جامعة مدينة السادات

A working paper

Flexibility and Manipulation: Earnings Management through Misclassification Practices in Egyptian Non-Financial Firms

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المجلة العلمية للدراسات والبحوث المالية والإدارية
كلية التجارة – جامعة مدينة السادات
المجلد السادس عشر – (عدد خاص – الجزء الثاني) – سبتمبر ٢٠٢٤م

التوثيق المقترح وفقاً لنظام APA:
Hassaan, Marwa & Salah, Wafaa, (2024), "Flexibility and Manipulation: Earnings Management through Misclassification Practices in Egyptian Non-Financial Firms", **المجلة العلمية للدراسات والبحوث المالية والإدارية**، كلية التجارة، جامعة مدينة السادات، ١٦ (خاص)، ٤٦٦ – ٤٦٩.

رابط المجلة: https://masf.journals.ekb.eg

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Abstract

This study explores management manipulation practices that aims at misclassifying operating cash flows. Furthermore, this study investigates the key factors that may drive such behavior using the Generalized method of moments (GMM) regression model applying to non-financial companies listed on the Egyptian Stock Exchange (EGX) from 2015 to 2023. The findings reveal significant diversity in cash flow classification, with high liquidity and young age being key determinants of earnings management. Additionally, the analysis shows that earnings management is influenced by board structure, and that such reclassification is more prevalent in firms that have high levels of leverage and lower publicly ownership percentage. These results are further confirmed by robustness checks and support the accounting choices theory. This study provides unique and comprehensive insights into earnings management practices in Arab markets. The findings have valuable implications for standard setters, policymakers, regulators, creditors, and investors. Overall, the results highlight the need for accounting standards-setting bodies to reassess the advantages and disadvantages of the flexibility allowed under the Egyptian Accounting Standards for non-financial firms, and its impact on the quality and comparability of accounting reports.

Keywords: management manipulation, cash flows misclassification, EGX.

Summary

Corporate governance refers to the mechanisms, processes, and relations by which corporations are controlled and directed. It encompasses a wide range of policies and practices that ensure a company operates in a fair, transparent, and accountable manner. Good corporate governance is critical in mitigating risks associated with earnings manipulation, especially in financially distressed firms. One of the primary roles of corporate governance is to enhance financial transparency. Transparent financial reporting is vital for the integrity of capital markets and investor trust. When corporate governance is robust, firms are more likely to adhere to ethical financial reporting standards, thereby reducing the propensity for earnings manipulation. The study's findings suggest that firms with strong corporate governance can better control misclassification practices, mitigating the extent of manipulation. This is particularly important in an emerging market like Egypt, where regulatory frameworks may not be as stringent as in developed markets.

Corporate governance also plays a significant role in reducing information asymmetry between managers and shareholders. In financially distressed firms, managers may have incentives to manipulate earnings to meet financial targets or avoid debt covenant violations. Strong governance structures, such as an independent board of directors and effective audit committees, can provide oversight and ensure that financial reports are accurate and reflect the true financial position of the company. This oversight is crucial in preventing managers from engaging in earnings manipulation practices. Effective corporate governance improves internal controls within a firm. Internal controls are processes designed to provide reasonable assurance regarding the reliability of financial reporting, the effectiveness and efficiency of operations, and compliance with laws and regulations. In the context of earnings management, strong internal controls can detect and prevent misclassification of cash flows, which is a common method of earnings manipulation identified in the study. Firms with robust internal controls are less likely to engage in such practices, thereby safeguarding the interests of investors and other stakeholders.

Earnings management, a practice wherein companies manipulate financial statements to present a desired image of their financial health, has been a topic of extensive scrutiny. In the context of emerging markets, such as Egypt, the prevalence of earnings manipulation practices raises significant concerns. This study aims to investigate the extent to which Egyptian firms engage in earnings manipulation through misclassification practices, particularly focusing on non-financial firms from 2015 to 2023. The study's objectives are threefold: to investigate whether Egyptian firms manipulate earnings through misclassification practices, to examine the extent to which financially distressed firms (measured by ZSCORE) engage in misclassification practices, and to analyze how corporate governance moderates the relationship between financial distress and cash flow shifting. Understanding whether Egyptian firms manipulate earnings is crucial for several reasons. Firstly, it provides insights into the reliability of financial reporting within a key emerging market. Secondly, it highlights the need for stronger regulatory frameworks and corporate governance practices to enhance financial transparency.

The relationship between financial distress and earnings manipulation is well-documented. Financially distressed firms are more likely to engage in earnings manipulation to present a healthier financial image. Corporate governance can moderate this relationship by implementing stringent financial policies and monitoring mechanisms. For example, the presence of a competent and independent board can scrutinize management decisions more effectively, reducing the likelihood of earnings manipulation. Additionally, governance mechanisms such as executive compensation tied to long-term performance rather than short-term financial metrics can align management interests with those of shareholders, discouraging

manipulation. Corporate governance also promotes an ethical culture within the organization. Ethical behavior at the top levels of management often trickles down to the rest of the organization. A strong governance framework can establish a code of conduct and ethical guidelines that deter managers from engaging in unethical practices such as earnings manipulation. The study highlights that firms with stronger corporate governance can better control unexpected cash flows, which is indicative of a culture that prioritizes financial integrity over short-term gains.

In conclusion, corporate governance plays a pivotal role in moderating the relationship between financial distress and earnings management. By enhancing financial transparency, reducing information asymmetry, improving internal controls, mitigating financial distress, and promoting an ethical culture, corporate governance can significantly curb the tendency of firms to engage in earnings manipulation. The findings of the study underscore the importance of strong governance frameworks in emerging markets like Egypt, where the flexibility of accounting standards can be exploited for manipulative practices. Strengthening corporate governance not only protects the interests of investors and other stakeholders but also fosters a more robust and transparent financial environment. As such, policymakers and regulators should prioritize the implementation and enforcement of effective corporate governance mechanisms to ensure the integrity of financial reporting and the overall health of the financial markets.