, this study sampled four different groups of interviewees representing all essential parties involved in EM "game". A total of 34 participants were interviewed, who were divided into four categories (Table VI), namely: firms' executives; investors; auditors; and regulators. Figure 1 shows that the "preparers" category – comprised of firms' executives – makes 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).

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Introduction and background questions

Earnings Management Motivations: External Motives

Opining Question**:** In your opinion what motivate you **(a firm management)** to adjust the reported earnings and the financial image of your firm **(of such firm)?**
1) Outsiders

Opining question: In your opinion what are the reaction of the outsiders regarding making deals with your firm (**a firm**) when reporting losses?

Probing Questions, could you tell me more about the reaction of:
- Investors (present and expected)
- Lenders and other creditors (present and expected)
- EGX Regulators
- Employees (present and expected)

Is that reaction motive you (**firm's management**) to adjust the profit number?

Opining question: Do you think, which external group is the most important to be concerned while preparing the financial statements ?
2) Economic Factor

Opining Question: In your opinion does the privatisation programme have effect on your (**a firm management's**) willing to adjust the profit number?
Probing Questions: could you tell me more about the effect of this programme on:
- The competition among firms for attracting both local and foreign capitals?
- Managers and employees share of profits
- The EGX's activity and role

Opining Question: In your opinion does this effect play role to motivate you **(a firm's management)** to adjust the financial image?
3) Mimetic Factor
Opining Question: Do you prefer to imitate **(do you think that firm's management prefers to imitate)** other firms, which could successfully publish favourable financial performance ? What are the effects of the failure coping with them?

Opining Question: In your opinion which financial target or profit level is more important to be achieved or imitated? why?

Probing Questions, could you talk more about
- Industrial norms and ratios
- Financial analysts' expectations
- Avoiding reporting losses
- Avoiding reporting profits decreases relative to last period (year or quarter)
- Reporting higher profits than previous year (reporting profits increases)

Words in **bold and between brackets** indicate to the part of the question, which was changed to rephrase the whole question to be suitable for interviewing groups rather than firm's management group.

Table I.
The interview guide

Industrial companies comprised textile companies, pharmaceutical companies and motor industry companies. Service companies include restaurant and hospitality companies 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. Finally, the EGX regulators group makes up 8.8 per cent of the total interviewed sample.

Most of interviewees were senior employees who were likely to exhibit high levels of integrity. Also, the researchers interviewed auditors, analysts, and the stock exchanges' authorities who had no incentive to be untruthful. In addition, the researchers made comparison between the answers of each interviewed group with others to test that all interviewees, and especially company managers, were providing reliable information about EM motives, and that the interviewees reflected their own beliefs and attitudes regarding EM incentives. Also, interviewees were asked similar questions in different ways in order to check the validity of the responses of one group against the answers of others.

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Table II. Demography of corporate executives

Manager	Position	Age	Years of experience	Certificate	Field/company
MAN1	Financial manager	42	12	Diploma in accounting and audit	Pharmaceutical industrial company
MAN2	Accounting manager	37	9	Diploma in accounting and audit	Pharmaceutical industrial company
MAN3	Financial controller	38	16	Master business administration (MBA)	Car industrial company (assembling cars)
MAN4	Financial manager	33	10	MBA	Car industrial company
MAN5	Financial manager	50	25	MBA	Textile company
MAN6	Financial manager	42	20	Diploma in accounting and audit	Restaurant and Hospitality
MAN7	Financial manager	28	6	MBA	Brokerage company
MAN8	CEO or Managing Director	60	41, in general 14 years in brokerage	MBA	Brokerage
MAN9	Chairman of the Board of Directors	55	27	PhD in accounting	Brokerage
MAN10	Financial manager	56	35	Master business administration (MBA)	Brokerage
MAN11	Chief executive officer (CEO) Managing director	59	27	PhD in financial and economics	Brokerage

Table III. Demography of external auditors

Auditor	Age	Experience	Firm size	Certificates	Position
AUD1	26	4	Big	Master in auditing	Auditor
AUD2	28	6	Big	Master in auditing	Auditor
AUD3	26	5	Big	Master in auditing and tax diploma	Auditor or Manager Deputy Director (direct auditor)
AUD4	25	4	Big	Diploma in Auditing	Senior
AUD5	45	12	Big	PhD in accounting and auditing	Partner
AUD6	45	18	Small	PhD in accounting and auditing	Owner, partner
AUD7	46	19	Small	PhD in accounting and auditing	Owner, partner
AUD8	30	7	Small	Diploma in auditing	Senior
AUD9	30	6	Small	Master in auditing	Auditor

Table IV. Demography of EGX regulators

Regulator	Position	Age	Years of experience	Certificate	Institution
REG1	–	49	10	PhD, UK	The Egyptian Exchange
REG2	–	39	6	MBA, Durham, UK	The Egyptian Exchange
REG3	–	43	8	MBA	The Egyptian Exchange

Furthermore, the interviewers tried to avoid leading the interviewees towards particular answers which they may prefer to hear and collect (Charmaz, 2001). The interviews were recorded digitally to capture the actual words of the interviewee and thus provide an accurate account as possible of the interview.

It is important for researchers to limit the amount of bias during the data analysis to enhance the research's validity (Lewis and Ritchie, 2003). Therefore, our research employed

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Financial analysts	Age	Year of experience	Position	Certificate (s)	Firm	
FAN1	42	16	Vice president/ researcher department	Certified portfolio management	Large	
FAN2	28	6	Financial analyst	MBA, Master in Business Administration	Medium	
FAN3	31	7	Technical analyst	Master in economics	Medium	
FAN4	35	12	Head of research/ financial and technical analyst	Diploma in investment management/master in investment management	Medium	
FAN5	35	15	Managing director (CEO)	Diploma in analysis stock markets/ diploma in fundamental Islamic finance	Medium	
FAN6	60	25	Financial analysis	PhD in finance	Medium	
FAN7	38	16	Managing director	MBA in financial analysis/diploma in financial analysis	Large	Vice president of the Egyptian committee of stock markets development, vice present of the Egyptian committee of finance and investment studies
FAN8	26	4	Financial analyst	Diploma in stock market studies/MBA in markets stock studies	Large	
FAN9	30	10	Financial analyst/ manager of research and of investment	Certificated Management Accounting (CMA)/ Certificated financial managers (CFM)/ Charted Market Techniques (CMT)/ Certificated Portfolio Managers (CPM)	Medium	
FAN10	27	8	Financial analyst		Medium	
FAN11	49	18	Financial analyst/ writer in the financial and economic press	MBA and PhD in finance	Large	Member in the Egyptian Capital Market Association ECMA, member of the Egyptian committee of stock markets development

Table V. Demography of financial analysts

"comprehensive data treatment" by incorporating, analysing, and inspecting all the data collected without exception, and by avoiding the use of brief "conversations, snippets" from interviews (Bryman, 1988; Silverman, 2000, 2010). Data were then analysed by using Ritchie and Spencer's (2002) thematic approach, requiring the implementing of the following steps. First, the researchers constructed a thematic framework or index based on the research questions, and interview questions. Indexing was next step, in which researchers systematically applied the thematic framework to the gathered information in its textual from.

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Table VI.
Numbers and percentages of the four categories of respondents included in interviews

			No. of interviewees
Auditors	Large firms		5
	Small and medium firms		4
Total			9 (26.4%)
Financial report users (financial analysts)	Securities brokerage firm		
	Large		4
	Medium		7
Total			11 (32.4%)
Firms' executives	Industrial companies	Textile Industrial Co.	1
		Pharmaceutical Industrial Co.	2
		Motor Industrial Co.	2
			5 (45.4%)
	Service companies	Restaurant and Hospitality Co.	1
		Securities Brokerage Co.	5
			6 (54.6%)
Total			11 (32.4%)
Regulators	Egyptian Exchange (EGX)		3
Total			3 (8.8%)
Total interviewees			34 (100%)

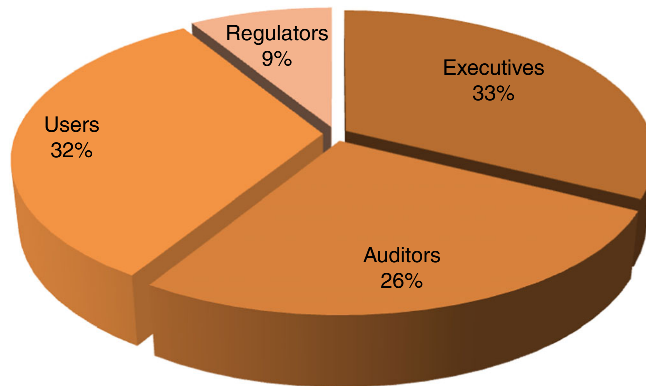

Figure 1.
Percentages of the four categories of respondents included in interviews

Next, the researchers transferred 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. Using direct quotations from participants' answers enhanced the validity of the research in terms of providing accurate and correct interpreting, and representing aspects of EM incentives in ways that they are perceived by the research respondents and population. Mapping was the final step in which the researchers focussed on interpreting the data and provided answers to the research questions. This was achieved by defining concepts; searching for patterns and connections; providing explanations for internal patterns within the data; comparing the participants' perceptions, beliefs, or experiences; and developing strategies for and "maps" of the nature of EM incentives.

6. Results and findings

This section analyses the responses of four groups who were interviewed to understanding the nature of EM in the context of the Egyptian economy, and in particular to understanding managers' incentives of Egyptian companies to adjust reported earnings upwards.

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6.1 Financial suppliers

The managers consistently recognised the importance of financial suppliers' expectations and believed that it was necessary to comply with their interests. All manager, auditor and analyst interviewed groups generally identify financial suppliers, both investors and lenders, as the most important and influential outside parties exerting pressure on managers to improve the earnings figure in the financial statements of the firms. This is because "[…] without publishing favourable financial reports financial suppliers, either stockholders or loan providers, will withdraw their money resulting in the closure of the firm and an end to its work" (AUD3, big firm, auditor). The following comment summarise executives' views:

> In my opinion, the most important interested parties which drive a firm's managers to care about positively adjusting the financial statements are investors whether current or expected, and lenders whether bond lenders or banks (M1, a financial manager).

When asked about investors' motivation to adjust the financial statements most of interviewed participants were quick to distinguish between two kinds of stockholding, stating that: "in the EGX there are two kinds of investors: long-term investors and speculators" (REG2). The interests of the long-term investors are served by reporting favourable financial results for the sake of maintaining and increasing their wealth (stock price) and gaining increased returns on their investment (dividends). Both regulators and analysts agreed and indicated two kinds of beneficial effects of reporting profits as a justification for why investors see profit increases as a requirement, commenting that: "reporting profits means that I achieve two kinds of gains: capital gains in terms of an increase in the stock price (I bought the stock for 10 pounds and its market value became 15 pounds) and revenues in terms of dividends" (REG2). Executives also generally agreed that:

> […] There are capital [funds] […] which are invested in the companies […] [So that] the main aim of any business is achieving profits […] investors pay and invest their money, of course, to get [good] returns on their investments and to increase their wealth […] otherwise, they can put their money in a bank to get satisfactory interests (M8, a managing director).

Although reporting high profits and increasing dividends generally satisfy the interest of long-term investors most executives agree that even when reporting losses and failing to declare dividends, investors might hold onto their current investments if they are given legitimate reasons justifying such a situation, especially, if the losses are due to either temporary circumstances or normal costs such as construction/reconstruction costs for a new project:

> Yes of course, there is reaction from investors in the case of achieving losses or not reporting preferred financial results […] The board of directors must justify reporting such losses to keep them. For example, new project in its beginning may achieve losses because of the structural expenses (M2, an accounting manager).

Similarly, earning high profits and receiving dividends are important expectations for potential investors. The managers' comments highlight the importance of adjusting upwards the financial results to provide a signal of good performance for stock market's participants:

> If I could achieve profit increases of 10% from one year to another investors will expect that dividends will be gradually increased across years as well; [therefore] they will prefer to purchase my stock (M3, a financial controller).

Analysts and regulators take the view that reporting a profit provides investors with a favourable first impression about the firm to be chosen as the best investment opportunity. As a result, potential investors will avoid investing in a firm that has reported losses and attempt to search for a better opportunity.

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Regulators assert that, in the case of unfavourable financial results, investors will "doubt the share", and hence will be willing to sell it. An auditor (AUD9) portrayed "reporting losses [as] a red line for investors to avoid investment in such a firm" and REG2 asserted: "why would I invest in a firm which is losing?".

Managers highlight that before potential investors buy a firm's stock for long-term investment, they will subject that firm to a deep analysis in order to evaluate its policies, strategies, the managers' effectiveness in achieving profits, the growth rate and market share in the future:

> Investors who would like to have long-term investment in a company will make very deep analysis and care about many issues including: the possibilities for the company to be expanded, its growth rate, its abilities and capacities to achieve profit, the managers' reputation and effectiveness and revaluation its assets (M5, a financial manager).

The comprehensive evaluation of a firm helps to enhance the potential investors' trust in the effectiveness of the company's managers and in its policies and future:

> Although Mobinil [a mobile telephone company] was achieving losses for three years its stock price increased due to the investors' trust in the managers' reputation, its future and policies [...] leading to investors' trust to buy its stock (M10, a financial manager).

In general where the firm reports losses or lower earnings than expected or decreases in dividends it might face decreases in its stock price. Those decreases are due to two reasons: the first is the excessive sales of the firm's stocks by current investors in order to buy another profitable firm's stocks; the second is the reluctance of potential investors to buy such stocks:

> Reporting losses could result in two things: first, less appetite to buy the company's stock by new investors; second, most current stockholders seek to sell their stocks even with losses [...] this automatically has dramatic negative influence on such company's stock price and on the firm's ability to obtain new investments [...] (M8, a managing director).

Executives and analysts expressed their belief that the excessive or immoderate sales of the firm's stocks by current investors, and potential investors' reluctance to buy such stocks, results in less demand for the firm's stock, leading to a lower stock price. Regulators asserted that, "like any market, buying and selling of the shares depends on demand and supply; if the demand exceeds supply the price will increase, and the opposite also holds true" (REG1).

This lower stock price leads to a reduction the firm's value and negatively affects investors' wealth.

Transient investors are the traders or speculators buying and selling securities in order to profit from short-term fluctuations in their market value and who engage in risky trading in the hope of making large gains. As argued by Bushee (1998), speculators behave as "traders" not as "owners", they put more emphasis on short-term earnings goals and base their investment decisions (i.e. selling and buying shares) on short-term published earnings. So that it is more expected that they will sell shares of a firm with announcement about bad earnings news.

The effects of traders' investment decisions on a firm's stock price become important when managers seek to issue new shares to attract additional capital. Consequently, there is an incentive for managers to manage the financial reports to avoid negative effects on the stock price of the raising new capital, as expressed in the following comment:

> The company's capital is not affected by the stock price in EGX [...] Increasing or decreasing in the stock price of the firm does not increase or decrease its current capital [...] But the stock price does affect the firm's capital when the company intends to issue new stocks for attracting new capital (M8, a managing director).

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Executives employed in a service firm, i.e. brokerage, highlighted the idea that:

> Raising new funds entails reporting favourable FRs to convey an indication of the firm's strength to stock market participants […] reducing the service commission is the main and most effective way to make positive adjustment in the business's activity and hence to boosting its revenues and profits […] firms that succeed in increasing their profits or at least preventing profits from decreasing are considered highly trustworthy and are evaluated as such in the stock market. This leads to a high demand for the stock due to considerable enthusiasm among market participants for buying such highly valued stocks (MAN 7,financial manager).

All executives, auditors and analysts also recognise the importance of raising capital through loans. They believe that the financial results affect firms' ability to raise loan capital from banks or bondholders. Reporting profits strengthens the borrower's negotiating position and makes it more likely that the firm can secure the required funds:

> My financial results affect my negotiation with the creditor and hence affect the credit terms […] (MAN3, a financial controller).

> Profit is the first number which the lenders give more concern, it is an indicator of my ability to repay a loan (MAN10, a financial manager).

In contrast, poor financial results are associated with higher risk and this will weaken the firm's position when negotiating with credit providers. With reporting losses, especially, if those losses are derived from operational activities, lenders either become reluctant to provide loans or will offer loans with more onerous conditions. Those conditions include limiting the amount of the loan, reducing the repayment period, raising the interest rate, and requiring collateral and guarantees:

> […] If lenders found losses are continuously achieved they would either reject the firm's credit request or provide it with the needed loan but with more strict terms. Due to more risk associated with funding the company the creditor or bank might charge a higher interest rate or shorten the repayment period […] (M6, a financial manager).

In summary, most of the managers interviewed agreed that both investors and lenders are important parties to consider when the financial statements are prepared. They also recognise the overall importance of the capital market in evaluating and responding to the contents of financial statements over the credit markets as source of finance.

6.2 Employees

Burgstahler and Dichev (1997) and Bowen *et al.* (1995) suggest that profitable firms are able to keep their talented and highly valued employees because those employees feel secure about keeping their jobs and expect gaining benefits not only in current period but also in the future.

Executives, auditors and analysts generally agreed that employees valued job security and a fair salary, for example "[…] For both current and expected employees, they seek job stability, a share of profits and other benefits […]" (AUD1, big firm, auditor).

All groups, but especially executives, thought that current and potential employees are interested in working for profitable firms because they will share in the profit achieved, resulting in creating a motive for managing the profits figure. Executives believe that a firm reporting profit is more attractive to current skilled employees than a firm making losses. Reporting profits also attracts potential skilled employees who will enjoy a percentage of its profits under profit sharing schemes. A financial controller (MAN3), working in a car manufacturing firm stressed this point by saying that:

> My company needs skilled workers and employees, so we try to keep the current skilled employees and attract potential ones […] Those employees always want to work for a firm reporting profits in order to continue or join receiving a portion of its profits. They think that the more profits the firm achieves, the

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> greater the percentage of profits the employees will receive […] So that we try to reduce advertising expenses in order to manage profits and, hence report increases in profits which makes our company viewed as a favourable place in which to work, especially for talented and highly valued employees.

In contrast, reporting losses makes skilled employees dissatisfied; they "will be worried and will prefer not to join the firm which reports losses" (FAN11), leading them to search for another position because they are highly wanted in the labour market:

> […] Of course current and potential employees care about the firm's profitability […] Reporting profits makes them more eager to work for the company. In the case of reporting losses, I just get the monthly salary as fixed income [and do not benefit from the profit sharing scheme] […] (MAN5, a financial manager).

> Reporting losses means no profit sharing; this makes employees dissatisfied; if I am professional and have good skills and greatly required of other companies, I will search for another company to get that advantage (MAN11, a managing director).

In addition to the potential for profit sharing, executives and analysts think that skilled employees favour working for a profitable firm because it helps them to achieve their work objectives. Potential employees will consider the overall prospects the firm before joining it. Their decision may well depend on whether or not it is a profitable firm which might have an impact on benefits the employees may receive, for example, promotion prospects, pensions, and medical insurance:

> For current employees, if the company achieves low rate of profit, the employees' ambitions will be constrained because the company cannot meet their aspirations. As for the potential employees, they will not be interested in getting a job in this company (MAN7, a financial manager).

> Of course […] if the employee sees that the company is a great company in its field and achieves good profits, expected employee will prefer to work in such a company (MAN7, a financial manager).

In addition to sharing the firm's profits and getting other advantages, executives, auditors and analysts think that the need for secure employment motivates employees to work for profitable firms. This is based on the belief that reporting losses reflects the firm's inability to survive in the future which in turn reflects uncertainty about its ability (or willingness) to both pay and keep the employees:

> […] Another reason that makes the employee care about the firm's profitability level is that reporting profits reflects the company's ability to survive. I cannot work for a firm achieving losses, because who can know whether it can continue working or not. Hence I cannot know whether I can secure my job or will lose it (MAN2, an accounting manager).

On the other hand, where there is a high level of unemployment (as is currently the case in Egypt), both current and future employees will be just pleased that they have a job and therefore take less account of the firms' short-term financial results than when unemployment is low and there are plenty of job vacancies in the economy.

6.3 Regulatory incentives

Managers agree that they are incentivised to adjust the upwards the financial statements in order to comply with the rules of the EGX "[…] 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 per cent of the firm in paid capital resulting from its basic activities for the last three years of listing application or registration and not reporting losses during such years" (REG3). Executives employed in restaurant and hospitality firms stressed this point by stating that:

> I faced a real situation that our company was not listed on the EGX but decided to be listed in order to attract new capital for expanding our activities. Deciding to *trade our stocks in EGX puts pressure*

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on managers to provide EGX with favourable operational results. Then we decided to *manage our reported earnings* […] (M6, a financial manager) (emphasis added).

Executives employed in restaurant and hospitality firms continued to express the view that the use of a variety of marketing tools as EM mechanism helps them to report operational profits, required by EGX. They stated that "[they] either try to reduce the price of hotel rooms or to broaden the credit terms, given to tourism companies, as much as possible in order to increase the service level and hence revenues so as to boost or manage the financial image upwards" (M6, a financial manager).

Moreover, the EGX's regulators emphasise the importance of reporting continuous profits by stating that, "referring to delisting rules, in the case of reporting losses or achieving profits of less than 5 per cent of the firm's paid capital for two consecutive years, the listing committee can delist this firm from the EGX […]" (REG3). Similarly a financial manager states that:

> […] reporting losses causes negative reaction from EGX, in accordance with EGX's rules reporting losses for two years running means delisting, which exerts pressure on the firms to manage its financial statements upward (M1).

Interestingly, a chairman of the board of directors (M9) highlights that in the period 2005-2009 a strict application of the listing rules caused a significant reduction the number of listed companies.

6.4 Benchmarking earnings

As reported by Cohen *et al.* (2010), Dechow and Skinner (2000) and Degeorge *et al.* (1999), there are three common earnings targets providing motivations for managers to modify the reported earnings: avoiding reporting losses, avoiding earnings decreases and meeting financial analysts' forecasts. As suggested by DiMaggio and Powell (1983), firms seek to model themselves on other firms by adopting the same organisational or accounting practices. This imitation helps the firm to enhance its economic and social fitness. Thus, achieving a similar level of profits or earnings as comparable firms provides a strong motive for the firm's managers to beat such targets.

This is supported by the responses of managers who stated they are subject to pressures to mimic the successful firms in their industry. Managers said they attempt to match or exceed the reported earnings and the market share of similar companies in order for their firm to be seen as successful. They believe that the wish to mimic the reported profits of other similar firms is a motive for the managers to modify the firm's financial statements:

> All economic entities aim at achieving profits […] I look around me and see this firm achieves x profit and another reports z profits, so I need to increase or adjust my profit to cope with them not only in the reported earnings but also in the market share (MAN10, a financial manager).

Importantly, managers believe that firms' failure to imitate the profit level of their peers might reflect hidden problems in their firms. It may also reflect management's ineffectiveness and its inability to gain the trust of external stakeholders:

> In general, if I gain 1% profit and others 5%; this implicitly refers to problems inside my company, which influence negatively the external parties' confidence in the company, this motives me to reach 5% profits and to imitate the same profit level others achieve (MAN1, a financial manager).

> If all companies achieve good financial results and my company does not it reflects management's failure and means it is unsuccessful (MAN6, a financial manager).

Auditors and analysts strongly agreed that the reason behind considering reporting the prevailing level of profit is due to managers' belief in the importance of "[…] proving firms'

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ability to survive in the field and to assert their management's effectiveness and success" (AUD3, big firm, auditor).

This leads a firm to try to meet the prevailing or "normal" level of earnings achieved by similar firms.

When asked about the "normal" earnings target they try to achieve their responses indicate that:

> […] in Egypt, the first and last aim of any manager is achieving profit and of course increasing such profits over time (MAN1, a financial manager).

This is because managers wish to increase investors' trust in the firm, because investors prefer "large profits and like to see positive change in the profits" (FAN10). Achieving such a target is an "attractive and important advertisement in the EGX" (AUD8, small firm, senior).

However, there were mixed views on the importance of analysts' earnings expectation as a target to motivate managers to modify the financial statements. On the one hand, the majority of executive, auditors and analysts think that "absolutely, financial analysts' expectations have no effect in Egypt; firms in general do not place any importance on such expectations, and hence do not seek to meet" (AUD3, big firm, auditor). Thus, financial analysts' forecasts do not constitute an important EM motive in Egypt.

According to the executives' and analysts' opinions, analysts' earnings forecasts are inaccurate and unrealistic, because they are either overestimated or not true because analysts may have certain self-interests. In addition, the financial analysts do not work in the company; they are not aware of the company's inside circumstances. "Analysts usually depend only on the financial statements, however, there are many other variables affecting the firm's profits, which they are not aware. Thus, their forecasts can mislead me […]" (M1, a financial manager). FAN8 confirms that "in order to establish accurate expectations, I must visit the firm which we are not permitted to do […] there is no real or live data I can depend on then I have to only analyze the FRs of the firms […]" (FAN8).

On the other hand, some managers suggest that financial analysts' expectations are an important target for managers to beat because "[…] their expectations affect the stock market and hence owners' wealth . If they expect that my company must achieve profit increases of 10% and I just achieved 7%, this may mean that I am viewed as a manager [who did not] use effectively the chances available for me […] This negatively impacts external parties' trust in the firm and its management" (M3, a financial controller).

Moreover, some executives refer to industrial norms (i.e. the sector's estimation for the earnings average of firms operating in such sector) as an important financial target, which motivates them to manage the financial results upward to compete with comparable companies. Regulators emphasise the importance of considering the industry norms as a target to be met because they will be used by outsiders, e.g. analysts who "[…] evaluate firms by comparing them together according […] to industry standards and norms […]" (REG1). "Lenders and financial analysts take into account the industrial average of profits, so I must compete with others in my industry by beating the average" (MAN9, a chairman of the board of directors).

Importantly, many executives seek to beat more than one target, they believe in meeting many targets together, focussing on the most important ones first:

> Managers seek to meet more than one target; the first important target is reporting profit higher than previous year […] (MAN2, accounting manager).

> Increasing profits across years is more important than meeting analysts' forecasts […] Industrial norms are important target followed by financial analysts forecast because both of them are close to each other (MAN10, financial manager).

As shown above, executives identify reported earnings increases as the main financial target, followed by industrial norms, then financial analysts' forecasts.

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6.5 The new economic reform

The economic reform process started by the Egyptian Government in the 1990s has had significant effects on managers' propensity to adjust the firms' financial statements. The interviewees believed that the privatisation programme influenced managers' intention to modify the financial statements. Managers believe that for firms that are privatised the published profit numbers are adjusted to increase executives' stake in such profits[2]. "[…] 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):

> The privatisation programme has played a very important role in motivating firms' managers' to increase the company profit. Before the privatisation programme it did not matter whether a firm achieved profits or losses because managers received the same remuneration. However, now managers receive percent of the company's profit so that after privatisation they became motivated to adjust the published profits upward from one year to another (MAN1, a financial manager).

Managers who were interviewed also thought that making upward adjustments to the published financial statements of all companies (and not just those recently privatised) becomes important to enhance a firm's ability to attract new capital. After the privatisation programme, "[…] the number of privatized firms dealing in the EGX has increased more than the private firms. The percentages of privatized and private firms' participation in the EGX and in investment activity in Egypt are almost 70% to 30% respectively" (AUD3, big firm, auditor), resulting in increased competition between those companies to attract capital. Thus, "[…] privatization programme has increased the pressure on company managers to adjust the financial reports 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). Similarly, a financial controller said:

> After the privatisation programme I consider my firm's shares as a product within the EGX. The increase in the number of companies trading their shares makes it necessary to enhance my share value to compete and attract customers (i.e. investors). This requires me to manage my financial accounts in order to keep my investors and attract new ones and to protect my firm's value and its share price (MAN3 A financial controller).

Managers believe that publishing favourable financial statements is important, and especially if the company intends to issue new shares, to signal to investors the firm's performance and so maintain the market value of the company:

> The privatisation programme put pressure on the firm to compete for attracting new capital especially in the case of initial public offering in the stock market. It becomes necessary for firms to give due concern for the published reports and financial information. I must give good indicators to the stock market by conveying good message and information through my financial reports (M9, a chairman of the board of directors).

In addition, the privatisation programme has boosted the EGX. It was a very important driver in reviving the EGX and so aiding the development of a more market-based economy. Executives said that this programme motivates them to publish favourable financial statements for their firms because of its key role in invigorating the Egyptian stock market:

> […] Deciding to trade our stocks on the EGX put pressure on us to adjust our financial statements to meet the listing/delisting rules […] (MAN6 financial manager).

The empirical data in this research provides support for using NIS as a theoretical framework to understand and explain the behaviour of managers towards EM within the context of the Egyptian economy. As suggested by NIS managers have strong incentives to comply with external pressures, i.e. coercive, mimetic, normative and economic motives in

المنارة للاستشارات

www.

order to modify the financial statements in an upwards direction. From the perspective of the managers themselves this behaviour has many beneficial consequences including: mobilising support, legitimacy, credibility and reputation from a broad range of external stakeholders; securing better access to capital and physical resources needed for the firms to expand and develop; achieving economic success and long-term sustainability.

7. Conclusion

This paper has provided empirical evidence that executives' motivations are shaped, determined and influenced by the context in which such firms are functioning. There are specific contextual factors, relating to Egypt, which strongly motivate managers to modify the financial image of the firm and report favourable results. These factors include an expanded range of stakeholders, specifically financial suppliers, employees and regulators; benchmarking earnings against firms in the same industry; and the new economic reforms in Egypt.

The first factor is providers of finance, namely, equity investors and lenders or bondholders. They are considered to be the most influential factors motivating managers to modify upwards the reported earnings of the firm. This is consistent with the thesis from the NIS literature that both capital markets and credit markets have strong impact on firms receiving funds from them (Meyer and Scott, 1982; cited in Carpenter and Feroz, 2001), to meet their requirements, whims and expectations.

The findings indicate that managers may modify earnings in different ways depending on the type of investor they are responding to. Although both long-term investors and speculators are interested in firms' profits and dividends each sees such profit differently. Long-term equity shareholders seek consistent returns on their investment, so they are interested in investing in profitable firms that consistently pay dividends. Therefore, in order to attract or retain these investors the firm's managers must meet their expectations in terms of achieving profits and providing dividends both in the short and long term. Consistent with using NIS as a lens to explain the behaviour of managers we can observe clear isomorphism with the coercive pressure from financial suppliers as external organisations. The upward revision of earnings is closely coupled with the requirements of investors and provides them with confidence about the firm, which in turn will motivate them to continue providing funds for the firm.

In contrast, the behaviour of managers towards speculative investors is consistent with the concept of de-coupling where there is a disconnect between the behaviour of the managers and the interests of the speculators and their coercive pressure. Managers do not pay as much attention to speculators who, by definition, engage in active trading on the stock market. Speculators' investment decisions are based on reported short-term earnings that may affect its short-term stock price. This is consistent with Bushee (1998) who provides evidence that high per cent of "transient institutions" ownership and frequent trading strategies encourage the firm's managers to adjust short-term earnings to replace earnings decreases with earnings increases.

In considering whether to offer a new loan or increase the loan to a firm lenders are interested in many aspects of the firm's performance, for example, achieving consistent profits and having a strong balance sheet. Therefore, reporting high earnings strengthens the firm's negotiating position for obtaining loans with favourable credit conditions. Although both equity investors and lenders increase the propensity of managers to engage in EM this research suggests that managers are more motivated by the expectations and coercive pressure of the former.

Concerns about employees, current and future, are the second factor influencing managers to produce favourable financial results. Keeping current high talented, skilled and valued employees and attracting potential ones exert pressure on firm's managers to

المنارة للاستشارات
www.

publish high earnings. Our research indicates that managers believe high profits is one of the key elements in making firms attractive for employees, especially because within the Egyptian context they have a legal right to share the firm's profits. The behaviour of managers is a form of legitimation activity where workers face uncertainty about the future viability of the firm; this may be especially pertinent given the current state of the economic situation in Egypt.

The effect of strict adoption of EGX rules for listing and delisting the firms' securities is considered as another influential motive for managers to modify upwards the financial. Managers cited the need for reporting profits in order to gain a listing, or retain a listing, on the EGX as an example of how their behaviour is subject to the coercive-regulative pressure existing in the Egyptian economic and political environment.

Another important motivational factor is imitating the same level of profits which other firms in the same industry are achieving. Achieving prevailing, or "normal", levels of profit motivates firms' managers to positively modifying the financial statements to be able to compete in its industry and to appear as successful and economically fit as similar firms. This managerial behaviour is a clear example of mimetic behaviour where it is important that the firm's financial results and performance are within a "normal" range so that the firm is neither regarded as too profitable (and hence attracting attention from other companies or the regulators) nor loss making so making it liable to financial collapse and liquidation.

Furthermore, managers focus on reporting profit increases as the first important target among many targets they seek to achieve. Reporting profit increases is followed by industrial norms target, then by the financial analysts' expectations as the least important target.

The final, factor that affects the behaviour of managers towards EM is the economy itself, and in particular the new economic reforms introduced into the Egyptian economy from the 1990s. The privatisation programme initiated by the Egyptian government in the 1990s was the most substantive change in the Egyptian economic system for many decades. This economic reform was an important environmental pressure that encouraged managers of these newly privatised firms to manage upward the financial image of their firms for the following reasons. Managers of privatised companies have the right to share in the firm's profits. The privatisation programme has increased the number of listed companies on the EGX, which in turn increased the competition among firms to attract new capital. Related to this is the importance of the listing rules on the EGX, which require companies not to report losses. We think that the behaviour of managers of privatised companies is consistent with the concept of legitimacy in the new economic environment. For these managers have a political stake in demonstrating that privatisation is good and works, hence they want to uplift profits as much as possible in order to get outsiders' support. Also, the government would support such behaviour to legitimise their decision to privatise many companies.

This paper provides support for using the NIS theoretical framework to understand and explain the behaviour of Egyptian managers towards the practice of earning management. By applying NIS, this research has been able to extend the previous literature on EM to include a broad range of external stakeholders and economic factors as explanatory factors in influencing managers EM behaviour. This paper adds to the existing EM literature by providing evidence of the importance that managers attach to the expectations of investors, lenders, employees and the rules of the EGX. Managers also engage in EM practices in response to economic factors; in the case of Egypt the privatisation programme under the new economic reforms have encouraged managers to adjust earnings upwards.

This paper also has implications for policy makers regarding the regulation of EM behaviour by managers. For example, there needs to be stricter accounting rules to reduce the extent of EM. EM behaviour may bring about temporary benefits to stakeholders but may cover up some more fundamental financial problems as the economy faces major

المنارة للاستشارات

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upheaval and uncertainties, so a policy implication might be to enhance the education and training of managers so that they focus more on the underlying performance of the company rather than spending their efforts of managing earnings.

Finally, we recognise that the paper has limitations. The paper adopted a particular theoretical framework, NIS, but alternative theories, for example, a political economy approach, may have provided different insights, especially with regard to whose interests are being served by the EM behaviour of managers. In addition, this paper provided coverage of the extent of EM in Egyptian companies but a further development would be to look in depth at the process of the decision making itself, which would require in depth case studies of one or two companies.

Notes

1. Law No. 159/1981 On Joint Stock Companies, Partnerships Limited By Shares & Limited Liability Companies.
2. After privatising the firm the Company Law No. 159 for the year 1981 gives firm's employees including managers the right to get 10 per cent of the profits achieved.
3. It mandated the Article 9 of the Decree of the Capital Market Authority's Board of Directors No. 30 – dated 18 June 2002.
4. It mandated Article 34 of Decree of the Capital Market Authority's Board of Directors No. 30 – dated 18 June 2002.

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Appendix

Article (9)/ Item (A) Egyptian Securities Listing of "Egyptian Financial Supervisory Authority's Board Decision" No. 50 of 2009[3]. Shares that are compliant with the following conditions 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 [their submittal of] stipulated in Item (D) and provided that average annual net profits of the company […] for the last three years preceding listing application […] shall not less than 5%, and provided that no losses are incurred during any of the three fiscal years preceding listing application.

Article 34 of the CMA Board of Directors Decision No. 94 of 2008 Regarding the Amendment of CASE listing and delisting Rules[4], securities shall be delisted in the case:

> Listing Committee shall delist the shares of a company if the company does not meet the requirements of the minimum net profit and shareholders' rights for two fiscal years after the listing […].

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