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Corporate governance and initial compliance with IFRS in emerging markets: The case of income tax accounting in Egypt

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ABSTRACT

The paper examines the corporate governance factors and the independent audit quality as determinants of compliance with IFRS recognition and disclosure requirements of income tax accounting in Egypt. Using the initial IFRS adoption in Egypt, the results show evidence that corporate governance factors that indicate the sophistication level of both company's management and owners (i.e., institutional ownership and foreign representation on the board) and the perceived quality of the engaged auditor improve compliance with IFRS requirements. Companies with higher levels of institutional ownership and foreign representation on the board are more likely to engage an audit firm with international affiliation and comply with IFRS recognition and disclosure requirements. The results underline the significance of professional development and regulations of local audit industries in emerging countries for actual compliance with IFRS requirements when they are officially adopted in these countries.

1. Introduction

Corporate governance in business organizations is a contributing factor to financial success and financial reporting quality. It is also a determining element in the evolution of financial reporting in emerging markets especially when they adopt and enforce new reporting regulations and standards. Prior literature on financial and accounting implications of corporate governance focuses more on highly-developed countries rather than emerging economies (Mueller, 2006). Studies on developed economies have generally examined corporate governance mechanisms in their relation to financial reporting quality and firm performance, including variables like independent non-executive directors (Chen & Jaggi, 2000), board composition (Haniffa & Cooke, 2002; Eng & Mak, 2003), and ownership structure (Eng & Mak, 2003). Ownership structure variables have also been examined including institutional ownership (Haniffa & Cooke, 2002), outside ownership (Chen & Jaggi, 2000), and governmental ownership (Naser, Alkhatib, & Karbhari, 2002).

In recent years, many emerging economies have proposed national corporate governance structures that are mostly voluntary (Rossouw, 2005). Some of these countries adopt some form of the Anglo-Saxon model of corporate governance, while others develop their own corporate governance structure. The effectiveness of corporate governance in emerging markets may be influenced by a set of factors different from those in Anglo-Saxon countries (Lazarides & Drimpetas, 2011).

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Because of the increasing flow of international capital into the developing world, it is important to understand corporate governance practices in these environments and how they affect accounting standards enforcement and financial reporting quality.

Prior research suggested that the independent audit process might be employed in emerging markets to alleviate agency problems and support, or even replace, some traditional corporate governance mechanisms (Fan & Wong, 2005). However, other prior research argued that effective corporate governance and audit quality are positively correlated as complements. Lin and Liu (2009) argue that effective corporate governance, accompanied by high-quality auditing, helps reduce the cost of capital. On the other hand, inefficient corporate governance, accompanied by low-quality auditing, may enable management to reap the private benefits of weak corporate governance and less transparent financial reporting.

Prior research on financial and accounting implications of corporate governance in emerging markets has reported mixed results. For example, in Taiwan, foreign and family ownership is found to have a negative effect on financial reporting quality, while state and institutional ownership has a positive effect (Klai & Omri, 2011). However, no corporate governance factors, other than audit quality, have any effect on earnings manipulation in the Saudi market (Al-Abbas, 2009). For general financial performance, different governance variables (including board size and independence) are significantly related to firm performance variables in Pakistan (Abdullah, Shah, & Hassan, 2008), but none of these corporate governance variables (except government and foreign ownership) have any significant association with firm performance in Malaysia (Anum & Ghazali, 2010). None of the typical corporate governance factors is found significant in Kuwait (Al-shammari & Al-sultan, 2010), while board size and composition are reported as main factors for effective corporate governance in the UAE (Adawi & Rwegasira, 2011). In Malaysia, only block ownership is found to deter financial statement misstatements, while other traditional corporate governance factors have no significant effect (Abdullah et al., 2008). In Greece, corporate governance mechanisms have no effect on earnings manipulation (Chalevas & Tzovas, 2010). In addition to financial reporting and earnings quality, corporate governance factors are found to have significant positive correlation with banks' performance and value in Taiwan (Huang, 2010), and financial distress in China (Hong-xia, Zong-jun, & Xiao-lan, 2008).

IFRS adoption and compliance are also affected by a country's economic transition stage. Development of institutional mechanisms like corporate governance structures and a reliable independent audit process serve to facilitate enforcement and compliance with IFRS (Hodgdon, Tondkar, Adhikari, & Harless, 2009). Such intertwined relation between progress of corporate governance structure, audit quality, and IFRS compliance and enforcement in emerging countries makes it necessary to examine the relation between these factors in individual emerging economies at different transition stages. With the increasing harmonization of global financial reporting standards and the global trend for both developed and emerging economies to adopt and enforce some version of IFRS, it is critical to examine how different corporate governance factors affect the initial adoption and enforcement of IFRS in individual emerging economies. This paper examines the effect of corporate governance factors and audit quality on compliance with IFRS recognition and disclosure requirements in Egypt during the year following its full adoption of IFRS in 2006. Egypt is used as an example of a major developing economy in the Middle East and North Africa (MENA) region which is generally overlooked in prior research. The paper focuses on recognition and disclosure requirements for income tax accounting as an example of a complex accounting standard with which compliance is affected by regulatory environment and different socioeconomic variables including different corporate governance factors.

Although Egypt is considered an emerging economy, results from prior research may not necessarily apply to its financial reporting environment. Like other economies, Egypt has its different corporate governance mechanisms and financial reporting environment that might differently affect initial compliance with IFRS recognition and disclosure requirements. Over the last few decades, the business environment in Egypt has experienced significant economic changes that affected accounting and financial reporting practices. According to Gray (1988) model of cultural influences on accounting systems, accounting measures and disclosures in Egypt (as part of the Near Eastern region in Gray's model) will tend to be more conservative and less transparent. Combined with strong central government control and a mix of public/private ownership of many companies listed on the Egyptian stock exchange, high levels of secrecy may make government ownership a unique corporate governance factor in Egypt. Furthermore, the fact that it is uncommon for Egyptian companies to cross-list in foreign stock exchanges and file with foreign regulatory agencies in accordance with internationally-recognized accounting standards will make the international affiliation of both board members and the independent audit firm additional unique corporate governance factors to examine in the Egyptian environment. Therefore, Egypt provides a distinctive opportunity to study issues of compliance with IFRS recognition and disclosure requirements in emerging markets in transition. The Egyptian stock exchange – Cairo and Alexandria Stock Exchange (CASE) – is one of the oldest stock exchanges in the world and the first to be established in the MENA region (Fawzy, 2003; Sourial, 2004).

The remainder of the paper is organized as follows: Section 2 presents institutional background about corporate governance and financial reporting in Egypt, Section 3 develops hypotheses, Section 4 describes the sample and methodology, Section 5 analyses the study results, while Section 6 concludes the paper.

2. Institutional background

Among many changes in the capital market and regulatory framework over the recent decades, Egypt has made efforts to comply with internationally accepted accounting and auditing standards. The accounting profession in Egypt has evolved to coincide with transition stages of its economic development. Over the period of nationalization and central planning,